Gas transporter licensees, energy supply licensees, and other interested parties

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Direct Dial: 020 7901 7000
Email: Andrew.Ryan@ofgem.gov.uk

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Decision letter about interim solution to recovery of Last Resort Supply Payment (LRSP) claims from customers connected to gas distribution networks (GDNs) and Independent Gas Transporters' (IGTs') networks

This decision letter relates to recovery of LRSP claims arising from failed energy retail suppliers going through the Supplier of Last Resort (SoLR) process.

In March 2022, we[1] consented to IGTs[2] revising their 2022/23 charges to reflect LRSP costs[3]. The consent was intended to facilitate LRSP cost recovery evenly between gas customers connected directly to a GDN network and those connected via an IGT network.

In April 2022 we consulted[4] on the proposed industry charging and payment arrangements relating to LRSP payments for 2022/23 (the proposed 'interim solution') and on the proposed arrangements for 2023/24 and beyond (the proposed 'enduring solution').

This letter sets out our decision for the interim solution. Industry has raised a uniform network code (UNC) modification[5] which seeks to address the enduring solution. Ofgem will consider the UNC modification in due course.

Our chosen option for an interim solution

After careful consideration of the options and responses received, we have decided to continue with our preferred interim option - LRSP payments to continue to be paid directly by GDNs to SOLRs, and an intra-year revision to tariffs in October to reflect the payment by IGTs to GDNs. There was a range of views on the preferred interim solution, but we consider our chosen option to be proportionate, and preferable to interim option 2, which was for both GDNs and IGTs to pay money to the SoLR, and interim option 3, which was a variation of option 1 but with adjustment to 2023/24 tariffs instead of 2022/23 tariffs.

[1] References to 'the Authority', 'Ofgem', 'GEMA' 'we' and 'our' are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day to day work.
[2] Independent Distribution Networks are those distribution networks who have Section B of the electricity licence switched off.
[3] [Recovery by IGTs of Last Resort Supply Payment (LRSP) claims arising from failed suppliers | Ofgem]()
[4] [Recovery by gas transporters of Last Resort Supply Payments | Ofgem]()
[5] http://www.gasgovernance.co.uk/0809

Background

When a small energy retail supplier fails, the customers of the failed supplier are allocated to another supplier under a competitive bidding process known as the SoLR process.

The incoming SoLR makes a claim for some costs incurred. That claim is known as an LRSP claim. GEMA considers that claim and when it approves a claim it becomes known as a Valid Claim[6]. The network licences require that DNOs and GDNs pay a Valid Claim presented by a SoLR.

In the past, the portion of the costs to be recovered from gas customers has been paid by GDNs and passed onto customers under the price control. That existing arrangement raises the issue of whether or not gas customers connected via an IGT network are charged the same as those connected directly to a GDN network and hence whether or not IGTs or shippers would receive a windfall gain.

Details of the interim solution options previously consulted on

In April 2022, we set out three broad options for the interim solution:

Interim option 1, our preferred interim option - The SoLRs continue to be paid directly by GDNs, and the IGTs would pay the GDNs for the recovered LRSP costs relating to the customers connected via an IGT network. To avoid GDNs over-recovering, GDNs would revise their 2022/23 tariffs by end of July, effective from 1 October 2022. Option 1 has no material impact on 2023/24 tariffs.

Interim option 2 - Both GDNs and IGTs would pay money to the SoLR. Under this option GDNs would pay the SoLR for the share of LRSP claims relating to customers connected directly to the GDN networks. IGTs would pay the SoLR for the share of LRSP claims relating to customers connected via an IGT network. This would require revisions to the approved SoLR claims and changes to the IGT licence conditions.

Interim option 3 - This option is similar to option 1 but involves GDNs lowering 2023/24 tariffs instead of adjusting 2022/23 tariffs within-year. GDNs would continue to pay the LRSP claims to SoLRs, but IGTs would pay the GDNs for their share of LRSP costs. GDNs would over-recover for 2022/23 and their 2023/24 tariffs would reflect any money received from IGTs during 2022/23. The GDNs would be able to ask for the penal rate of interest to be waived for any over-recovery associated with IGT payments.

Responses to our open letter

We have reviewed the responses received to our open letter dated 20th April 2022.

We received a range of responses, with many expressing general support for option 1 and several supporting option 1 as their preferred solution. Others expressed a preference for option 2, whilst others expressed a preference of option 3.

<u>Responses supporting Ofgem's preferred option</u>

Two GDNs, the Independent Networks Association (INA), an IGT, and a large retail supplier are in favour of Ofgem's preferred option, an intra-year revision to network charges.

One GDN reasoned that this option would swiftly resolve the issue of a potential windfall for the IGTs, and it would also be the least burdensome solution for suppliers because

[6] Standard licence condition 9 of the Gas Supply licence

there would be no requirement to make amendments to the already submitted LRSP claims.

One GDN mentioned that, from an initial review, it would not foresee the GDNs having any accounting or tax issues, as this is a pass-through cost and revenue for them.

Another GDN noted that it is important to ensure that all customers contribute to the recovery of LRSP costs, not just those connected directly to GDNs. The same GDN supports the principle that IGTs also recover charges from customers connected to their networks. The GDN, noting the advantages and disadvantages of each proposed interim solution option which was set out in the consultation, concurs with Ofgem's assessment of the disadvantages of options 2 and 3, and therefore is minded-to support implementation of option 1.

The INA supports interim option 1 because it represents a fair allocation of costs across domestic gas customers, without over-recovery in the 2022/23 charging year. It also allows a proportionate solution, avoiding the need for a licence condition to be put in place for IGTs for an interim scheme that will only be in place for one year.

An IGT considers that option 1 would be most appropriate because it would minimise the administrative burden for both IGTs and gas shippers, reduce costs for consumers connected to GDN networks ahead of winter, and minimise tax implications for all parties.

The large supplier which supports option 1 noted that, of all the options proposed for an interim solution, it believes this is the most sensible and practicable solution given its understanding of the challenges that have been outlined for the whole IGT community to be able to establish LRSPs directly.

Two GDNs are broadly supportive of option 1 but would prefer option 2. One GDN recognises that the mechanics of this can be made to operate in a relatively straightforward manner, but its preference would be that a licence change is made to permit GDNs to collect this money from IGTs.

<u>Responses opposing alignment of Gas Transporters with Electricity Distribution</u>

One GDN opposed a change to the charging arrangements on the basis that the charging arrangements for IDNOs were set up differently from IGTs after the IGT charging arrangements for IGTs were in place.

<u>Challenges to option 1 from one GDN</u>

One GDN saw some challenges to the chosen option saying it will require:

1. A voluntary arrangement to be entered between GDNs and IGTs.
2. GDNs and IGTs to reach agreement on the legal and commercial nature of the payments.
3. Analysis of GDN licence compliance requirements.
4. An intra-year change to GDN SoLR charges, requiring two months' notice.

Support for Option 2 from three GDNs

One GDN which does not support option 1 said that it supports option 2 instead. That GDN prefers option 2 on the basis that it is likely to require less work and take no longer to implement. Other advantages stated for option 2 are:

1. It follows the existing process in the licence.
2. It is under the control of Ofgem.
3. The process involves only the parties directly affected.

The GDN notes that there is no difference in terms of customer impact between options 1 and 2.

Another GDN is broadly supportive of option 1 but would prefer option 2 as it would place identical regulatory requirements onto IGTs as exist for GDNs. By switching on Standard Condition 48 for IGTs, this could be achieved, although that may require a longer lead time.

A third GDN recognises that as an interim solution option 1 is the most practicable and least disruptive. However, it is concerned that there is currently no contractual or licence mechanism in place between GNDs and IGTs to allow the transfer of funds that this option would create. That GDN prefers option 2 because activation of special licence condition A48 in IGT licences would enable them to recover costs from gas shippers and make the subsequent payments directly to SoLR suppliers.

Reasons for our decision about an interim solution

No consensus in responses.

The responses received included support for and opposition to each of the three options for an interim solution. The result is that none of interim options would be supported by all of the stakeholders who responded, so whichever option is chosen, some stakeholders will not agree with the choice.

Advantages and disadvantages of option 1

We do not consider it proportionate to revise existing approved SoLR claims such that they are paid by both GDNs and IGTs. The IGTs have agreed to pay the SoLR money received from shippers to the GDNs, and the GDNs and IGTs are close to agreeing a multi-party agreement/contract whereby GDNs will send an invoice to IGTs, who will then pay the GDNs the SoLR charges they have received from shippers.

Option 1 has the advantage that it has no material impact on 2023/24 tariffs.

However, there are still questions around the VAT treatment to be resolved.

Consideration of responses in favour of option 2 over option 1

Under option 2, GDNs would pay the SoLR for the share of LRSP claims relating to customers connected directly to the GDN networks while IGTs would pay the SoLR for the share of LRSP claims relating to customers connected via an IGT network.

A GDN which prefers option 2 over option 1 did so on the basis that it is likely to require less work and take no longer to implement. Ofgem is concerned that revising the approved SoLR claims would require scheduling within a tight timeframe and might cause confusion.

One GDN cited advantages for option 2: it follows the existing process, is under Ofgem control, and involves only the parties affected. Ofgem acknowledges those advantages, but considers that revising the approved SoLR claims is a significant disadvantage of option 2.

Consideration of concerns raised about option 1

The GDN that prefers option 2 to option 1 raised some concerns about option 1. That GDN referenced a different charging process being selected for IDNOs after the charging process for IGTs has been put in place. Ofgem's view is that selecting a different charging process for IDNOs does not logically indicate that the charging process for IGTs was preferable. Also, it does not follow logically that if the charging process differs between IGTs and IDNOs that the LRSP recovery process should not consider using procedure that is similar to the recovery procedure that works for IDNOs.

Conclusion on choice of an option for an interim solution

From the issues set out in the open letter and raised in the responses, it is clear that none of the options is without disadvantages. Taking into account all the available information, Ofgem concludes that option 1 is a pragmatic and proportionate interim solution.

Next steps

The GDNs and IGTs are very close to finalising the arrangements whereby the GDNs invoice the IGTs for the amounts relating to the interim SoLR payments, and the agreement will be signed shortly. One network has said it will ask for consent to invoice the IGTs for these payments, under the powers set out in Standard Special Condition A36.3(d). Once received we will consider, but based on our discussions with that network we are minded to grant the consent.

Upon receipt of a request by GDNs to revise tariffs intra-year, Ofgem proposes to give consent for GDNs to revise SoLR-related tariffs from 1 October 2022 to reflect the receipt of money from IGTs. Ofgem plans to issue the tariff revision consent in time for revised tariffs to be published by 31 July 2022[7]. We will not consider GDNs to be in breach of Standard Special Condition A48.3 of the licence if they reduce tariffs to reflect the money received from IGTs, associated with this interim solution.

Ofgem considers a revision to the Regulatory Instructions and Guidance (RIGs) definition of recovered revenue to include SoLR money received from IGTs is sufficient. If the changes in RIGs are not considered sufficient, Ofgem will consult on proposed licence changes to broaden the definition of Recovered Revenue to include the receipt of money from IGTs related to the interim solution. Ofgem welcomes further discussion with networks on this issue.

It is Ofgem's intention that GDNs will be held harmless from any impacts of IGT SoLR revenue not being included in Recovered Revenue, in particular the impact on the under-recovery term (K_t) and application of penal interest rates. Ofgem also recognises that there is an element of forecasting involved, and it is our intention that GDNs will be held harmless from any discrepancy between forecast receipts and actual receipts, associated with the implementation of this interim solution.

As previously discussed, Ofgem believes the proposals do not result in additional tax being paid by networks. It is not Ofgem's intention for networks to be subject to an additional tax burden as a result of these proposals, and Ofgem will consider further the tax allowances within Allowed Revenue should it become apparent that there are tax implications. Ofgem's welcomes continued engagement with networks on this issue.

[7] The lower network charges will be reflected in a lower network charge component of the Retail Price Cap (RPC) from October 2022. The reduction in the annualised network charge component of the RPC bill will be around £6.

If you have any questions regarding this letter, please contact Andrew Ryan (Andrew.Ryan@ofgem.gov.uk) in the first instance.

Yours sincerely,

Jonathan Gorrie
Chief Financial Advisor
For and on behalf of the Gas and Electricity Markets Authority