DCUSA

Part A: Generic

DCUSA Change Proposal (DCP)	At what stage is this document in the process?
DCP 333:	**01 – Change Proposal**
Appropriate treatment and allocation of eligible use of system bad debt costs	**02 – Consultation**
	03 – Change Report
	04 – Change Declaration

Date Raised: **12 November 2018**

Proposer Name: **Andrew Enzor**

Company Name: **Northern Powergrid**

Company Category: **DNO**

Purpose of Change Proposal:

The intent of this change proposal is to ensure that associated costs are recovered fairly and equitably from customers where a DNO or IDNO Party incurs eligible use of system bad debt due to the insolvency of electricity suppliers whose supply licence has subsequently been revoked.

Governance:

The Proposer recommends that this Change Proposal should be:

- Treated as a Part 1 Matter
- Treated as a Standard Change
- Progressed to a Working Group

The Panel will consider the proposer's recommendation and determine the appropriate route.

Impacted Parties:

DNOs, IDNOs and Suppliers.

Impacted Clauses:

Schedule 16, multiple paragraphs.

Schedule 17 and 18, paragraphs 13, 16, 24 and 25

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Indicative Timeline

The Secretariat recommends the following timetable:	
Initial Assessment Report	14 November 2018
Consultation Issued to Industry Participants	TBC
Change Report Approved by Panel	17 April 2019
Change Report issued for Voting	19 April 2019
Party Voting Closes	10 May 2019
Change Declaration Issued to Parties	14 May 2019
Change Declaration Issued to Authority	14 May 2019
Authority Decision	18 June 2018

Any questions?

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1 Summary

What?

1.1 From time-to-time, an electricity supplier operating in the competitive retail market may have its supply licence revoked by the Authority. Prior to having its supply licence revoked, the electricity supplier is likely to have failed to pay outstanding invoices (or invoices yet to be) levied by the distributor, leaving the distributor with bad debt. This change proposal is only concerned with any bad debt associated with unpaid use of system charges to Distribution Network Operators (DNOs) and Licensed Distribution Network Operators (LDNOs, i.e. Independent Distribution Network Operators (IDNOs) and DNOs operating outside of their Distribution Services Area).

1.2 For DNOs (and where the DNO operates outside of its Distribution Services Area under the same licence), the current mechanism to recover such bad debt is as set out in the 2005 best practice guidelines[1], which utilises a 'logging up' mechanism throughout a price control period with an adjustment reflected in the subsequent price control settlement. The amount a DNO can recover is subject to adjustments outlined in the 2005 best practice guidelines and is relative to procedures taken to mitigate and recover the debt in accordance with Schedule 1 ('Cover') of DCUSA. IDNOs do not currently have a mechanism to recover bad debt.

<u>Review of the electricity distribution licence</u>

1.3 Ofgem has convened a distribution licence review group specifically looking at issues associated with the recovery of costs associated with the appointment of a Supplier of Last Resort (SoLR) and distributor bad debt costs. That group has proposed changes to the electricity distribution licence, which will be subject to statutory consultation in due course. Under the proposals, each DNO will be required to add the costs associated with any eligible bad debt (as determined by the Authority) to its revenue allowances using a new pass-through term. This will include eligible bad debt incurred by IDNOs, where the DNO will recover the costs for, and make payment to, the IDNO.

Why?

1.4 The costs do not relate to customers' future use of the distribution system. The costs are incurred by distributors as a result of an electricity suppliers' failure to pay use of system invoices prior to having its supply licence revoked or which are due to be invoiced and become eligible for payment after a licence has been revoked but which relate to the period before that licence was revoked.

1.5 Without changes to Schedule 16, the proposed changes to the electricity distribution licence would currently result in all customers contributing to the recovery of these costs, with unit charges increasing via revenue matching (i.e. 'scaling' or the 'residual'). This is unlikely to present an appropriate means of apportioning such costs to customers.

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

1.6 If this change were not made, pass-through eligible bad debt costs would be recovered through the existing revenue matching process, and whereby an LDNO (under its relative price control) would likely increase its charges to users connected to its network in line with the increase in the host DNO's charges, so customers connected to LDNO networks would contribute. However, the increase in revenue matching which the pass-through costs would create would be subject to LDNO discounts, and so the host DNO's charges to an LDNO would increase, but only by a proportion of the increase in charges for customers connected to the host DNO's network. Hence LDNOs would see an increased margin as a result of eligible bad debt pass-through costs.

1.7 Ofgem has convened a distribution licence review group specifically looking at issues associated with the recovery of costs associated with the appointment of a SoLR and distributor bad debt costs, which has agreed that changes to the DCUSA should progress in parallel to the review of the licence to ensure an efficient and coordinated implementation. The proposed changes will not be implemented if the associated changes to the electricity distribution licence (which will be subject to statutory consultation) are not approved. This follows precedent set in other codes such as the Uniform Network Code (UNC).

1.8 As such, with this being a Part 1 matter, it is anticipated that the Authority would only approve this change proposal subject to its approval of consistent changes to the electricity distribution licence.

How?

1.9 The proposed solution is to exclude revenue relating to eligible bad debt when carrying out the 'revenue matching' step in the Common Distribution Charging Methodology (CDCM) and when calculating charges in the Extra High Voltage (EHV) Distribution Charging Methodology (EDCM). LDNO discounts would be applied to CDCM tariffs calculated at this stage, with a subsequent adjustment made to all tariffs (including those for LDNOs) to recover pass-through eligible bad debt costs. There are a number of options for the way in which this adjustment is calculated. We believe the Working Group should assess the merits of each option and consider any additional options as necessary.

1.10 This change proposal assumes that IDNOs recover eligible bad debt via the host DNO. If changes to the distribution licence result in an IDNO recovering its bad debt costs directly through its own use of system charges, the Working Group should assess the appropriate means of achieving this. In such a circumstance the proposed solution would be to exclude revenue relating to a DNO's eligible bad debt from use of system charges levied on LDNOs entirely. This will ensure each distributor will recover eligible bad debt costs from customers connected directly to its own network only (i.e. the host DNO would recover its bad debt costs from customers connected to its network and not customers connected to LDNO networks, whilst IDNOs would recover their bad debt costs from customers connected to their networks).

1.11 This change proposal also assumes that bad debt incurred by a DNO operating outside of its Distribution Services Area is recovered by the DNO under the same licence (the status quo) – however it is anticipated that any deviation from this assumption would only impact the changes to the distribution licence.

1.12 Therefore, whilst this change proposal reflects the current proposed licence drafting, any solution implemented should represent the licence changes approved by the Authority following the statutory consultation period.

2 Governance

Justification for Part 1 and Part 2 Matter

2.1 The change will have an impact on competition in the distribution of electricity, by removing the potential for a distortion caused by the recovery of eligible bad debt incurred by distributors.

Requested Next Steps

2.2 This Change Proposal should:

- Be treated as a Part 1 Matter
- Be treated as a Standard Change
- Proceed to Working Group

2.3 Whilst the change is to be treated as a standard change, timely implementation will be important given the recent revocation of a number of supply licences and the scope for the changes to the electricity distribution licence to apply retrospectively with regard to any eligible bad debt already incurred in the current price control period.

3 Why Change?

Supply licence revocations

3.1 Over the past three years, there have been five instances of supply licences being revoked (four being in the last year) therefore exposing distributors to bad debt:

- GB Energy Supply Ltd ceased trading in November 2016[2];
- Future Energy Supply Limited ceased trading in January 2018[3];
- Iresa Limited ceased in July 2018[4];
- Gen4U ceased trading in September 2018[5]; and

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[2]https://www.ofgem.gov.uk/system/files/docs/2016/11/electricity_supply_revocation_2.pdf

[3]https://www.ofgem.gov.uk/system/files/docs/2018/01/fe_elec_revocation_002.pdf

[4]https://www.ofgem.gov.uk/system/files/docs/2018/08/notice_of_revocation_of_electricity_licence_-_iresa.pdf

- Usio Energy Supply Limited ceased trading in October 2018[6].

3.2 Alongside these, recent headlines have suggested that multiple small suppliers are in financial difficulty.

Eligible Bad Debt

3.3 DNOs currently recover eligible bad debt by 'logging up' the debt in the current price control period which is subsequently reflected in base allowed revenue in the following price control period; in line with the 2005 best practice guidelines and necessary credit cover arrangements. Based on the current arrangements, to recover eligible bad debt incurred in RIIO-ED1, Ofgem will adjust the RIIO-ED2 price control settlement accordingly as part of the RIIO-ED1 close-out process.

3.4 In respect of the five instances of supply licences being revoked above, the associated bad debt is material, and current arrangements require DNOs to carry the debt throughout the RIIO-ED1 and due to the profiling of allowances in the next price control settlement, DNOs will not be able to fully recover the costs until the end of RIIO-ED2.

3.5 The significant delay in DNOs recovering eligible bad debt has been under review for some time, and in the intervening period DNOs have been required to commence the short-term recovery of third party costs also incurred by energy suppliers as a result of the revocation of a supply licence; namely the recovery of Co-operative Energy Limited's Last Resort Supply Payment (LRSP) claim. Under changes proposed to the electricity distribution licence, each DNO will be required to add eligible bad debt costs to its revenue allowances as a pass-through item, including any eligible bad debt incurred by LDNOs, where IDNOs specifically currently have no means of recovering such costs.

Treatment of costs

3.6 Eligible bad debt costs do not relate to customers' future use of the distribution system. The costs represent use of system bad debt incurred by distributors as a result of an electricity suppliers' failure to pay invoices prior to having its supply licence revoked or which are due to be invoiced and become eligible for payment after a licence has been revoked but which relate to the period before that licence was revoked. Without changes to Schedule 16, the proposed changes to the electricity distribution licence would result in all customers contributing to the recovery of these costs, with unit charges increasing via revenue matching. This is unlikely to present an appropriate means of apportioning such costs to customers.

3.7 Consideration is needed as to which customer groups should contribute to the recovery of pass-through costs, and in particular through which tariff element. This should be considered in the

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[5] https://www.ofgem.gov.uk/publications-and-updates/gen4u-ltd-notice-revocation-electricity-supply-licence

[6] https://www.ofgem.gov.uk/publications-and-updates/usio-energy-supply-limited-notice-revocation-gas-supply-licence

context of the ongoing Ofgem-led Targeted Charging Review (TCR)[7], launched via a Significant Code Review (SCR). The current methodologies would result in the recovery of these costs manifesting as a stronger price signal for reduced overall consumption via an increased unit charge. This risks users who are able to reduce overall consumption doing so, and so contributing less and resulting in additional costs being borne by other users. This is in contradiction to the principles of the TCR, and until the outcome of the TCR is known, the treatment and allocation of these costs should be considered on individual merits.

3.8 Careful consideration is also needed for the calculation of tariffs for LDNOs. If eligible bad debt costs are simply recovered through revenue matching (as would be the case if this change were not made), an LDNO would benefit from higher potential revenue under its relative price control (as the host DNO charges would increase) but its costs would not increase proportionally as the increase in the host DNO's tariff for customers connected to its network would be discounted when calculating tariffs applicable to the LDNO; hence the LDNO would be a net beneficiary of the process. An IDNO will recover its eligible bad debt costs from DNOs similar to how a Supplier of Last Resort (SoLR) recovers a LRSP claim and so is reimbursed for its bad debt through a separate mechanism and should not be a beneficiary from this mechanism.

Part B: Code Specific Details

4 Solution and Legal Text

4.1 There are at least four possible solutions to this issue, all of which are variations on the same theme, being that eligible bad debt pass-through costs are excluded from both the calculation of revenue matching in the CDCM and the calculation of EDCM tariffs. A subsequent adjustment is then made to (a subset of) tariffs, with the same absolute adjustment being made to the tariff for end customers connected to a DNO network and end customers connected to LDNO networks, thus ensuring that LDNOs are entirely neutral to the recovery of costs whilst ensuring that customers connected to LDNO networks contribute to the same level as customers connected to DNO networks.

4.2 Customers who:

- are connected to LDNO networks where the DNO to LDNO is at the HV Substation network level or above; and
- meet the definition of 'Designated Properties' as defined in the distribution licence, i.e. those who would be treated as CDCM customers if they were connected to a DNO network

[7] https://www.ofgem.gov.uk/electricity/transmission-networks/charging/targeted-charging-review-significant-code-review

- have tariffs calculated in the EDCM, by applying discounts to CDCM tariffs. In order to ensure consistent treatment of such customers, these tariffs must also be increased by the same adjustment as is being made to DNO end customer tariffs; hence it will be necessary to create a link between the CDCM and EDCM to ensure that:

  1) tariffs for Designated Properties connected to LDNO networks which are calculated in the EDCM are subject to the same adjustment as tariffs for customers connected to DNO networks calculated in the CDCM; and

  2) the adjustment to tariffs (calculated in the CDCM) takes into account revenue which will be derived in the EDCM from the application of step 1, to avoid over-recovery of the new pass-through costs.

Option A

4.3 Exclude any revenue relating to eligible bad debt pass-through costs from the existing calculations for tariffs for users connected to DNO networks and tariffs for LDNOs in both the CDCM and EDCM, with the costs recovered through a subsequent adjustment to all unit rates of all tariffs for all demand customers which are Designated Properties (including those calculated in the EDCM), with the same p/kWh adjustment being made to all tariffs (including those for LDNOs).

4.4 Advantages:

- Maintains the principle by which revenue matching is achieved in the CDCM.

4.5 Disadvantages:

- Results in higher unit rates, giving a stronger cost signal to customers to reduce overall usage of the network. The costs associated with the new pass-through terms cannot be reduced through reduced network usage, and so this stronger cost signal is not appropriate and contradicts the principles set out in Ofgem's TCR.

Option B

4.6 Exclude any revenue relating to eligible bad debt pass-through costs from the existing calculations for tariffs for users connected to DNO networks and tariffs for LDNOs in both the CDCM and EDCM, with the costs recovered through a subsequent adjustment to the unit rates of tariffs for domestic customers (including those calculated in the EDCM), with the same p/kWh adjustment being made to all tariffs for domestic customers (including those for LDNOs).

4.7 Advantages:

- Maintains the underlying principle by which revenue matching is achieved in the CDCM, albeit applied to a restricted group of customers.

4.8 Disadvantages:

- Results in higher unit rates, giving a stronger cost signal to customers to reduce overall usage of the network. The costs associated with the new pass-through terms cannot be reduced through reduced network usage, and so this stronger cost signal is not appropriate and contradicts the principles set out in Ofgem's TCR.

- Whilst the debt may primarily relate to residential customers, unlike the 'safety net' guidelines for credit balances a SoLR can recover via an LRSP claim, unpaid use of system invoices may include 'business customers'. However, a distributor incurring new eligible bad debt is likely to be associated with the same trigger as the appointment of a SoLR, therefore the bad debt will relate to the same customer base and which to date is almost entirely associated with residential customers – therefore there is merit in considering this option further.

Option C

4.9 Exclude any revenue relating to eligible bad debt pass-through costs from the existing calculations for tariffs for users connected to DNO networks and tariffs for LDNOs in both the CDCM and EDCM, with the costs recovered through a subsequent adjustment to the fixed charges of tariffs for all demand customers which are Designated Properties (including those calculated in the EDCM), with the same p/day adjustment being made to all tariffs for all customers who receive a fixed charge (i.e. all except unmetered supplies).

4.10 Advantages:

- The costs do not discriminate against different types of customers.
- The costs associated with the new pass-through terms cannot be reduced through reduced network usage; hence a fixed charge is arguably the most appropriate means of recovery.

4.11 Disadvantages:

- Deviates from the underlying principle by which revenue matching is achieved in the CDCM.

Option D

4.12 Exclude any revenue relating to eligible bad debt pass-through costs from the existing calculations for tariffs for users connected to DNO networks and tariffs for LDNOs in both the CDCM and EDCM, with the costs recovered through a subsequent adjustment to the fixed charges of tariffs for domestic customers (including those calculated in the EDCM), with the same p/day adjustment being made to all tariffs for domestic customers (including those for LDNOs).

4.13 Advantages:

- The costs associated with the new pass-through terms cannot be reduced through reduced network usage; hence a fixed charge is arguably the most appropriate means of recovery.

4.14 Disadvantages:

- Deviates from the underlying principle by which revenue matching is achieved in the CDCM.
- Whilst the debt may primarily relate to residential customers, unlike the 'safety net' guidelines for credit balances a SoLR can recover via a LRSP claim, unpaid use of system invoices may include charges in respect of all types of customer. However, a distributor incurring new

eligible bad debt is likely to be associated with the same trigger as the appointment of a SoLR, therefore the bad debt will relate to the same customer base and which to date is almost entirely associated with residential customers – therefore there is merit in considering this option further.

Legal Text

4.15 Draft legal text for Schedules 16, 17 and 18 is provided as attachments 1 to 3 respectively. The proposed text is identical for each of the three proposed solutions with the exception of clauses 53a and 101 of Schedule 16 and clause 25.3 of Schedules 17 and 18 which all show four options.

Text Commentary

4.16 The approach taken to the CDCM legal text is to add an additional step to the existing four stage process. The existing legal text has step three as revenue matching and step four as the application of LDNO discounts. These two steps need to be carried out targeting revenue allowances with eligible bad debt pass-through costs excluded; hence an amendment has been made to step three to ensure that revenue relating to those costs is excluded from revenue allowances at this stage. Step five then deals with the allocation of eligible bad debt pass-through costs to customers, with the same absolute amendments being made to tariffs for customers connected to the host DNO network and tariffs for LDNOs.

4.17 The changes made to the EDCM legal text ensure that revenue relating to eligible bad debt pass-through costs is excluded from the calculation of tariffs for Designated EHV Properties, with the adjustments calculated in the CDCM then being applied to LDNO tariffs calculated in the EDCM.

5 Code Specific Matters

Reference Documents

5.1 Links to reference documents are included in footnotes throughout.

6 Relevant Objectives

DCUSA Charging Objectives	Identified impact
☐ 1 that compliance by each DNO Party with the Charging Methodologies facilitates the discharge by the DNO Party of the obligations imposed on it under the Act and by its Distribution Licence	None
☒ 2 that compliance by each DNO Party with the Charging Methodologies 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 participation in the operation of an Interconnector (as defined in the Distribution Licences)	Positive

☒ 3 that compliance by each DNO Party with the Charging Methodologies results in charges which, so far as is reasonably practicable after taking account of implementation costs, reflect the costs incurred, or reasonably expected to be incurred, by the DNO Party in its Distribution Business	Positive
☒ 4 that, so far as is consistent with Clauses 3.2.1 to 3.2.3, the Charging Methodologies, so far as is reasonably practicable, properly take account of developments in each DNO Party's Distribution Business	Positive
☐ 5 that compliance by each DNO Party with the Charging Methodologies facilitates compliance with the Regulation on Cross-Border Exchange in Electricity and any relevant legally binding decisions of the European Commission and/or the Agency for the Co-operation of Energy Regulators.	None
☐ 6 that compliance with the Charging Methodologies promotes efficiency in its own implementation and administration.	None

Charging objective one: no impact.

Charging objective two: better facilitated by avoiding the distortions which would occur in tariffs for LDNOs if the change were not made.

Charging objective three: better facilitated by all options by ensuring that eligible bad debt costs are allocated to customers appropriately.

Options which ensure these costs are recovered from all users are likely to be the most cost reflective, to ensure all customers contribute. The costs to be recovered cannot be reduced by reduced network usage, so this objective will be better facilitated by options which ensure these costs are recovered through fixed charges. Hence Option C is considered to facilitate this objective most fully, followed by option A, followed by option D, followed by option B. For the avoidance of doubt, all options are considered to meet this objective better than the status quo.

Charging objective four: better facilitated by ensuring appropriate allocation of eligible bad debt pass-through costs in the CDCM.

Charging objective five: no impact.

Charging objective six: no impact.

7 Impacts & Other Considerations

7.1 This change will have an impact on DNOs, IDNOs and suppliers. No system impacts are anticipated, as the change will use existing tariff structures and will only impact the rates calculated.

Does this Change Proposal impact a Significant Code Review (SCR) or other significant industry change projects, if so, how?

7.2 Depending on the desired solution there is potential overlap with the TCR SCR, in that the change is linked to the mechanism by which revenue matching is achieved. However, the solutions proposed in this change proposal only include revenue relating to eligible bad debt costs and so leave the application of revenue matching unaltered for the remainder of DNO revenue i.e. this change deals with costs which are currently not allocated or recovered as part of the distribution charging methodologies or indeed DNO allowed distribution network revenue.

7.3 As detailed throughout, changes are in progress for the distribution licence. These licence changes are the driver for this DCUSA change which has been discussed with Ofgem as part of the review of licensing arrangements.

Does this Change Proposal Impact Other Codes?

7.4 No other codes are impacted by this change proposal.

BSC	☐
CUSC	☐
Grid Code	☐
MRA	☐
SEC	☐
Other	☐
None	☒

Consideration of Wider Industry Impacts

7.5 The change has been discussed as part of the distribution licence review group consisting of DNOs and Ofgem.

Confidentiality

7.6 Non-confidential.

8 Implementation

8.1 Upon implementation of the proposed changes to the electricity distribution licence, the change should be implemented as soon as possible. Given the impact on tariffs calculated in the CDCM and the 15 months' notice required of a change to use of system charges, the earliest feasible date is likely to be 01/04/2021.

Proposed Implementation Date

8.2 1 April 2021.

9 Recommendations