

Electricity Suppliers, Electricity
Distributors, Gas Suppliers, Gas
Transporters, and all other
interested parties

Email: RegFinance@ofgem.gov.uk

Date: 30 December 2021

To interested parties,

Statutory consultation on modifications regarding Last Resort Supply Payment Claims for electricity supply, gas supply, electricity distribution and gas transportation licence conditions¹

Background & Purpose of this Consultation

The unprecedented and unexpected rise in gas and electricity prices over recent months has put energy markets under severe strain. We² are taking steps to protect the short and long-term interests of consumers, particularly through the supplier failures which those price rises have triggered. Wholesale prices continue to rise and so there may be further supplier failures in 2022.

When a supplier fails, the only routes by which Ofgem can protect customers from significant harm is through the Supplier of Last Resort (**SoLR**) process³, or, where this is not possible, through the Special Administration Regime (**SAR**).

The SoLR process allows the SoLR taking on customers to claim their net costs of doing so via the Last Resort Supply Payment (**LRSP or SoLR Levy**).⁴ Historically some SoLRs have waived their right to make that claim through the SoLR bidding processes. Recent SoLRs have not waived those rights. Indeed, in order to keep the SoLR process working, Ofgem has had to speed up the Levy process. The current high wholesale gas prices are driving very significant SoLR levy claims.⁵

The way in which SoLR Levies are socialised across energy consumers and paid to the SoLR means that those significant costs will be:

- included in electricity and gas distribution charges for 2022/23 set on 31 January 2022;
- therefore, reflected in the price cap decisions which Ofgem take in February 2022; and
- included in the retail price cap (**RPC**) and so consumer charges from April 2022.

The RPC which will apply from April 2022 will also reflect increasingly high wholesale prices. Ofgem therefore expects that RPC to rise significantly and has been rapidly exploring options for reducing the impact on consumers.

¹ Published under Sections 11A of the Electricity Act 1989 and 23 of the Gas Act 1986.

² The terms “the Authority”, “we” and “us” and “Ofgem” are used interchangeably in this document.

³ Customers could face various significant harms, ranging from loss of credit balances to interruptions to supply to, ultimately, wider instability in the network and wholesale markets.

⁴ Further details are available in our SoLR Levy Guidance here: [solr_revised_guidance_final_21-10-2016.pdf](#).

⁵ [Faster SoLR levy process: consents to Last Resort Supply Payments | Ofgem](#)

One of those options is third-party financing of the SoLR Levies. Such finance could potentially achieve two policy objectives:

- Smoothing the impact of current extraordinary SoLR levy payments on 2022/23 consumer bills; and
- Enabling greater ongoing competition in the SoLR processes (by enabling greater working capital availability).

The modifications proposed here are designed to support both of those two policy objectives. We are proposing changes to the electricity and gas supply standard conditions; electricity distribution standard condition and gas transporters standard and standard special conditions⁶ which underpin the SoLR arrangements, principally the process for making a claim for a LRSP.

Before implementing any changes following this consultation, the Authority will further consider whether third-party finance is, in principle, in customers interests. Additionally, before approving or amending any particular SoLR Levy Claim to support such financing, it would have to be satisfied that the rates, or likely rates, together with any consumer gain sharing mechanism, were reasonable and in consumers' interest.

The timescales for this consultation are necessarily tight because of the pace of market developments and our policy development over recent weeks, together with the benefits of ensuring any modifications are in place in January, ahead of RPC decisions in early February. We would welcome representations and comments from a wide range of stakeholders. We are particularly interested in the views of consumer groups and potential finance providers as well as the licensees who will be most directly affected by these changes.

Context: SoLR Levies and Third-Party Finance

When a SoLR takes on the customers of a failed supplier, it has to finance the additional costs of doing so (for example procuring the energy it supplies to those customers, honouring any credit balances the customers had with the failed supplier or particular costs of onboarding those customers).⁷ Such costs of supplying those customers are, ultimately, recoverable through either the charges those customers pay direct to the SoLR or the Levy payments the SoLR collects from certain network licensees.⁸ The SoLR must find a way of financing the costs until then and it can take many months, or even years, for SoLR Levy payments to come through.

To date, there are multiple suppliers who have been able to secure such finance, especially given the faster process which we put in place which shortens the recovery time. Most of the SoLRs who have been appointed recently are part of larger, often global, corporate groups and have relied upon group financing. If there was a clearer, or more certain, route to third-party financing, a greater number of suppliers may be able to act as SoLR, or for those who have already acted as SoLR to take on more customers.

Additionally, if third-party (re)financing was available for those SoLR Levy costs which have already been incurred and which we've approved for 2022/23 recovery, it may be possible to spread the

⁶ We recognise the Independent Gas Transporters subject to Standard Condition 48 do not usually participate in the SoLR levy process. We have included these modifications for consistency.

⁷ SoLRs are generally appointed for 6 months.

⁸ Network licensees raise their use of system charges to pay SoLR Levies. Those use of system charges are paid by other suppliers and/or shippers, who in turn pass the costs onto their customers. The SoLR Levy mechanism therefore socialises the cost of the SoLR process across all customers.

impact of those costs on consumer bills over multiple years. The interest and other fees required by that third-party financier would likely mean that the cost to consumers was higher in absolute terms, but there could be value for consumers in meeting those costs over a longer time period.

Rationale for Intervention and Our Proposals

We have been closely monitoring suppliers' financial stability for some time, expanding that monitoring to all suppliers in the autumn. That monitoring has made clear that suppliers' working capital needs are under greater pressure. We have also been considering various ways to reflect the additional costs and uncertainties facing suppliers, which are likely to be beyond what is accounted for in the existing price cap methodology.⁹

We have been scoping the viability of these proposals with a number of interested parties. There is broad support for trying to find a way of mitigating the financial impact on customers and the wider industry/economy of the likely sharp increases in April 2022 and there is interest from private finance providers, although only one has proposed that it could deliver the required structures and financing by the timescales required for current LRSPs ie end January 2022.

The proposals set out in this consultation are designed to work for any third-party finance provider, and we would particularly welcome responses from financiers who may have comments on this consultation and alternative proposals.

We have developed initial proposals which are designed to support arrangements where a third-party financier 'buys' any and all rights the SoLR has to the future levy payments. The third-party financier (or special purpose vehicle (SPV) which it creates for the purpose) then receives the SoLR Levy payments from the network licensees, instead of the SoLR. The value of those payments would be adjusted to take account of a) the decrease in SoLR working capital costs caused by the shorter payback period for the SoLR and b) likely increase to reflect the additional financing costs. The timing of the payments could also be altered, spreading the impact on customer bills in any one year.

These proposals would not result in a loan being made to either the network licensees or the supplier; although we do not consider that they would prevent such additional or alternative arrangements in the future. We anticipate that these proposals could support arrangements which help avoid the risks of further supplier failure and the potentially complex implementation which may be required where existing debt arrangements are affected.

The rest of this section describes, in high level terms, how a third-party financing arrangement may work both initially for any arrangement in January 2022 and on an enduring basis. We expect that further significant work would be required to implement these arrangements in any particular case, including negotiations with supplier(s)/SoLR(s), engagement with networks and, ultimately, diligence and pricing on the levy rights themselves.¹⁰

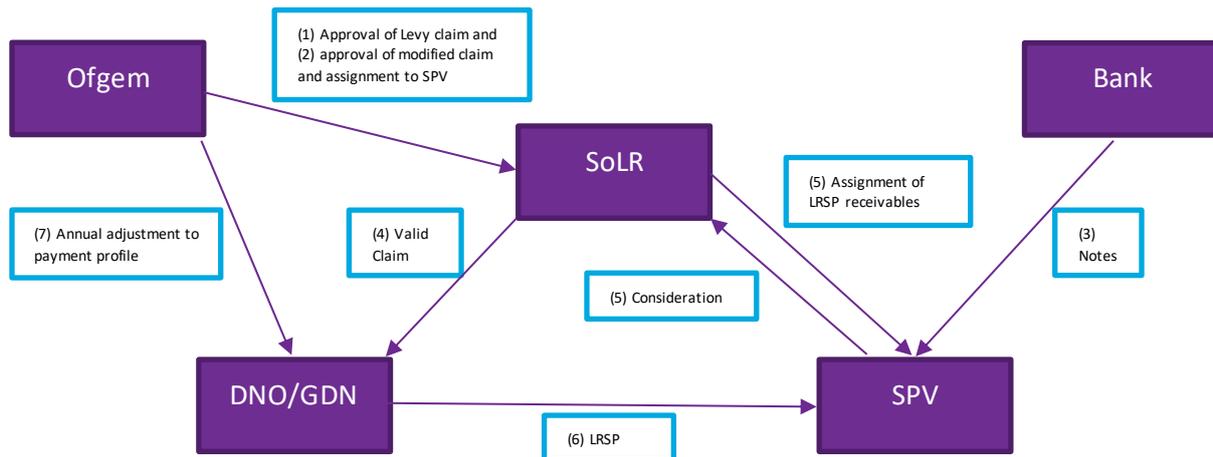
It has been noted to us that S.7B(5)(b) of the Gas Act 1986 and S.7(3A) of the Electricity Act 1989 could be read as meaning that standard licence conditions can only require a licensee to make payments to another licensee, particularly where it is raising use of system charges to do so rather than funding the payment from its own reserves. We note that S.7B(5)(b) is expressly without prejudice to the broad generality of the scope of licence conditions and circumstances in which they may be modified

⁹ <https://www.ofgem.gov.uk/publications/overview-19th-november-2021-price-cap-consultations>

¹⁰ We understand that there are different views as to whether the existing electricity arrangements (in particular the Distribution Connection and Use of System code) create contractual rights which could be assigned and that further work is ongoing in relation to the other potential SoLR rights, eg under the licences.

and consider the generality in both sections to be deliberate and important. Subject to responses to this consultation, we consider these proposed modifications to meet the core test of being ‘requisite or expedient’. We also note that there are many licence conditions which require, or effectively require, payments to non-licence third parties, for example the various requirements to be parties to and make payments under industry codes. Further, in this instance, any payment would be to an assignee of a licensee rather than an entirely unconnected third-party. We therefore consider the proposed modifications to be consistent with both of those sections but would be grateful for any further details or reflections.

Figure 1: Third-party financing arrangement



To describe each of the numbered stages:

- (1) Ofgem approves SoLR Levy claims. Initial claims from recent SoLRs have already been approved and do not include any costs associated with this potential structure. In the future, the financing arrangements may be put in place before the SoLR is appointed (albeit likely supplemented with some form of bridging support) and included in the amount approved.

For those initial claims which have already been approved, if an alternative arrangement is made in January, Ofgem could either revoke or amend them (with SoLRs' consent).¹¹ We do not expect there to be any compulsion for SoLRs to agree to change those approved claims, but SoLRs may agree because:

- (i) they will get the SoLR Levy amount within the same time period (or possibly earlier); and/or
- (ii) such an alternative arrangement may help SoLRs, and other suppliers, avoid any impact on fixed price contracts which the pass through of SoLR levy costs may create.

¹¹ Standard Licence Condition 2. Interpretation of standard conditions of the Gas and Electricity Supply Licences

For any initial arrangement, although the revision would take place after 31 December 2021, and so beyond the various licence deadlines for inclusion in 2022/23 charging statements, networks may be able to prepare alternative charging statements in January – one which reflected the full amounts of approved SoLR Levy Claims, and one which either did not or reflected alternative values for the financing costs to be payable in 2022/23.¹²

In enduring arrangements, in order to dovetail with the annual cycle of network charge setting, it may be necessary to set specific points in the year by which any re-financing takes place and financing costs reflected in SoLR Levy Claims.

- (2) The SoLR would submit a modified claim to Ofgem, effectively or actually seeking consent to assign the SoLR Levy to the SPV. The modified claim would be for its original claim plus any net financing costs (if known) or (if not known) a methodology for determining financing costs.¹³ The modified claim could specify a payment profile over which the SoLR Levy would be paid by network licensees and Ofgem could determine that, or an alternative, payment profile.

That SoLR request would include information which would help Ofgem to assess if the proposal was in consumers' interests, eg whether any net increase in cost to consumers was appropriate given the potential benefits of deferral. As part of that assessment, Ofgem would consider any commitments regarding gain share for consumers in future sales or refinancing of the SPV. Any new or amended SoLR Levy consents given by Ofgem could be subject to conditions, eg a requirement that the SoLR procures that the SPV enters into an agreement/undertaking relating to adjustments and gain-sharing. It may also include a condition relating to subsequent assignment (but note (4) below).

It seems likely that it would not be possible to set absolute amounts for each year of SoLR Levy payment in advance, eg because interest payments will fluctuate. There would therefore need to be a mechanism by which the parameters of those changes were agreed, and absolute amounts confirmed at specified points, likely annually by Ofgem.

- (3) A bank (or, possibly, banks) would lend to an insolvency remote SPV an amount equal to 100% of the amount of the modified claim, to enable the SPV to purchase such claim without any discount.

If that financier required particular representations and warranties in order to lend, it would socialise and secure confirmation of those as part of arranging the transaction.

As we set out in our Open Letter on 29 October 2021 and Decision Letter on 1 December 2021,¹⁴ the faster SoLR levy process includes a true up mechanism covering the difference

¹² Whether there are any financing costs to be payable in 2022/23 depends on the terms of any financing arrangement made.

¹³ These costs would be net because there would be a reduction in the amount of working capital included in the initial SoLR Levy if the SoLR was being re-paid over a shorter period.

¹⁴ [Letter to suppliers on supplier of last resort levy claims | Ofgem](#) and [Decision letter on supplier of last resort levy claims | Ofgem](#)

between the amount of incurred costs included in an initial claim and the actual outturn costs. We expect to publish a template of that true-up shortly and anticipate that any reduction in the value of the initial claim would be set off against the subsequent claim, reducing the amount of that subsequent claim. In the unlikely event that there is still an amount due from the SoLR, it would be payable by the SoLR, not the SPV.

Steps (4) and (5) would happen in quick succession.

- (4) The SoLR would present its (modified) Valid Claim (with payment profile etc.) to network licensees for payment together with notification of the assignment/disposal to the SPV.
- (5) SPV will purchase from the SoLR its SoLR Levy receivables. This could be a true sale, resulting in the SoLR Levy receivables no longer being owned by the SoLR and therefore these assigned SoLR Levy receivables likely not forming part of a SoLR's bankruptcy estate (although the SoLR/consumers will retain any true-up risk).

As set out above, the assignment to the SPV itself is likely to be subject to conditions. It should be noted in this context that (i) the SPV may create security over the SoLR Levy receivables that it has purchased, and (ii) if there is no restriction on one bank transferring its notes to another investor, it may be that protection for consumers is through the gain-share mechanism agreed with the SPV at the outset.

- (6) The network licensees would pay directly to the SPV into a segregated collection account. The SPV uses those SoLR Levy collections to pay (i) senior financing expenses, (ii) interest due on the Notes and any commitment fees, (iii) principal repayments on the Notes to reduce the Note balance to zero and (iv) any remaining amount to the network licensees as part of an adjustment mechanism determined under (7) (which in turn should be applied to reduce customer charges).
- (7) Our current expectation is that each year Ofgem would liaise with the SPV/Bank about expected interest charges on the Notes for the following year, with Ofgem notifying the network licensees of the amount by which their charges will need to be adjusted to include this expected interest charge. In a year where there is a re-financing/capital markets access, it is possible that the adjustment could be larger but still capable of being accommodated in changes to charges directed by Ofgem under the adjustment mechanism.

Effect & Impact of the Proposed Modifications

The modifications set out in the attached notices aim to achieve the following effects:

Electricity and Gas Supply Standard Licence Condition 9

- Licence recognition that a SoLR may assign its rights and that, were it does so, the network licensee may pay the approved third-party.
- Clarity that the costs associated with third-party finance can be included in the SoLR Levy amount.
- A new mechanism to support a multi-year payment profile.

- Flexibility to disapply the 6-month time limit on submission of approved levy claims to the relevant network company, in order to support the splitting of any claim into separate years and the deferred submission of any year's part of that claim.

Gas Transporter Standard Special Condition A48, Independent Gas Transport Licence Standard Condition 48, and Electricity Distribution Standard Conditions 1 and 38B

- Licence recognition that a SoLR may assign its rights and that, were it does so, the network licensee may pay the approved third-party.
- A new mechanism to support a multi-year payment profile.¹⁵
- A reconciliation mechanism for any annual adjustments.

We consider the impact of these modifications on licensees do not create new licence obligations. The modifications have been designed to not require a particular course of action but to provide clarity about the processes, particularly where multi-year payments are to be used.

It may be possible to achieve similar effects without licence modifications. For example, by relying solely on conditions within consents to specify when, and how, their value was to be presented to the network licensees and collected/paid through use of system charges. Additionally, as a SoLR's ability to assign its rights does not come from the licence, it is not created by these modifications. However, making modifications which expressly recognise any assignee and arrangements for payment to it, including multi-year payments, should help reduce the risks in any such arrangement.

We therefore do not consider these modifications to have a significant or disproportionate impact on licensees or, in themselves, on consumers. These modifications may be net beneficial to competition, particularly if they do enable suppliers and SoLRs to access greater working capital. Ultimately, if these modifications do support a third-party financing arrangement which we consider to be in consumers' interests, then they could have a material net benefit for consumers as well as any suppliers or shippers who avoid having to pay substantially increased use of system charges in any one year.

We would however be grateful for any responses in relation to the impact of these modifications. We are also aware that code modifications could further support third-party financing and would be grateful for any representations on potential code changes.

Next Steps

Nothing in this consultation should have any immediate effect on the SoLR Levy consents which we have already issued. We understand that those consents are in the process of being submitted to the network licensees and we have issued the derogation requested by the DNOs to allow them to raise their 2022/23 charges on relatively short notice. This track should continue unless and until any alternative arrangements are put in place.

In January we will continue to work with all stakeholders to understand whether there any alternative financing arrangements which could, and should, be made. We will consider all representations made as part of this consultation in parallel with that. Although these modifications may not be necessary for any alternative arrangement to be made in January, subject to those representations, we may make our decision on any modifications following this consultation in the second half of January.

¹⁵ For these purposes, we have used the 31 December date proposed in our recent separate consultation on modification to this licence condition. If we decide to make either or both modifications, we shall use the same date for each.

Alongside this document we have published draft licence modification Notices for the gas and electricity supply licences, as well as the electricity distribution and gas transportation licences. Stakeholders have until 27 January 2022 to respond to this statutory consultation and can send views to regfinance@ofgem.gov.uk. If we decide to make any modifications following this consultation, they will take effect not less than 56 days after the decision is published.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the nonconfidential responses we receive alongside a decision on next steps on our website at www.ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Simon Wilde', with a stylized, flowing script.

Simon Wilde

Director, Analysis and Assurance

Duly authorised by the Authority

Attachments:

1. Gas Supply - Statutory Consultation Notice
2. Gas Transporter - Statutory Consultation Notice
3. Electricity Supply - Statutory Consultation Notice
4. Electricity Distribution - Statutory Consultation Notice