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18th May 2022

WWU response to Ofgem's open letter about recovery of Last Resort Supply Payment claims from customers connected to GDN and IGT networks

Dear Andrew,

Thank you for the opportunity to respond to this open letter.

Our response starts with a summary of the history of charging for Independent Gas Transporters (IGTs) and Independent [electricity] Distribution Network Operators (IDNOs) and then provides our views on each of the three interim options and the enduring solutions for recovering Last Resort Supplier Payment (LRSP) claims. Ofgem's past policy decisions creates a legitimate expectation amongst licensees and wider stakeholders that the existing regulatory arrangements for recovering amounts from customers on IGT networks to pay LRSP claims would continue to be used. We then go on to demonstrate that, contrary to Ofgem's view, using these arrangements (option 2) is less work than Ofgem's preferred solution (option 1).

WWU supports interim option 2 and supports using option 2 for the enduring solution for LRSP claims. Any change to these arrangements will require a consultation that also considers the recovery of costs of Suppliers in Special Administration followed by the appropriate statutory consultations in due course.

Summary of history of charging on IGT and IDNO networks

IGTs have always charged Shippers directly for the use of their system. This means that a Shipper transporting from the beach to a customer on an IGT network will receive an invoice from the IGT and upstream GDN as well as from National Grid for the use of the NTS.

In 2003, after much previous debate, the IGT relative price control was introduced; this required charges (for connections made after the introduction of these arrangements) for the use of the IGT system to be set so that at time of connection the total charge to the customer was no more than if they were directly connected to the GDN network. This also laid out how charges would change each year but did not require IGT charges to exactly follow GDN charges; this meant that, in subsequent years, customers on IGT networks do not necessarily pay the same as if they were connected to GDN networks. This did not make any changes to the process for charging, each transporter continuing to issue invoices for use of its system.

In 2004 Ofgem consulted on charging arrangements for IDNOs. It is worth noting that IGTs were well established before IDNOs came into existence. In 2005 Ofgem reached a decision on IDNO charging arrangements and decided to continue with the existing practice of Suppliers being invoiced by the IDNO with the IDNO passing payments to the DNO. There was no support for changing to the same arrangement as

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existed for IGTs. A clear policy decision was therefore made that having different charging arrangements for electricity and gas was appropriate. In the intervening 17 years this issue has not been the subject of a consultation as to whether they should be aligned.

In relation to Transporter licences, in 2022 Ofgem issued a statutory consultation to amend both Standard Condition 48 and Standard Special Condition A48. Standard Condition 48 covers LRSP Claims and is turned off in IGT and GDN licences. Standard Special Condition A48 exists in its place in GDN licenses. The fact that Ofgem consulted on Standard Condition 48 suggests it must have contemplated using it for IGTs otherwise it would have consulted on removing all the provisions in it, effectively removing it from the Standard Conditions.

In October 2019 UNC modification 0687 (raised by a Shipper) was sent to Ofgem with a recommendation to implement it. This modification clearly set out the arrangements for GDNs raising SoLR charges to Shippers to Supply Points on GDN networks. IGT Supply Points were excluded and no responses raised this as a problem, presumably assuming, as WWU did, that separate claims would be raised by Suppliers to IGTs. Had Ofgem made a timely decision on 0687 after it was submitted to them and before the Covid 19 lockdown occurred in March 2020, then the issue with IGTs would have become clear in 20/21 or 21/22 when LRSP claims were about 1% of the levels that are being recovered in 22/23.

Therefore, parties have a legitimate expectation that the existing regulatory routes would be used for LRSP claims for both GDNs and IGTs. It is untenable to suggest that electricity arrangements should now apply to gas and use that as a reason to override existing arrangements in gas without going through the proper governance process, including a full statutory consultation, required for such a change in policy.

Interim option 1 – intra-year revision to network charges

In this option IGTs will collect SoLR revenue from Shippers, pass them to GDNs who will treat this income¹, on Ofgem's instruction, as price controlled revenue for regulatory reporting purposes, despite it not representing transportation services by GDNs to Shippers. GDNs will amend their SoLR charges from 1st October 2022 to reflect the income received from IGTs.

Challenges of this approach

Our view is that Ofgem has understated the challenges of this approach which will require:.

- A voluntary arrangement to be entered into between GDNs and IGTs;
- GDNs and IGTs to reach agreement on what the payments from IGTs to GDNs represent from a legal and commercial nature and the resulting accounting, corporation tax and treatment together with who bears any within year payment risk;
- analysis of the implications on GDNs licence compliance of this additional revenue and what licence changes are required to ensure that GDNs are not inadvertently in breach of licence by treating the revenue as Ofgem proposes; and
- an intra-year change to GDN SoLR charges; the UNC requires DNs to provide two months' notice of such changes so all necessary changes need to be in place before 31st July 2022.

Voluntary agreement between DNs and IGTs

Creating this entirely new agreement will be time consuming not least because there are a significant number of parties involved. We currently have questions regarding the legal and commercial nature of the payment from IGTs to GDNs and what it represents, and therefore the appropriate accounting and resulting tax treatment. Notwithstanding this, we consider it unreasonable that GDNs should be required to put considerable resources into resolving a problem has nothing to do with GDNs. In the absence of clarity around what the payment represents legally, there is also a risk of unintended consequences, that could potentially jeopardise the accounting treatment in respect of business as usual LRSP claims under Standard Special Condition A48.

¹ We use income rather than revenue because it is not clear what the payments from IGT's to GDNs represents from a legal, commercial or accounting perspective

Should any intolerable implications, accounting or otherwise, arise from these discussions, WWU would not voluntarily enter an arrangement with, nor accept payments from, IGTs in the absence of a licence obligation to do so

What amounts received by GDNs from IGTs represents

We discuss the detail of these points below; however, there is also a potential discrimination point to consider.

Ofgem is proposing that:

- charges paid by Shippers in relation to the part of LRSP claims to be recovered from customers on IGT networks and transferred to GDNs is treated as transportation revenue; whereas
- charges paid by Shippers to GDNs in relation to the part of LRSP claims to be recovered from customers on GDN networks to pay LRSP claims is treated as SoLR revenues in accordance with Standard Special Condition A48.

The two approaches mean that there will be differences in approach on various points including, for example, how bad debt or over or under collection would be treated.

As there will be two approaches to the treatment of amounts collected to pay the LRSP claims, GDNs will have to carefully monitor the income and would not be able to net off, for example, over collection by IGTs against under collection by GDNs as the IGT income and GDN income is treated differently. This creates an undue regulatory burden on GDNs.

We think that treating the two income streams, that only exist to pay LRSP claims, differently is not appropriate.

It is important to be clear regarding the treatment of different revenue and income streams received by GDNs.

- Price controlled revenue is revenue from Shippers for transportation services to them.
- SoLR revenue from Shippers for payment of LRSP claims from Suppliers is covered Standard Special Condition A48. It is neither price controlled revenue, nor transportation revenue from non-Shippers, nor any sort of revenue to the GDN, as it exists solely to fund valid claims from SoLRs.
- Income received from IGTs is not covered by either of the above and could be revenue for provision of transportation services to non-Shippers (for example revenue from the provision of emergency services to IGTs) or metering revenue (for example revenue from the provision of IGT Post Emergency Metering Services); both are outside the price control and must not be accidentally included by any changes made to implement option 1.

Licence compliance

Our initial review has highlighted the following points

- Standard Special Condition A48(3) requires the GDN to set SoLR charges to recover income to pay the LRSP claims; if these claims are not amended but GDNs reduce their SoLR charges then GDNs will be in breach of A48. The easiest way to address this is for Suppliers to amend their claims by the appropriate amount and provide GDNs with revised valid claims; an alternative approach would be to amend A48 to carve out the total revenue GDNs expect to receive from IGTs in respect of SoLR from the total the GDNs need to recover, though this would require a licence modification;
- Ofgem's intention is that the revenue from IGTs to Shippers paid to GDNs would need to be recognised as price controlled revenue for the purposes of Special Condition 2.1 (Revenue Restriction). SpC2.1 states that *"The purpose of this condition is to ensure that the licensee sets Network Charges to aim to recover no more than Allowed Revenue."* It is clear from the definitions of Network Charges and then Licensed Activity² that SoLR income does not contribute to either Allowed or Recovered Revenue. If Ofgem wishes to give effect to its intention it will need to amend SpC2; however this would be a fundamental change to the definition of Allowed and Recovered Revenue with potential implications wider than Gas Distribution.
- If Ofgem took forward the above approach it would need to ensure that no unintended consequences arise. For example, we consider it unreasonable that any over collection caused by IGT SoLR

² Licensed Activity means the activities of the licensee connected with the development, administration, maintenance and operation of the Distribution Network and with the Supply Of Distribution Network Services
Network Charges means charges made or levied, or to be made or levied, on any person by the licensee for the provision of services as part of its Licensed Activity.

payments from IGTs should be included in determining whether the penal rate applies so this calculation would need to be calculated using the definitions of Allowed and Recovered Revenue excluding income from IGTs, rather than any revised definition required for bullet point 2.

These examples show first, that the licence would require amendment to enable Ofgem to implement its preferred option; and second, that this will be a complex task to ensure that there are no unintended consequences.

It is not possible to circumvent the licence by amending reporting requirements contained in the Regulatory Instructions Guidance under Special Condition A40 because that is out of scope of that licence condition. Paragraph 1 of A40 states:

The RIGs are the primary means by which the Authority directs the licensee to collect and provide the information to the Authority that the Authority needs to enable it to administer the special conditions of this licence and, where not referenced in the licence, the Final Determinations.

This refers to the Authority being provided with information enable it to administer the special conditions, that is to make them work as defined in the licence. Changing words in the RIGs cannot change a definition that is written in a licence condition and which takes precedence over it.

Intra-year price change

The UNC requires that DNs provides two months' notice of changes to SoLR charges so all these changes need to be completed before 31st July 2022 to enable revised charges to be published.

The licence does not require licensees to obtain a direction or consent from Ofgem to amend SoLR charges (although as noted earlier we will need to receive amended valid claims). Standard Special Condition A4 (as modified by D11) requires a direction or consent from Ofgem, but only in relation to the charges to which this condition applies, and paragraph 1 of A4 makes it clear that it only applies to charges in relation to transportation arrangements. SoLR charges are not charges in relation to transportation arrangements as they are charges to recover certain unrecoverable costs incurred by Suppliers who are Suppliers of Last Resort. SoLR charges are governed by Standard Special Condition A48. A48 is silent on the matter of mid-year price changes, neither expressly forbidding them nor providing for permission to be sought from Ofgem; therefore, our view is that should a change to SoLR charges be required the licensee may make changes without seeking permission from Ofgem. A48 envisages that that SoLR charges are set in response to LRSP claims and hence there was no need to put in provisions regarding a mid-year price because there was no expectation of the claims being amended or that there would be another source of income to meet these claims.

In summary, our view is that option 1 requires more work than Ofgem has indicated and in total it will require:

1. SoLR Suppliers to amend existing LRSP claims;
2. Ofgem statutory consultations to amend a number of clauses in GDN licences;
3. The legal nature of the payment between IGT and GDN to be determined;
4. GDNs and IGTs to enter a legal arrangement voluntarily; and
5. GDNs will need to change their SoLR charges.

Points 1, 2 3 and 4 all need to be completed before 31st July which is UNC deadline for publishing changes to SoLR charges if they are to take effect on 1st October 2022.

WWU does not support option 1.

Interim option 2 - Both GDNs and IGTs to pay money to the SoLR

In this option GDNs would amend their charges as before but rather than IGTs paying money to GDNs, the IGTs would pay the SoLR directly.

Compared to option 1, option 2 does **not** require:

- GDNs and IGTs to enter an entirely new legal agreement and evaluate the accounting implications for GDNs; and

- detailed one off changes to the GDN licence requiring a statutory consultation which will then need to be removed by further consultation to implement the enduring solution.

Option 2 (as does option 1) requires:

- SoLR Suppliers to amend existing LRSP claims (option 1 requires these to be revised for GDNs, option 2 requires them to be revised for GDNs and IGTs).

In addition option 2 requires:

- Ofgem to turn on Standard Condition 48 in IGT licences.

In the open letter Ofgem states:

On the other hand, option 2 would involve licence modifications to Standard Licence Condition 48 for IGTs and possible A48 for GDNs, subject to the appropriate consultations. It would also involve revisions to already approved LRSP claims and a detailed set of re-profiled LRSP payments to ensure the correct flows of money. All of these changes would require extensive consultation with networks and suppliers.

We do not consider that changes would be required to Standard Special Condition A48 and although amending the LRSP claims would require work, we think that characterising this as extensive consultation with networks and suppliers is over-stating the work. When Ofgem was considering allowing a third party to finance LRSP claims to GDNs earlier in 2022 it regarded the work required to restate the LRSP claims to be easily achievable in a short period of time. The open letter appears to have been written to justify Ofgem's preferred position rather than being a balanced appraisal of the available options presented to stakeholders.

We appreciate that Standard Condition 48 would need turning on in IGT licences; however, we think that the work involved would likely to be much less than the work required to under option 1 to introduce a number of licence modifications for GDNs temporarily for the duration of the interim solution and to draft an entirely new agreement between IGTs with GDNs. Suppliers would need to amend their LRSP claims to GDNs and issue new ones to IGTs but they would need to amend their claims to GDNs under option 1 as described above and so there is not a significant amount of additional work for them.

Overall this is likely to require less work than for interim option 1 and take no longer to implement. Other advantages are that it follows the process envisaged, and the legitimate expectation created, in the licence, is under the control of Ofgem (because there would be no reliance on GDNs to voluntarily enter an arrangement with IGTs) and the process only involves the parties directly affected. There is no difference in terms of customer impact between options 1 and 2.

WWU supports option 2.

Interim option 3 – GDNs to lower 2023/24 tariffs, instead of adjusting 2022/23 tariffs

This option is the same as option 1 except that there is no mid year price change by GDNs, instead GDNs would return the overcollection of SoLR revenue in 23/24 rather than by the end of 22/23.

Option 3 has all the disadvantages of Option 1 plus the added detriment to domestic consumers of them being over-charged for a further six months.

WWU does not support option 3.

Enduring solution from 2023/24

Our view is that once option 2 is implemented for 22/23 then the obvious, and simplest, approach is to continue with this in 23/24 and subsequent years. IGTs collectively are no longer small businesses and although there are about 14 IGT licensees most of the meter points are in the control of two organisations each with a number of GT licences. We appreciate that some licences contain a very limited number of Supply Points and this adds to the administrative work but this additional work is not material and the licence holders could have taken steps

to consolidate Supply Points in licences and terminate the redundant licences should they have thought it worthwhile.

Our view is that the existing arrangements in gas are clear and work well, and unless there is a change of policy intent by Ofgem, followed by an appropriate statutory consultation, then they should continue. The fact that they are different from electricity is not a reason to over ride them with an open letter, that does not give a balanced assesement of the options.

The enduring solution needs to take into account the likely treatment of the costs of the Bulb Special Administration and how this will be recovered. The costs incurred by SoLRs and the costs incurred by the Bulb Special Administration come from the same root cause. It follows that it is reasonable to expect that the recovery of these costs will be from the same customers, that is there should not be a material difference in the distribution of the costs depending on whether a SoLR is appointed or whether the failed Supplier is placed in Special Administration. We realise that a SoLR can only claim wholesale costs for the first six months so it may be reasonable for the costs of the Bulb Special Administration to be treated in two parts; those that a SoLR Supplier would have been able to recover and those that a SoLR would not have been able to recover. It may be appropriate to recover these two sets of costs using different mechanisms. These are complex and material issues and until resolved the existing processes in licences should be used for recovery of LRSP claims.

Conclusion

Our view is that interim option 2 should be used for 22/23 and this should be continued to be used for 23/24 and future years pending a future consultation.

A proper consultation process is required to determine whether the arrangements should change and this needs to consider equality of recovery between the recovery of Last Resort Payment Claims and the costs of Special Administration of failed Suppliers.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Carly Evans', written in a cursive style.

Carly Evans
Head of Regulation
Wales & West Utilities