| DCUSA Change Proposal (DCP) | At what stage is this document in the process? |
|---|---|
| | 01 – Change Proposal |
| | 02 – Consultation |
| | 03 – Change Report |
| | 04 – Change Declaration |

# DCP 332:

## Appropriate treatment and allocation of Last Resort Supply Payment claim costs

**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 Party receives a claim from a Supplier of Last Resort for a Last Resort Supply Payment claim.

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 clauses.

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

## Contents



**Any questions?**


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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 2019 |

# 1 Summary

## What?

**Supplier of Last Resort (SoLR)**

1.1 From time-to-time, an electricity supplier operating in the competitive retail market may have its supply licence revoked by the Authority. When this occurs, Ofgem may appoint a Supplier of Last Resort (SoLR), with all customers of the insolvent supplier then being supplied by the SoLR. Any credit balances held by 'non-business' customers of the insolvent supplier at the time of its supply licence being revoked are protected by Ofgem's Safety Net[1] - in effect, the SoLR becomes liable for any credit balances for non-business customers held by the insolvent supplier at the time of its supply licence being revoked. The safety net guidelines currently state that:

> *"Business customers' credit balances are not protected under the Safety Net. Business customers should contact the company's administrator to ask them what to do about their credit balances."*

1.2 The SoLR may make a claim for a Last Resort Supply Payment (LRSP), primarily to cover the costs associated with customer credit balances for which it has become liable, but also to recover other costs associated with its appointment as a SoLR (e.g. exposure to short term wholesale energy costs to supply additional customers, and financing costs to fund repayment of credit balances). Where applicable, the costs are split between gas and electricity customers (typically based on customer numbers), and a claim is made to Gas Distribution Networks (GDNs) and Distribution Network Operators (DNOs), with the GDNs and DNOs in turn recovering the costs from customers via use of system charges.

1.3 Under the existing electricity distribution licence conditions the DNO is required to increase its use of system charges and in doing so undermine the 15 months' notice period, and is required to subsequently ignore the consequential revenue when determining its under/over recovery position. This ensures that allowed revenue (and use of system charges to recover it in any future period) is not impacted.

**Review of the electricity distribution licence**

1.4 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 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 the appointment of a SoLR to its revenue allowances using a new pass-through term. This treatment is consistent with the mechanism by which GDNs recover costs associated with the appointment of a SoLR, utilising a miscellaneous pass-through term which no longer exists in the electricity distribution licence.

## Why?

1.5 The costs do not relate to customers' future use of the distribution system. The costs are incurred by DNOs in order to facilitate an equitable apportionment to customers of the costs associated with the protection which customers receive should their supplier have its licence revoked.

[1] 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

1.6 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.

1.7 The safety net for non-business customers applies equally to those connected to DNO networks and to those connected to Licensed Distribution Network Operator (LDNO) networks. The Authority-approved mechanism by which DNOs are recovering Co-operative Energy Limited's LRSP claim applies only to customers connected to DNO networks, and so excludes customers connected to LDNO networks. When approving this mechanism, Ofgem determined that this was appropriate given the very short timescales involved, but stated that it was not setting a precedent and that customers connected to a LDNO network rather than directly to a DNO network should also contribute to the recovery of such costs.

1.8 If this change were not made, pass-through SoLR costs would be recovered through the existing revenue matching process, which would represent a slight improvement in this regard as a 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 SoLR pass-through costs.

1.9 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).

1.10 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?

1.11 The proposed solution is to exclude revenue relating to the appointment of a SoLR 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 SoLR 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.

1.12 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 the costs associated with the appointment of a SoLR.

## 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 shortfall or excess revenue recovery compared to LRSP claims already being recovered via use of system charges (currently only Co-operative Energy Limited's LRSP claim).

# 3 Why Change?

**Supplier of Last Resort (SoLR)**

3.1 Standard conditions eight and nine of the electricity supply licence[2] make provision for Ofgem to issue a Last Resort Supply Direction, and for a supplier with a Last Resort Supply Direction to make an LRSP claim to GDNs and DNOs. As drafted, the electricity supply licence requires that a SoLR make its LRSP claim from each DNO which had at least one customer of the insolvent supplier connected to its network at the time of having its supply licence revoked. This is subject to change, with Ofgem having recently issued a statutory consultation on changes to the supply licence[3] which would require a SoLR to make its LRSP claim from all GDNs and DNOs.

3.2 Over the past three years, there have been five instances of supply licences being revoked (four being in the last year) and the subsequent appointment of a SoLR:

- GB Energy Supply Ltd ceased trading in November 2016[4], with Co-operative Energy Limited appointed as the SoLR[5];
- Future Energy Supply Limited ceased trading in January 2018[6], with Green Star Energy (a subsidiary of Hudson Energy Supply UK Limited) appointed as the SoLR[7];
- Iresa Limited ceased in July 2018[8], with Octopus Energy Limited appointed as the SoLR[9];

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[2] https://epr.ofgem.gov.uk//Content/Documents/Electricity%20Supply%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf

[3] https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-proposed-modifications-solr-supply-licence-conditions

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

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

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

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

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

[9] https://www.ofgem.gov.uk/system/files/docs/2018/07/last_resort_supply_direction_-_electricity.pdf

- Gen4U ceased trading in September 2018[10], with October Energy Limited appointed as the SoLR[11]; and
- Usio Energy Supply Limited ceased trading in October 2018[12], with First Utility appointed as the SoLR[13]

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

3.4 Of the five instances noted above, LRSP claims have only been made by Co-operative Energy Limited, in January 2018, in respect of its activities as SoLR for the former customers of GB Energy Supply Ltd. Claims could yet be made by Green Star Energy, Octopus Energy Limited, and First Utility.

3.5 In order to comply with standard condition 38 of the electricity distribution licence, each DNO was required to increase its use of system charges in 2018/19 to recover the costs associated with Co-operative Energy Limited's LRSP claim. 2018/19 charges had been published in December 2016, in line with the DCUSA requirement to give 15 months' notice of a change to use of system charges. Hence, in order to comply with the distribution licence, DNOs requested[14] and were granted derogation from the requirement to provide 15 months' notice when changing 2018/19 charges to recover LRSP claim costs[15].

3.6 The need for derogation highlighted flaws with the existing distribution licence, which are in the process of being addressed. Under changes proposed to the electricity distribution licence, each DNO will be required to add SoLR costs to its revenue allowances as a pass-through item.

**Treatment of costs**

3.7 The costs which will be included in the new pass-through term does not relate to customers' future use of the distribution system. The costs are incurred by DNOs in order to facilitate an equitable apportionment to customers of the costs associated with the protection which customers receive should their supplier have its licence 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.

3.8 Consideration is needed as to which customer groups should contribute to the recovery of SoLR pass-through costs, and through which tariff element. This should be considered in the context of the ongoing Ofgem-led Targeted Charging Review (TCR)[16], launched via a Significant Code

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

[11] https://www.ofgem.gov.uk/publications-and-updates/ofgem-appoint-octopus-energy-supplier-last-resort-customers-gen4u

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

[13] https://www.ofgem.gov.uk/publications-and-updates/ofgem-appoints-first-utility-take-customers-usio-energy

[14] http://www.northernpowergrid.com/asset/0/document/4097.pdf

[15] https://www.ofgem.gov.uk/system/files/docs/2018/02/coop_solr_derogation_letter_0.pdf

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

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.

3.9 Careful consideration is also needed for the calculation of tariffs for LDNOs. If the costs associated with the appointment of a SoLR are simply recovered through revenue matching (as would be the case if this change were not made), a 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 whereby a DNO is primarily, if not entirely, seeking to recover costs for the SoLR only.

3.10 This issue has been avoided in the most recent, and only, instance of a LRSP claim by only applying an increase in use of system 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 safety net in the same way as DNO connected customers.

# 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 the new 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

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 SoLR 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 all customers contributing to the costs associated with the appointment of a SoLR, where only non-business customers benefit from the safety net which protects credit balances; hence arguably creates a cross-subsidy from industrial and commercial to residential customers.
- 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 SoLR 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.
- Residential customers are considered to represent the primary beneficiaries of the protection which the safety net provides. This option ensures that only residential customers contribute to the costs associated with the appointment of a SoLR.

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.

***Option C***

4.9 Exclude any revenue relating to SoLR 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 associated 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.

- Results in all customers contributing to the costs associated with the appointment of a SoLR, where only non-business customers benefit from the safety net which protects credit balances; hence arguably creates a cross-subsidy from industrial and commercial to residential customers.

***Option D***

4.12 Exclude any revenue relating to SoLR 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 new pass-through 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:

- Residential customers are considered to represent the primary beneficiaries of the protection which the safety net provides. This option ensures that only residential customers contribute to the costs associated with the appointment of a SoLR.
- 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.

## 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 four 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 any SoLR pass-through costs excluded; hence an amendment has been made to step three to ensure that revenue relating to the costs is excluded from revenue allowances at this stage. Step five then deals with the allocation of SoLR 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 the new 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 costs associated with the appointment of a SoLR are allocated to customers appropriately.

Options which ensure these costs are only recovered from residential users are likely to be the most cost reflective, to avoid a non-cost reflective cross-subsidy from industrial and commercial to residential customers. 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 D is considered to facilitate this objective most fully, followed by option B, followed by option C, followed by option A. 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 SoLR 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 SoLR 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 both the distribution and supply licences. 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