Ofgem's '*Informal consultation on modification to the Electricity Distribution Licence to recover the costs associated with appointing a Supplier of Last Resort*' – a plain English guide

1. This paper should be read alongside the document named '*Appendix – proposed modifications to the electricity distribution licence to recover the costs associated with appointing a supplier of last resort*', published by Ofgem as part of its informal consultation[1].

Recovery of supplier of last resort (SoLR) costs - Overview

2. The primary aim is to retain the distribution connection and use of system agreement ('the DCUSA') requirement on distribution network operators (DNOs) and licensed distribution network operators (LDNOs) to provide 15 and 14 months' notice of a change to use of system charges respectively. These notice periods will be retained in all but exceptional circumstances in which there is an unprecedented level of supplier default (i.e. a breach of the materiality threshold in standard condition 38B '*Treatment of payment claims for last-resort supply where Valid Claim is received on or after 31 March 2019*' ('SLC38B')).

3. Following modifications to the electricity distribution licence ('the licence') the default position would be that DNOs recover approved (by the Authority) last resort supply payment (LRSP) claims, i.e. 'Valid Claims', via a new pass-through cost (the SLR term) with a two year lag, up to the materiality threshold. DNOs would therefore typically incur cost in making payments to a SoLR and recover the costs two years later.

4. The materiality threshold represents the cash flow risk a DNO takes when incurring such material costs at short notice, and being unable to recover the costs for at least two years. Unlike other pass-through costs no base allowance is included in a DNOs base demand revenue e.g. DNOs pass-through the difference between transmission connection point charges incurred and those included in base demand revenue, which can be positive or negative.

5. If the materiality threshold is breached a DNO would be able to seek an increase to use of system charges which would take effect from the following April (subject to when a Valid Claim is received).

6. The materiality threshold equates to £49m over two consecutive years or 1% of total DNO allowed revenue (opening base demand revenue i.e. the PU term) in 2012/13 prices. It is calculated as 0.5% of DNO opening base demand revenue per year adjusted by customer numbers to reflect how a Valid Claim would be allocated to DNOs. In nominal terms this is over seven times the SoLR claim of £7.7m made by Co-operative Energy Limited (CEL) as a result of the failure of GB Energy Supply Limited (GBESL).

Recovery of use of system bad debt - Overview

7. Use of system bad debt would also be recovered via new pass through costs (the EBD term) albeit with a three year lag i.e. debt incurred in any regulatory year would be recovered three years later.

8. The recoverable amount of debt is relative to the age of the debt at the time an electricity supplier becomes insolvent.

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[1] https://www.ofgem.gov.uk/publications-and-updates/informal-consultation-modification-electricity-distribution-licence-recover-costs-associated-appointing-supplier-last-resort

9. Under current arrangements DNOs recover use of system bad debt via the price control close out process, with any amounts claimed and approved by the Authority recovered over the duration of following price control period. Independent distribution network operators (IDNOs) currently have no mechanism to recover such costs after they have been incurred.

10. The modifications to the licence provide IDNOs with a mechanism to recover use of system bad debt from DNOs, using a similar process to the SoLR arrangements. An IDNO will make an approved claim (a 'Valid Bad Debt Claim') to a DNO who is then required to pay the IDNO and recover the costs in the same regulatory year; being the next regulatory year for which use of system charges have not been set (subject to when a Valid Bad Debt Claim is received).

11. This essentially puts debt recovery for both DNOs and IDNOs on an equivalent basis in terms of when any approved claims will be recovered.

The licence modifications

12. The remainder of this paper will step through each licence condition which Ofgem is consulting on, as published in its informal consultation, and explain what the intent is and how it will be achieved. The relevant paragraph in the condition will be referenced where appropriate prior to explaining what the intent of that paragraph is.

13. Where key changes are expected in the imminent statutory consultation, or where the Northern Powergrid consultation response identified a key need to change, or where an assumption has been made, this will be *flagged*.

Standard licence condition 38 '*Treatment of payment claims for last-resort supply where Valid Claim is received before 31 March 2019*' ('SLC38')

14. SLC38 is an existing licence requirement and the modifications to it will cease the application of this condition for any claims received after 31 March 2019. This condition will otherwise remain unchanged.

15. *Our understanding is that this date will be amended to 1 April 2019 in line with the start of a new regulatory year. We have proposed that there is a need for greater clarity as to when SLC38 should be followed, by amending paragraph one*.

16. The current process by which a DNO recovers a Valid Claim is shown in Figure 1***Figure 2***.

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

17. This condition applies when *(note the expectation is that the date will also change to 1 April 2019)*:

    a. **SLC38A.1a** – A Valid Claim is received before 31 March 2019 but where the DNO has not commenced recovering costs for the SoLR. We consider 'commenced recovering' to mean that a DNO has published use of system charges to recover a Valid Claim. A Valid Claim would then be recovered in accordance with SLC38B. *If Octopus Energy Limited ('Octopus') does not make a Valid Claim by 30 January 2019 this will apply.*

    b. **SLC38A.1b** – A Valid Claim is received before 31 March 2019 and where the DNO has commenced recovering the costs for the SoLR, but where the DNO has not commenced recovering/returning

any shortfall/excess revenue after the Relevant Regulatory Year (as defined in SLC38). In the context of the CEL claim, and based our interpretation of 'commenced recovering', this is if a DNO has not published revised 2019/20 use of system charges specifically to recover/return any shortfall/excess before the licence modifications are implemented. The shortfall/excess would be recovered/returned in accordance with SLC38B. In the context of the CEL claim the difference between the revenue recovered in 2018/19 and the value of the Valid Claim (the 'Specified Amount' as defined in SLC38), i.e. being the necessary adjustment to 2019/20 use of system charges, would be dealt with by adjusting allowed revenue via the new pass-through term in 2021/22. *This will potentially apply to the CEL Valid Claim for some DNOs. This is likely to apply to the forthcoming Valid Claim from Octopus on the assumption the claim is made by 30 January 2019*.

c. **SLC38A.2** – A Valid Claim is 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 eventualities will inevitably leave a residual imbalance at the conclusion of the existing SLC38 process. In the context of the CEL claim, and based on our interpretation of 'commenced recovering', this is if a DNO has published revised 2019/20 use of system charges specifically to recover/return any shortfall/excess before the licence modifications are implemented. The residual imbalance would be dealt with in accordance with SLC38B. In the context of the CEL claim the difference between the consequential revenue recovered (2018/19 and 2019/20) and the value of the Specified Amount, i.e. being the residual balance which SLC38 does not provide means to recover/return, would be dealt with by adjusting allowed revenue via the new pass-through term in 2022/23. *This will apply to the CEL Valid Claim for most DNOs*.

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

18. **SLC38B.1** – This condition applies to any Valid Claim received on or after 31 March 2019 *(note the expectation is that the date will also change to 1 April 2019)* or in the circumstances specified in SLC38A.

19. **SLC38B.2** – A special administration regime (SAR) in the form of a memorandum of understanding (MoU) between the Authority, the Department for Business, Energy and Industrial Strategy (BEIS), and Her Majesty's Treasury (HMT)[2] sets out the possibility of either the Authority or BEIS applying for an Energy Supply Company Administration Order (ESCO). An ESCO applies to what is an undefined 'large' energy supplier. If a successful application is made the SoLR process would not be followed and therefore SLC38B would not apply (nor should the other licence conditions by default as a SoLR would not be appointed).

20. **SLC38B.3** – From the date of receipt of a Valid Claim which has either: not breached the materiality threshold; or has breached the materiality threshold but the DNO will not treat that claim to have done so, for a period of 60 days' from that date the DNO will make no payments to a SoLR. The Valid Claim will be paid in full within 15 months' of receipt.

21. *It is our expectation that the 60 day period of no payment will be increased to three months to ensure that in providing 15 months' notice of a change to use of system charges the DNO has not already published charges for the year in which the revenue will be recovered. Otherwise a four year lag is introduced*

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

between incurring and recovering costs due to the further two year lagged correction of over/under-recovery.

22. *This is to account for Valid Claims received early in a calendar year which would result in payment to the SoLR in the same regulatory year as the Valid Claim was received; where use of system charges for the regulatory year revenue will be recovered (i.e. two years later) will have already been published in the previous December.*

23. *For example, and based on a 60 day no payment window, a Valid Claim received on 1 January 2020 would require payment to be made to the SoLR from February 2020 i.e. in 2019/20 – these costs would therefore be recoverable in 2021/22. However, DNOs will publish 2021/22 use of system charges in December 2019. The DNO will therefore not be able to recover the costs until 2023/24 due to the two year lag on the correction of over/under-recovery.*

24. *Further, in order for supporting changes to the DCUSA[3] to work DNOs will 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 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 SoLR at this point.*

25. *It is also worth noting that three months in this context is only viable providing that a DNO can calculate with reasonable certainty how much it will be required to pay in a regulatory year and so how much it will be required to recover in the regulatory year for which it will next publish use of system charges (i.e. as a minimum Ofgem will need to have published its minded to position on the value of the claim (the Specified Amount) and the split between gas and electricity networks will need to be known).*

26. *SLC38B.3 provides for DNOs only to make monthly payment instalments. However standard condition 9 'Claims for Last Resort Supply Payment' of the electricity supply licence ('SLC9') provides for a SoLR to request payment in monthly or quarterly instalments. We therefore expect the licence to conform to this (this also applies to SLC38B.9).*

27. **SLC38B.4** – The aggregate value of SoLR payments made in any regulatory year will be recovered via the new pass-through term (SLR, specifically the SLRA term within). This excludes payments relating to any Valid Claim in breach of the materiality threshold, but not those which have breached the materiality threshold but where the DNO will not treat that claim to have done so. In any regulatory year, the costs which will be passed through are equivalent to the amounts paid to any SoLR, and are not necessarily the value of any relevant Valid Claims received. For example, and based on a three month no payment window, a Valid Claim made on 1 January 2020 would likely entirely be recovered 12 months from 1 April 2020 therefore payment would fall in one regulatory year only i.e. 2020/21. However, a Valid Claim made on 1 July 2020 would result in roughly 50% of the claim being recovered between October 2020 and March 2021 i.e. 2020/21, and 50% from April 2021 to September 2021 i.e. 2021/22.

28. **SLC38B.5 –** For any Valid Claim which would result in the aggregate payments in any regulatory year being above the materiality threshold, within 28 days from receipt of the Valid Claim, the DNO has the right to

[3] 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*'

provide notice to the Authority that it intends to increase previously published use of system charges (akin to the existing SLC38 process) in order to align cost with revenue.

29. The regulatory year for which prices will be increased (the Relevant Regulatory Year as defined in SLC38B) is relative to when the Valid Claim is received; being the forthcoming 1 April providing it is not less than 60 days from the date of receipt of the Valid Claim.

30. *It is our expectation that the 60 day period will be increased to three months to ensure that a DNO has sufficient time to publish revised use of system charges and provide the requisite (currently 40 days') notice period required in accordance with the DCUSA. The 60 day period does not provide sufficient time to achieve this, especially when the DNO is required to request derogations from the Authority to do so. As a result this also does not provide sufficient time for LDNOs to publish revised use of system charges, and the adjustment to previously published use of system charges is unlikely to be published in time for Ofgem to account for it when publishing supplier price caps. A DCUSA change will soon be raised which seeks to further speed up this process by removing the need for DNOs to request derogations when a Valid Claim breaches the materiality threshold (as presented to the January 2019 distribution charging methodology development group (DCMDG) meeting).*

31. *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. The intent is also that following commencing the recovery of any Valid Claim which breaches the materiality threshold and which the DNO publishes revised use of system charges to recover at short notice, that any subsequent Valid Claim should be assessed against the materiality threshold as if any Valid Claim which breached the threshold had not occurred. This is because the DNO is already protected from cash flow risk in respect of a Valid Claim which breaches the materiality threshold (by virtue of the timing of cost and revenue being closely aligned) and so, if there was 'headroom' below the materiality threshold in any given regulatory year before the Valid Claim which breached the materiality threshold was received, that 'headroom' should remain available for a future Valid Claim.*

32. *For example (and assuming breach of the materiality threshold was always recovered at short notice) if a DNO's materiality threshold was £1.0m, and it received a Valid Claim resulting in the DNO incurring cost of £0.5m in 2019/20, £0.5m headroom would remain in 2019/20. If the DNO then received a Valid Claim which would result in it incurring cost of £0.6m in 2019/20, it would publish revised 2020/21 use of system charges to recover this (as opposed to recovering it in 2021/22 which would be the default position), and £0.5m of headroom would still remain. The DNO would utilise this headroom to pay any further Valid Claim which impacted 2019/20 where the aggregate value of payments in 2019/20 did not exceed £1.0m; and where the Valid Claim also did not result in a breach of the materiality threshold in the following year as well i.e. in 2020/21 (otherwise revised 2020/21 use of system charges would recover this Valid Claim as well, subject to when it was made).*

33. *SLC38B.5 as presented in Ofgem's informal consultation results in the assessment of whether a Valid Claim breaches the materiality threshold in any given regulatory year including any payments made by the DNO in relation to all Valid Claims, including those where the materiality threshold has been breached.*

34. *We expect SLC38B.5 will be amended to achieve the desired intent. This will be achieved by excluding any Valid Claims which breached the materiality threshold and are being recovered and paid in the same regulatory year when calculating whether a new Valid Claim would breach the materiality threshold.*

35. **SLC38B.7 –** For consistency and simplicity the entirety of any Valid Claim is dealt with using the same mechanism i.e. two year lagged pass-through vs pass-through but cost and revenue in the same regulatory

year. When a Valid Claim breaches the materiality threshold, and where that claim is considered alongside any other Valid Claim resulting in costs being incurred in the same regulatory year, the DNO can recover the full value of that Valid Claim by amending previously published use of system charges and providing a minimum of 40 days' notice in the process. Therefore it is not just the value in excess of the materiality threshold which will be recovered on this basis, but the entire Valid Claim (the Specified Amount, which becomes the Excess Specified Amount).

36. *We expect that the definition of Excess Specified Amount will be amended to be more explicit to support this intent.*

37. **SLC38B.8 and SLC38B.10 –** A Valid Claim will be recovered on a two year lagged pass-through basis other than where a DNO has provided notice and where necessary received approval to recover a Valid Claim which has breached the materiality threshold in the same regulatory year in which costs will be incurred. SLC38B.8 provides for an instance where the materiality threshold has already been breached, the DNO will still be required to recover any Valid Claim which does not breach the materiality threshold, or where it does and the DNO will not treat that claim to have done so, using the default two year lagged pass-through arrangements (i.e. the example in paragraph 32).

38. *We propose to consolidate SLC38B.8 and SLC38B.10, resulting in a small amendment to SLC38B.8 and the removal of SLC38B.10.*

39. *The right to seek an increase to previously published use of system charges when the materiality threshold is breached is conditional so that a Valid Claim that breaches the materiality threshold can still be treated as if it had not depending on a DNOs tolerance to cash flow risk and raising funds if necessary. Although this could lead to some inconsistency in approach between DNOs, we believe that there is benefit in providing DNOs the flexibility not to increase prices at short notice and whereby the majority of a Valid Claim resulting in breach of the materiality threshold may actually be within the materiality threshold i.e. it may only exceed by a small proportion of the Valid Claim or in absolute terms be considered immaterial.*

40. **SLC38B.9 –** This paragraph gives effect to what a DNO must do to recover a Valid Claim which has breached the materiality threshold and where the DNO is seeking to align cost and revenue in the same regulatory year. This is the Excess Specified Amount, and which will be recovered on a pass-through basis albeit using the ESA term within the SLR term, and where ESA is not lagged unlike the SLRA term.

41. *It is worth noting that the same methodology for calculating use of system charges will be used to recover a Valid Claim, whether in breach of the materiality threshold or not. This methodology is subject to DCP 332 'Appropriate treatment and allocation of Last Resort Supply Payment claim costs'.*

42. *SLC38B.9b can only be achieved with supporting changes to the DCUSA, which will be submitted to the February 2019 Panel (as presented to the January 2019 DCMDG). In the absence of a DCUSA change which will alleviate the need for a DNO to request a derogation in accordance with SLC38B.6, it is likely that a number of 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, SLC38B.9b does not need to be changed when supported by a change to the DCUSA and as such we did not propose to make any changes. We believe the DCUSA change will benefit all stakeholders, including Ofgem with price caps in mind.*

43. *An additional paragraph is required (expected to replace SLC38B.10) which will specifically absolve DNOs of the need to provide three months' notice of changes to use of system charges in accordance with paragraph*

11 of standard condition 14 'Charges for Use of System and Connection' ('SLC14'). This is consistent with SLC38.8; however a change is needed to SLC38.8 to correct the paragraph reference in SLC14.

44. This proposed process by which a DNO will recover a Valid Claim is shown in Figure 2.

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

45. **SLC38C.1** – This condition applies when a DNO receives a Valid Bad Debt Claim from a Bad Debt Claimant; being an IDNO. Standard condition BA5 '*Claims for Use of System Bad Debt*' ('BA5') is a new standard condition in the IDNO licence only, which provides for an IDNO to make a Valid Bad Debt Claim.

46. **SLC38C.2** – A Valid Bad Debt Claim will paid to an IDNO during the Applicable Regulatory Year (as defined in SLC38C), which is the regulatory year for which a DNO will next be setting use of system charges for; subject to when the Valid Bad Debt Claim is received. A 40 day window, ending 31 December, exists to prevent a Valid Bad Debt Claim being received whilst DNOs are in the final stages of setting use of system charges and a need to include such a claim in the target revenue for the period in which use of system charges are being set. 40 days roughly aligns to when DNOs are in receipt of inflation figures to be used when setting use of system charges; which is one of the final inputs DNOs require before locking down target revenue. A Valid Bad Debt Claim received less than 40 days before 31 December will result in cost and revenue being deferred to the next year for which a DNO will be setting use of system charges for.

47. **SLC38C.3** – BA5 sets out conditions where an IDNO would be required to submit an adjustment to a previous Valid Bad Debt Claim, namely: where the value of the claim has changed due to Settlement inaccuracies (subject to a 10% materiality threshold relative to the value of the original claim); and where the IDNO has recovered a proportion of the debt previously claimed from a DNO as a creditor of the administration process for the supplier from whom the debt was originally incurred. SLC38C.3 specifies that where a DNO receives an adjustment to a previous Valid Bad Debt Claim, and where it is required to pay the IDNO, it shall do so.

48. *We expect that SLC38C.3 will be amended to prevent a situation where a DNO could be required to pay an adjustment reconciling an adjusted Valid Bad Debt Claim to the original value, before having made a payment to the IDNO relating to the original claim. Due to timing of when the original claim will be paid and recovered, it is possible that the debt will be 'fully reconciled' i.e. the RF Settlement Run for the final day of supply on which the debt relates will be published. The expectation is that any payment from a DNO to an IDNO for an adjusted Valid Bad Debt Claim will be aligned to the next payment of the original claim, providing it is not less than 30 days from the IDNO having made the adjusted claim, otherwise it shall be the next instalment, and if no further instalments are due 30 days from the date of the claim.*

49. **SLC38C.4** – The aggregate value of any Valid Bad Debt Claims to be paid in the Applicable Regulatory Year, plus any adjustments to previous claims received in that year, will be recovered (or returned i.e. if the adjusted claim results in the IDNO paying the DNO) via the relevant pass-through term (the IBDA term within the EBD term).

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

50. **BA5.1** – This condition provides the means for an IDNO to make a Valid Bad Debt Claim to a DNO. A Valid Bad Debt Claim must be approved by the Authority. BA5 largely follows the principles of SLC9. A Valid Bad Debt Claim relates to use of system charges only.

51. **BA5.2** – An IDNO may make a claim to a DNO in respect of both the initial debt position and any adjustments relating to either Settlement inaccuracies or where the IDNO has, since making the initial claim, recovered a proportion of those costs from the administrator of the supplier who in the process of its insolvency has resulted in the IDNO incurring the bad debt.

52. **BA5.3** – IDNOs can recover bad debt incurred since 1 April 2018 on an annual basis and a Bad Debt Claim (i.e. before it is approved by the Authority) must be made within 60 days' from the end of the regulatory year in which the debt was incurred. The IDNO is required to notify the Authority and submit a claim using a template defined by the Authority; which is likely to be the same as that used by DNOs and which DNOs have used to recover use of system debt incurred during DPCR5 via the close out process.

53. **BA5.4** – IDNOs currently have no means of recovering use of system bad debt after it has been incurred. Therefore IDNOs are likely to be carrying bad debt relating to previous regulatory years for which it shall be entitled to recover. This is limited to debt incurred since 1 April 2015 i.e. since the beginning of RIIO-ED1. IDNOs have until 30 June 2019 (equivalent to 60 days from the end of 2018/19) to claim for this debt. Therefore any claims for debt incurred between 1 April 2015 and 31 March 2019 will be recovered at the same time.

54. **BA5.5** – The Authority has three months to approve a Bad Debt Claim, which will determine the value of bad debt the IDNO is allowed to recover i.e. the Relevant Amount.

55. **BA5.6** – The Relevant Amount will only differ from the value of the Bad Debt Claim submitted by the IDNO in relation to the IDNOs compliance with credit cover arrangements (i.e. Schedule 1 '*Cover*' of the DCUSA) and any necessary adjustments relative to the age of the debt at the time the supplier whose insolvency has resulted in the debt being incurred becomes insolvent. The proportion of debt which can be recovered reduces with age relative to the date of insolvency.

56. **BA5.9** – An IDNO can make a Valid Bad Debt Claim to a DNO where, in that DNOs Distribution Services Area, the supplier whose insolvency has resulted in the IDNO incurring the bad debt supplied customers connected to the IDNO. *The definition of Relevant Distributor should be amended to provide greater clarity that this is the intent i.e. customers must be connected to the IDNO and not necessarily the DNO.* The claim must specify: the proportion of debt to be recovered from each DNO (being the debt incurred in that DNOs Distribution Services Area); any interest on that amount; and the payment instalments – the default position for which is 12 monthly instalments.

57. **BA5.10** - An IDNO has six months from the date the Authority approves to a Valid Bad Debt Claim being made to make the claim from a DNO.

58. An IDNO shall make adjustments to a previous Valid Bad Debt Claim where:

    a. **BA5.11** – The fully reconciled debt (i.e. RF Settlement Run is published for the final day of supply by the supplier who as a result of its insolvency resulted in the IDNO incurring use of system bad debt) is at least ±10% of the Relevant Amount (i.e. the value of the previous claim); where the adjusted claim value is defined as the 'Revised Relevant Amount'. The IDNO has 60 days from receipt of the relevant final RF Settlement Run to: notify the Authority and DNO; where the Revised Relevant Amount is lower than the Relevant Amount, pay the DNO the difference plus interest; and where the Revised Relevant Amount is higher than the Relevant Amount submit a further Valid Bad Debt Claim for the difference plus interest (which the DNO must pay to the IDNO).

    b. **BA5.13** – The IDNO is successful in applying to recover use of system bad debt (the 'Recovered Amount') from the administrator of the supplier whose insolvency resulted in the IDNO incurring

the debt, and where the IDNO has also recovered a proportion of the debt from a DNO via a Valid Bad Debt Claim. The IDNO has 60 days from recovering the debt to: notify the Authority and DNO; and pay the DNO a proportion of the Recovered Amount (proportionate to the amount recovered from the DNO in the original Valid Bad Debt Claim).

59. *Similar to the expected amendment to SLC38C.3 as noted in paragraph 48, we expect that both BA5.11 and BA5.13 will be amended to prevent a situation where an IDNO could be required to pay an adjustment to a Valid Bad Debt Claim (i.e. reimburse a DNO) before having received payment from the DNO for the original claim. This is unlikely to apply in the instance an IDNO recovered debt from an administrator due to how long the administration process can take, but could apply in relation to fully reconciled debt.*

60. *Appendix 1 of BA5 sets out the proportion of bad debt which an IDNO can recover relative to the age of the debt on the date the supplier who resulted in the IDNO incurring the debt became insolvent. We expect the table will be amended to specify that any debt which was not due on the date of the suppliers insolvency (e.g. any unbilled use of system invoices) will be fully recoverable. This adjustment will also need to be made to the equivalent appendices in charge restriction condition (CRC) 2B 'Calculation of Allowed Pass-Through Items' ('CRC2B').*

CRC2B '*Calculation of Allowed Pass-Through Items*' ('CRC2B')

61. CRC2B is amended to enable a DNO to include any necessary adjustments to its allowed distribution network revenue as required by the new licence conditions (i.e. SLC38A, SLC38B and SLC38C).

62. The changes introduce a new SoLR term (SLR) which comprises two key elements.

    a. The SLRA term which primarily represents the recovery of Valid Claims which have either not resulted in breach of the materiality threshold, or where the DNO has elected not to treat the Valid Claim as if it did breach the materiality threshold (or is required to do so by the Authority). The SLRA term also includes the correction of any shortfall or excess revenue recovered in accordance with SLC38 and SLC38A, plus any costs the DNO reasonably incurs as a result of following the requirements of the SoLR process e.g. financing costs potentially. The SLRA term also provides the DNO with the means to return any 'refunded' costs from the SoLR where the SoLR has recovered costs from the administrator of the supplier for which it was appointed SoLR to the former customers of, and where the SoLR recovered (or is recovering) a proportion of those costs via Valid Claims from DNOs.

    b. The ESA term, being the Excess Specified Amount, represents the aggregate value of Valid Claims which have breached the materiality threshold and where the DNO is recovering the claim in the same year it pays the SoLR i.e. at short notice. Therefore there is no lag on the ESA term, unlike the SLRA term.

63. The changes also introduce a new use of system bad debt term (EBD) which comprises four key elements.

    a. The HBD term which represents 'historic bad debt' which a DNO has incurred between 1 April 2015 and 31 March 2018, and which is recoverable in 2021/22; this is also the earliest IDNO bad debt relating to the same period can be recovered.

    b. The EBDA term which represents the bad debt incurred by a DNO in any regulatory year from 2019/20 and is recovered subject to a three year lag. Again this is consistent with IDNO bad debt recovery, subject to timing of when a Valid Bad Debt Claim is made.

c. The RBD term represents any bad debt which the DNO, since having commenced recovering a proportion of that bad debt via the EDBA term, has recovered from the administrator of the supplier whose insolvency resulted in the DNO incurring that debt. The RBD term will therefore only represent a negative adjustment to allowed revenue. *An adjustment is either required to SLC38C.4 or the RBD term to ensure that, where an IDNO has both claimed from a DNO and recovered a proportion of that debt from an administrator, a DNO is not required to return such costs via both the IBDA and RBD terms. SLC38C specifies that any adjusted Valid Bad Debt Claim results in an amendment to the IBDA term, but part b of the definition of the RBD term also requires a DNO to return any such amount. We believe it is cleaner and avoids potential timing issues if part b of the RBD term is removed, therefore the IBDA term relates solely to IDNO bad debt (whether to be recovered or returned) and RBD applies only to DNOs (as do the HBD and EBDA terms).*

d. The IBDA term represents IDNO use of system bad debt to be recovered via a Valid Bad Debt Claim, including claims to recover debt incurred since 1 April 2015 from DNOs and, where applicable, adjustments to previous claims (which may be positive or negative).

CRC2A '*Restriction of Allowed Distribution Network Revenue*' ('CRC2A')

64. *An unintended consequence of the licence changes, which was not captured by the informal consultation, is the need to amend part C 'Calculation of Base Demand Revenue (BRt)' of CRC2A, specifically the TRU term.*

65. *The TRU term is the inflation true-up mechanism, necessary due to some revenue allowances being inflated by forecast retail price indices (RPI) i.e. the RPIF term, until RPI for the period is finalised i.e. the RPIA term. Allowed revenue is retrospectively adjusted via a two year lagged adjustment i.e. allowed revenue does not change in previous regulatory years as a result of the RPI true-up.*

66. *The TRU term adjusts all revenue allowances inflated using the RPIF term by the differential between the forecast and actual RPI indices; plus a time value of money adjustment using the weighted average cost of capital (WACC).*

67. *The REV term represents the aggregate value of all revenue allowances inflated using the forecast RPI indices, to which the inflation differential described in paragraph 66 is applied. The REV term does not use the pass-through term principal formula i.e. the PT term in accordance with CRC2B, but instead at present individually defines the need to adjust each pass-through cost which is inflated using the forecast RPI indices.*

68. *Due to some pass-through costs which do not apply to all DNOs not being inflated by the forecast RPI indices, simply referencing the PT term is not appropriate without backing out certain pass-through costs.*

69. *Therefore the new pass-through costs i.e. the SLR term for SoLR costs and EBD for use of system bad debt, which will be inflated using the forecast RPI indices, are not captured within the RPI true-up (TRU) as is required. We therefore expect this issue to be addressed.*

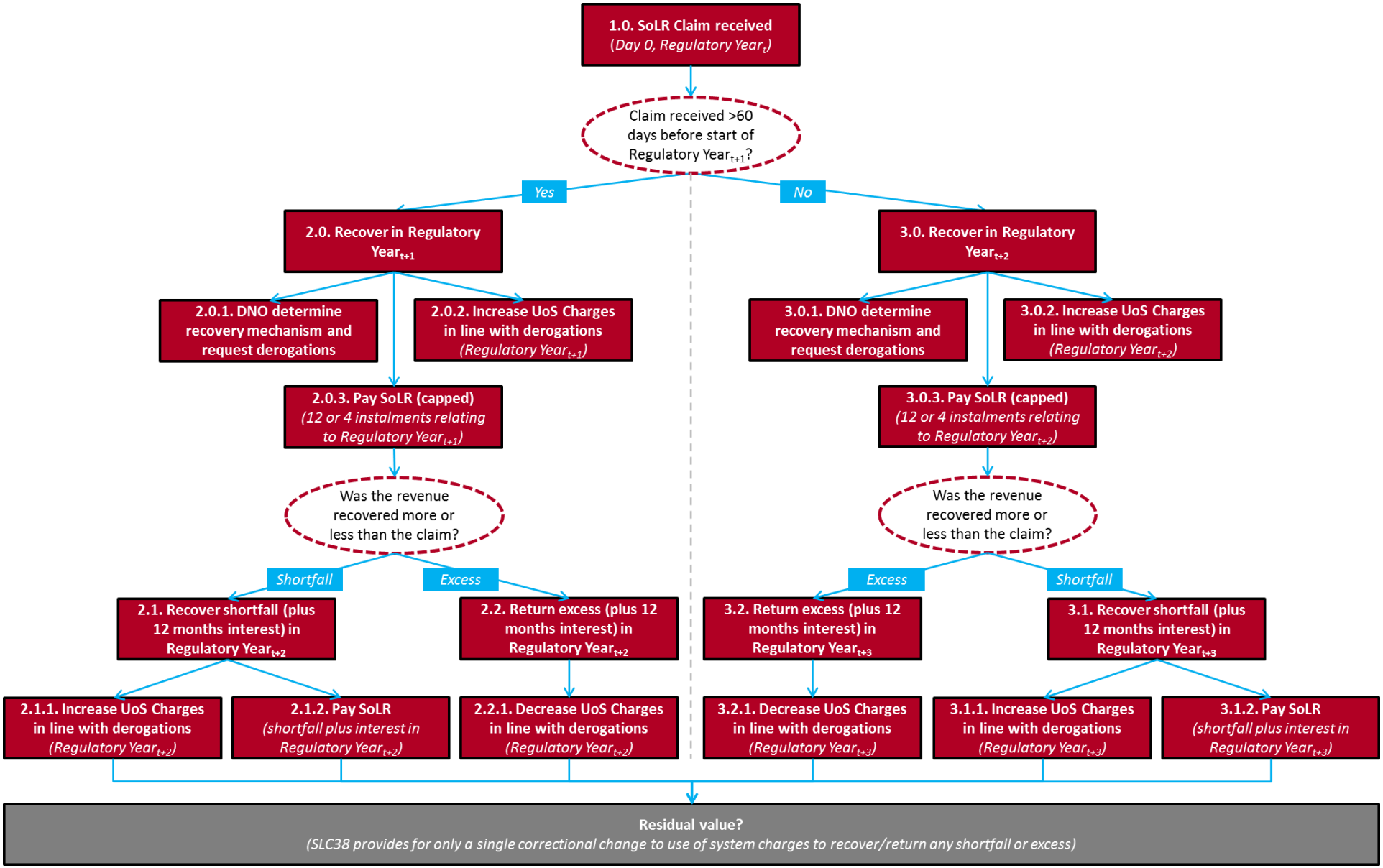

Figure 1. Current process for recovering a Valid Claim

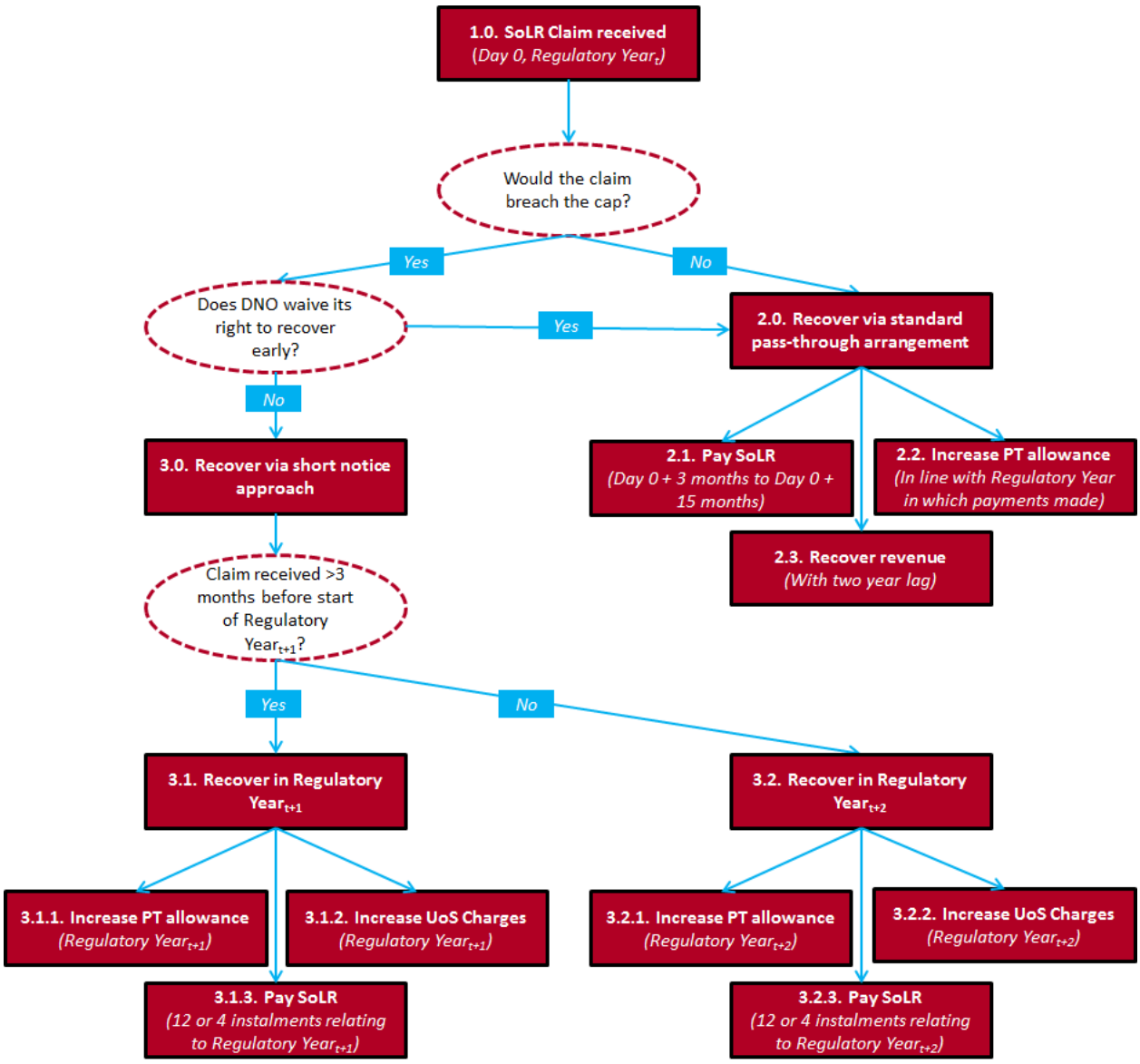

Figure 2. Proposed process for recovering a Valid Claim