

## Consideration of responses to the consultation document: Supplier of Last Resort – security cover and levies

In June 2001 Ofgem published a consultation paper “Supplier of Last Resort – security cover and levies”. The paper proposed that the level of the security cover (“the bond”) for a Supplier of Last Resort in both gas and electricity should be set to zero at the point the Utilities Act standard licence conditions are introduced.

This note describes the main issues raised in objection to the proposal and Ofgem’s consideration of them. Copies of the 14 responses received are available on Ofgem’s website<sup>1</sup>.

### **1. Setting the bond to zero**

A number of issues were raised by those respondents that disagreed or were ambiguous about the proposal to set the bond to zero.

#### **a) Issue**

Some respondents suggested that setting the bond to zero would mean that less financially stable companies would obtain supply licences, thereby increasing the risk of failure and consequent inconvenience to customers. Respondents argued that a bond should be seen as an appropriate cost of operating in the market. Its size would be proportional to the supplier’s business and its cost would reflect the supplier’s credit rating.

#### **Ofgem’s response**

The Authority must ensure that a licence holder can finance its proposed activities when a licence application is being assessed. Application Regulations specify the information that must be provided as part of a licence application. However Ofgem does not consider that any check it could perform on a potential licensee at the time its application is being considered will necessarily provide continuing comfort about its financial viability once the licensee commences operations.

From time to time, companies in competitive markets fail. On the one hand, failure is regrettable, in that investors lose money, jobs are lost and inconvenience is caused to customers. On the other hand, failure can be a sign that competition is working effectively. This is because in many cases it is the degree of rivalry between companies and the extent to which customers exercise choice that inevitably leads to success for some companies and failure for others. This logic applies as much in relation to the gas and electricity supply markets as it does to other markets. It is therefore inevitable that some gas and electricity suppliers will fail.

#### **b) Issue**

Some respondents suggested that other market participants should not have to pay for the bad debt of a rival. Although a bond imposes a cost, this is in proportion to the risk associated with the licensee concerned. The cost of the risk should be borne by the company concerned.

#### **Ofgem’s response**

As the new standard licence conditions are currently worded the bond can only be used by a SoLR to recover its otherwise unrecoverable costs. It is not available to cover the failed supplier’s bad debts.

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<sup>1</sup> <http://www.ofgem.gov.uk/ssf/responses.htm#security>

It is true that other market participants (and possibly customers) would pay increased electricity distribution or gas transportation costs in the event that there was a claim on the levy. However we would always seek first to appoint a SoLR that had agreed not to make a claim (unless we consider that domestic customers would be caused hardship). In addition a SoLR's deemed contract prices can be set so that it can cover its reasonable costs and reasonable profits. We would therefore expect an efficient SoLR to be able to cover its own costs. A claim on the levy is therefore unlikely.

**c) Issue**

Some respondents suggested that the scope of the bond should be extended to enable other costs such as energy balancing charges or distribution use of system charges to be recovered.

**Ofgem's response**

There are terms in the BSC and Network Code that require credit cover to be provided for these charges. Modifications are currently being considered that would require provision of cover to minimum levels together with more accurate ways of calculating indebtedness. This would limit other parties' exposure to pre-default debt prior to receivership.

Transco and electricity distribution businesses require minimum levels of cover. Ofgem's consultation on credit cover (due to be published in October) will consider whether the levels and types of cover currently in place are appropriate.

Now that the Utilities Act 2000 standard licence conditions are in force the risk of high levels of post-receivership debt should be reduced because Ofgem will be able revoke a licence and appoint a SoLR quickly after receivership.

**d) Issue**

Some respondents suggested that it may not be possible/practical for a SoLR to adjust its deemed contract prices to exactly reflect the costs of supplying the customers.

**Ofgem's response**

The standard licence conditions allow a SoLR to set its deemed contract prices to cover its reasonable costs of supply together with reasonable profit. It can also increase those charges. While there may be circumstances where this might present some issues for a SoLR we would expect an efficient supplier to quickly sign up the failed supplier's customers on normal contractual terms so that they are not paying deemed contract prices for longer than necessary.

**e) Issue**

Some respondents suggested that the costs faced by a SoLR in transferring customers should not be underestimated; they may be linked to the circumstances that initially led to insolvency.

**Ofgem's response**

We recognise that there are administrative and logistical issues for any SoLR. It is a commercial decision for any supplier whether the circumstances are appropriate for it to volunteer to be a SoLR. If there were no volunteers then any SoLR would be able to make a claim (via the levy) for its otherwise unrecoverable costs. Our criteria will enable us to select the best SoLR(s) for the particular circumstances of the failed supplier. In either case the SoLR is only responsible for relevant costs from the actual time it is appointed.

**f) Issue**

Some respondents suggested that it is not always possible for suppliers to pass on the costs of increased DUoS charges to customers.

**Ofgem's response**

The relevant distribution and transportation standard licence conditions do not allow the licensee to enter into a contract with suppliers/shippers unless the terms can be varied in the event that a levy has to be paid to a SoLR. It is a commercial decision for suppliers whether or not to include such terms in their contracts with customers.

**2. Distribution Companies' costs**

The Distribution Companies that responded were concerned about their inability to recover their own costs of administering any levy scheme.

One respondent suggested that the cost of a levy should be recovered through the NGC's transmission charges rather than from 14 Distribution Companies.

**Ofgem's response**

Ofgem recognises that the requirement for Distribution Companies to implement a levy will give rise to administrative costs and that the standard licence conditions do not provide a means for recovering those costs. We have therefore considered ways in which Distribution Companies could recover the costs of administering the levy (for instance by amending the relevant licence conditions or treating the costs as an excluded service). We have also balanced consideration of these ideas against what we consider to be a small chance that any claim will be made, given that Ofgem will seek to appoint a SoLR that does not want to make a claim.

The suggestion of recovering the cost via transmission charges would involve changes to the licence conditions of the Distribution Companies and the NGC. The DTI has just carried out an extensive consultation process on the new standard licence conditions. As it is unlikely that Distribution Companies will have to administer a claim, pursuing changes to licence conditions does not seem appropriate.

We have therefore concluded that the most appropriate way to deal with this situation (if it arises) is for Ofgem to consider at the time of any levy being claimed what is the most appropriate way for Distribution Companies to be able to recover their costs.

**3. Transco's costs**

Transco raised concerns about the practicality of raising its transportation costs to pay a levy to a SoLR. Transco believes that in practice it would not be possible for it to raise its transportation costs because of the very small amount of money involved. It would like a practicable methodology for recovering its costs.

**Ofgem's response**

As for Distribution Companies, we have concluded that the most appropriate way to deal with this situation (if it arises) is for Ofgem to consider at the time of any levy being claimed what is the most appropriate way for Transco to be able to pay it.