

Modification proposal:	<b>Distribution Connection and Use of System Agreement (DCUSA)</b> <b>DCP332 – Appropriate treatment and allocation of Last Resort Supply Payment claim costs</b> <b>DCP333 – Appropriate treatment and allocation of eligible use of system bad debt costs</b>		
Decision:	The Authority <sup>1</sup> directs these modifications <sup>2</sup> be made <sup>3</sup>		
Target audience:	DCUSA Panel, Parties to the DCUSA and other interested parties		
Date of publication:	1 October 2019	Implementation dates:	1 April 2020 (DCP332) 1 April 2021 (DCP333)

## Background

Electricity and gas is supplied to customers through a competitive process in Great Britain. Competition has the potential to bring many benefits to consumers, but a competitive process occasionally leads to companies failing. The gas and electricity supply market is no exception.

Ofgem ensures continuity of supply to the failed supplier's customers and prevents wider market impacts by appointing a Supplier of Last Resort (SoLR). This process also provides protection for the credit balances of the failed supplier's residential customers. Certain costs are incurred as part of this process, some of which fall on distribution network operators (DNOs).

The costs which fall to DNOs are mainly in two categories:

- subject to Ofgem's consent, claims from SoLRs to DNOs for a Last Resort Supply Payment (LRSP); and
- use of system bad debts, i.e. the unpaid dues, to the DNOs, of one or more electricity suppliers that have had their electricity supply licence revoked.

DNOs recover these costs from their own customers by increasing their Distribution Use of System (DUoS) charges. Following consultation, in May 2019 we published our final decision on licence changes to resolve issues faced by DNOs in the recovery of LRSP and SoLR-related bad debt costs.<sup>4</sup>

## The modification proposal

Northern Powergrid (Northeast) Limited (The Proposer) raised two modification proposals relating to the recovery of LRSP and eligible bad debt costs claims. The modifications have been developed in parallel to the review of the licence, focusing on the calculation of DUoS charges, which are specified in Schedules 16-18 of DCUSA rather than the licence.<sup>5</sup>

<sup>1</sup> References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work. This decision is made by or on behalf of GEMA.

<sup>2</sup> 'Change' and 'modification' are used interchangeably in this document.

<sup>3</sup> This document is notice of the reasons for this decision as required by section 49A of the Electricity Act 1989.

<sup>4</sup> <https://www.ofgem.gov.uk/publications-and-updates/decision-modifications-electricity-distribution-licence-recover-costs-associated-appointing-supplier-last-resort>

<sup>5</sup> The methodologies for calculating these charges are the Extra High Voltage Distribution Charging Methodology (EDCM) for the large, industrial customers connected at the highest voltages, and the Common Distribution Charging Methodology (CDCM) for the remaining customers.

The Proposer raised DCPs 332 and 333 on 14 November 2018. The proposals seek to ensure that appropriate mechanisms are in place so that customers contribute to the recovery of the costs without distorting the underlying cost signals generated by the existing charging methodologies, and without unduly affecting licensed distribution network operator (LDNO) margins.<sup>6</sup> The proposals focus on the way that additional pass-through costs are recovered – specifying the tariff elements and customer groups from which to recover the costs. DCP332 covers the costs elements relating LRSP claims, and DCP333 relates to bad debt recovery.

The Proposer suggests that the two proposals can address two issues with the existing approach to cost recovery of SoLR costs: (i) how those are recovered (by which customers and through which tariffs), and (ii) ensuring equal treatment between DNOs and LDNOs and their respective customers.

*(i) How to recover the costs*

The proposals state that the current position of the costs being recovered by all customers through unit charges does not represent an appropriate means of apportioning such costs to customers. The Proposer suggests that the recovery of such residual charges through unit rates is inconsistent with the principles of Ofgem’s Targeted Charging Review (TCR) Significant Code Review (SCR).<sup>7</sup> In particular, a unit rate recovery creates a risk that those less able to reduce their electricity consumption contribute disproportionately to the SoLR costs.

In addition, the proposals explore the most appropriate group of customers from whom to recover the two sets of costs. The proposals presented options for recovering costs from all demand customers or from only domestic customers.

*(ii) Treatment of LDNOs*

The Proposer highlights a concern with the current treatment of LDNOs and their customers. The current approach of including the SoLR and bad debt costs in the revenue matching step, and before application of the LDNO discounted tariffs, has the potential to allow LDNOs to benefit from relatively higher margins following a SoLR event. The current mechanism means that LDNOs would be facing relatively lower tariffs for use of the DNO’s network compared with the increased costs faced by the host DNO. In contrast, tariffs for end customers would be the same regardless of whether they are connected to a LDNO or DNO, increasing LDNOs’ margins.

This issue has been avoided in LRSP claims made to date by only applying an increase in DUoS charges to customers connected to DNO networks. However, this effectively exempts customers connected to LDNO networks from contributing to the costs, despite LDNO-connected customers receiving the benefits of the protections offered by the SoLR process in the same way as DNO-connected customers.

*Development of the proposals*

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<sup>6</sup> An LDNO can be either an independent distribution network operator (INDO) or a DNO operating outside of its own distribution service area (DSA). The charges that the LDNOs pay to the respective DNOs to operate within their DSA are discounted to reflect the fact that the LDNO provides the ‘last mile’ of the distribution network.

<sup>7</sup> In our TCR minded-to decision, published in November 2018, we consulted on our preferred option that residual charges should be recovered from domestic customers via a fixed charge, rather than through unit charges, as is currently the case. We plan to publish our final TCR decision later this year. See: <https://www.ofgem.gov.uk/electricity/transmission-networks/charging/targeted-charging-review-significant-code-review>

A single Working Group developed the two proposals, discussing four possible approaches to how to recover the costs. All exclude the SoLR pass-through costs from both the calculation of revenue matching in the CDCM and the calculation of EDCM tariffs. Instead, an adjustment is made to (a subset of) tariffs, with the same absolute adjustment being made to tariffs for end customers connected to DNO networks and end customers connected to LDNO networks. This ensures that LDNOs are neutral to the recovery of costs and that that customers connected to both LDNO and DNO networks contribute proportionately to SoLR costs.

The Working Group examined the following four tariff recovery options for each proposal:

- Option A – costs recovered through unit rates for all demand customers;
- Option B – costs recovered through unit rates for domestic customers;
- Option C – costs recovered through fixed charges for all demand customers with a fixed charge; or
- Option D – costs recovered through fixed charges for domestic customers.

The Working Group unanimously agreed that Option D is the most appropriate solution for DCP332 as:

- recovery of pass-through costs through unit charges is not appropriate as it inconsistent with the principles of the TCR – options A and B are therefore not further considered; and
- LRSP costs relate to the credit balances of domestic customers – option C was therefore not further considered.

Following a consultation, the Working Group agreed that Option C is the most appropriate solution for DCP333. The reasons for rejecting Options A and B were the same as for DCP332. It preferred Option C in this case as:

- unlike for DCP332 which predominately relates to credit balances of domestic customers, use of system bad debt costs are incurred for domestic and non-domestic customers alike and so should be recovered from all demand customers; and
- unlike for DCP332, changes to charges to bad debt would maintain the 15 months’ notice period so the arguments for amending as few tariffs as possible to minimise changes to previously published charges do not apply for DCP333. This is because DCP333 would not change previously published charges.

### **DCUSA Parties’ recommendation**

We received the change declaration for DCPs 332 and 333 on 13 August 2019. In all party categories where votes were cast (no votes were cast in the CVA Registrant or Gas Supplier categories), there was majority (>50%) support for the proposals and the proposed implementation dates. For two of these party categories, there was unanimous support for the proposals and implementation dates. In accordance with the weighted vote procedure, the recommendation to us is that DCPs 332 and 333 are accepted.

The outcome of the weighted vote is set out in the table below:

<b>DCP332</b>	Weighted voting (%)							
	DNO		IDNO/OTSO		Supplier		CVA Registrant	Gas Supplier
	Accept	Reject	Accept	Reject	Accept	Reject	n/a	n/a
Change solution	100	0	100	0	60	40		

Implementation date	100	0	100	0	60	40		
<b>DCP333</b>	Weighted voting (%)							
	DNO		IDNO/OTSO		Supplier		CVA Registrant	Gas Supplier
	Accept	Reject	Accept	Reject	Accept	Reject	n/a	n/a
Change solution	100	0	100	0	60	40		
Implementation date	100	0	100	0	60	40		

### Our decision

We have considered the issues raised by the proposals and the Change Declarations and Change Reports dated 13 August 2019. We have considered and taken into account the vote of the DCUSA Parties on the proposal which is attached to the Change Declaration. We have concluded that:

- implementation of the modification proposal will better facilitate the achievement of the Applicable DCUSA objectives;<sup>8</sup> and
- directing that the modifications are approved is consistent with our principal objective and statutory duties.<sup>9</sup>

### Reasons for our decision

We consider these modification proposals will facilitate Applicable Charging Methodology Objectives 2, 3 and 4 better, and have a neutral impact on the other relevant objectives.

***Second Applicable Charging Methodology Objective – that compliance with the Relevant Charging Methodology facilitates competition in the generation and supply of electricity and will not restrict, distort, or prevent competition in the transmission or distribution of electricity or in the participation in the operation of an Interconnector***

The change reports state that the two proposals will better meet this objective by avoiding distortions in tariffs for LDNOs in the absence of this change. The proposed changes will ensure that costs for LDNOs increase proportionately to the costs of a SoLR event to the host DNO. The majority of DCUSA voting parties agreed that Objective 2 would be better facilitated by the two change proposals.

#### *Our position*

We agree that DCPs 332 and 333 would better facilitate Objective 2 because they would remove a potential distortion in competition in the distribution of electricity between DNOs and LDNOs. The proposals ensure that LDNO margins are not unduly affected by SoLR events, enabling equivalent treatment with DNOs.

***Third Applicable Charging Methodology Objective – that compliance with the Relevant Charging Methodology results in charges that, so far as is reasonably***

<sup>8</sup> The Applicable DCUSA Objectives are set out in Standard Licence Condition 22.2 of the Electricity Distribution Licence.

<sup>9</sup> The Authority's statutory duties are wider than matters that the Parties must take into consideration and are detailed mainly in the Electricity Act 1989 as amended.

***practicable after taking account of implementation costs, reflect the costs incurred, or reasonably expected to be incurred, by a Distribution Services Provider in its Distribution Business***

For both DCP332 and DCP333, the change reports state that Objective 3 will be better facilitated by these changes by ensuring that costs associated with the recovery of LRSP and eligible bad debt costs claims are allocated to customers appropriately. The two reports add that, as the costs to be recovered cannot be reduced by reduced network usage, this objective will be better facilitated by options which ensure these costs are recovered through fixed charges.

The DCP332 change report states that recovery from domestic users is likely to be the most cost reflective approach, to avoid a non-cost reflective cross-subsidy from industrial and commercial to domestic customers. The vast majority (c.90%) of LRSP costs to date have arisen from the protection of domestic customers' credit balances. Given the case-by-case nature of costs from LRSP claims, and the dominant role of costs related to domestic customers, the Working Group considered that a more complicated approach that involved recovery beyond domestic customers would be disproportionate.

The DCP333 change report states that recovery from all users is likely to be the most cost reflective approach, to ensure all customers contribute. This is because all customers benefit from network costs which may ultimately become eligible bad debt.

The majority of DCUSA voting parties agree that the proposals better facilitate Objective 3. Where rationale was provided by parties, it supported that in the change reports, described above.

Two voting parties do not support the change proposals. One party notes that large suppliers entering administration would use the Energy Supply Company Administration process (as opposed to the SoLR process), so targeting cost recovery for DCP332 may not be appropriate. It also considers that DCP333 may reduce the incentive for distributors to operate efficiently and manage bad debt. However, DCP333 does not affect the ability of DNOs to recover eligible bad debt; rather it specifies the mechanism for doing so.

Another party does not support the proposals. For both proposals, the party states that introducing a cost allocation principle (e.g. attributing LRSP costs to domestic customers) risks undermining the desired outcomes from the TCR. For DCP333, it considers that domestic customers would bear a disproportionate burden of bad debt costs. It considers that the methodology and implementation date for the recovery of all residual costs should follow the outcome of the TCR.

*Our position*

We consider that the proposed approach of recovering costs through fixed charges, that cannot be avoided by changes in network use, is appropriate. This better facilitates Objective 3 than the baseline approach of collecting costs via unit charges. We do not agree that delaying implementation until the outcome of the TCR would be a proportionate way to address an existing deficiency in the charging methodology that does not directly interact with the TCR SCR. We consider that the changes to tariff calculations from the proposals should be taken into account in any modification proposals that flow from the conclusions of the TCR.

LRSP costs that are predominately related to the protection of domestic customers will be collected from domestic customers (DCP332), and bad debt costs that are not readily attributable will be recovered from all demand customers (DCP333). These cost allocation approaches are necessarily estimates that may result in inexact attribution of costs. In contrast, the baseline approach is to collect SoLR-related costs from all customers, regardless of the source of these costs.

In particular, DCP332 would enable recovery of LRSP costs from domestic customers to which the LRSP costs have so far principally related. This is consistent with the approach taken for the derogations we have issued to date to allow DNOs to recover LRSP costs, partly because this was a pragmatic approach leading to fewer tariff changes at relatively short notice.<sup>10</sup> We are neutral as to whether or not the cost attribution approach of DCP332 better facilitates Objective 3. While LRSP costs claimed to date have principally related to domestic customers, the mechanisms in place to respond to an SoLR event (including LRSP cost recovery), exist to benefit all customers by supporting the continued efficient operation and integrity of the market.

On balance, we accept the position of the majority of DCUSA voting parties that the proposals will better facilitate Objective 3. In particular, we consider that the recovery of costs via fixed charges rather than unit charges represents an improvement on the baseline.

***Fourth Applicable Charging Methodology Objective – so far as is consistent with the first three Applicable Charging Methodology Objectives, the Relevant Charging Methodology, so far as is reasonably practicable, properly takes account of developments in a Distribution Services Provider’s Distribution Business***

The Change Reports state that Charging Objective 4 will be better facilitated by the changes by ensuring appropriate allocation of pass-through costs in the CDCM. The majority of DCUSA voting parties agreed.

*Our position*

We agree that DCPs 332 and 333 would better facilitate Objective 4 by formalising the SoLR cost recovery process into the distribution charging methodologies. SoLR events continue to affect distribution businesses. The two proposals prescribe a methodology that gives effect to our earlier decision on changes to the distribution licence related to SoLR events.

**Decision notice**

In accordance with standard licence condition 22.14 of the Electricity Distribution Licence, the Authority directs that modification proposals DCP332: *Appropriate treatment and allocation of Last Resort Supply Payment claim costs* and DCP333: *Appropriate treatment and allocation of eligible use of system bad debt costs* be made.

**Andrew Self**  
**Head of TCR**

Signed on behalf of the Authority and authorised for that purpose

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<sup>10</sup> For example, <https://www.ofgem.gov.uk/publications-and-updates/decision-grant-all-dnos-derogations-charging-years-201920-and-202021-due-last-resort-supply-payment-claim>