

Flying too close to the sun – SoLR processes in water and energy

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Cornwall Insight has published a paper looking at the various SoLR processes in GB water, electricity and gas. In the paper, we discuss and compare the various SoLR regimes: for electricity and gas customers, managed by Ofgem; for England & Wales non-domestic water customers, managed by Ofwat and MOSL; and for non-domestic water customers in Scotland, managed by WICS and the CMA.



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In this short paper, we discuss and compare the Supplier of Last Resort (SoLR) regime in the energy sector with the equivalent processes in the two competitive GB business markets for water retail. These are the SoLR process run by Ofwat in England & Wales, and the Water Industry Commission for Scotland's (WICS's) Provider of Last Resort (PoLR) process in Scotland.

Water retailer Aquaflow Utilities will exit the non-domestic retail market in England & Wales and enter liquidation on 9 April. This will be the first test of Ofwat and MOSL's SoLR processes in the two years since the market has been open. Aquaflow had won 241 Supply Point Identifiers (SPIDs) according to data from market Operator Services Ltd (MOSL), which Ofwat indicated represented 74 distinct customers. MOSL data shows that it retailed annual water services of approximately 17MI, and 24MI of sewerage services. This makes it one of the smallest retailers operating across England and Wales. Ofwat has already revoked its licence and published advice to customers on what to expect.

SoLR processes for the electricity, gas and water industries are called into play by the sector regulators (Ofgem in electricity and gas, Ofwat or WICS in water) when a supplier or retailer suffers a disorderly market exit; in other words an exit without having made provision for the future retail services of its customers. The SoLR processes for electricity and gas sit within the electricity and gas supply licences. For water, they sit in their own codes: the Interim Supply Code for England and Wales, and the Market Code for Scotland. In many ways the processes are similar, but there are differences in key aspects. Figure 1 sets these out.

In electricity and gas, the SoLR is required to honour the credit balances of current domestic customers, and it has become common to also offer to honour the balances of domestic customers who are in the process of switching away but who have not had their balances refunded yet. However, non-domestic customers are not covered by this "safety net" and unless the SoLR chooses to honour credit balances as well, these customers must seek to recover balances through the administration process, as they would for any commercial contract. This is also the case for water retailer customers in England and Wales.

In the Scottish water market, the Provider of Last Resort (PoLR) process randomly but equally allocates the SPIDs of the failed company across all eligible retailers. Retailers with under 20% market share are permitted to opt out of this process, but by default all retailers are eligible. Three Scottish retailers have exited the market so far: Aquavitae's licence was revoked by WICS in September 2008, Satec in July 2012, and Suez in January 2018.

Figure 1: Key facets of SoLR process in electricity, gas and water

Feature	Domestic	Non-domestic	Non-household	Non-household
Customer credit balances	Protected for current customers	Not protected; customers must recover their credit from the administrator	Not protected; customers must recover their credit from the administrator	Not protected; customers must recover their credit from the administrator
Customer debt	Transfers to SoLR	Collected by administrators	Collected by administrators	Collected by administrators
Timing	The Energy Act 2004 requires 14 days' notice of a company expecting to exit the market	The Energy Act 2004 requires 14 days' notice of a company expecting to exit the market	Ofwat requires early notification when a retailer cannot meet its obligations, and it can revoke licences before the retailer enters liquidation	Retailers required to inform CMA that exit is likely and seek trade sale of customer base; failing this, CMA will issue a termination notice
SoLR/PoLR tariff for customers of failed provider	Must reflect "no more than the reasonable costs of supply" plus "a reasonable profit"	Must reflect "no more than the reasonable costs of supply" plus "a reasonable profit"	"Reasonable" prices and terms. No undue preference for or against by a retailer, vs existing customer base	Mandatory "deemed contracts" are prescribed by WICS, with a pre-set default tariff
Selecting a replacement supplier	Either mandated by Ofgem, or selected through competitive bidding process	Either mandated by Ofgem, or selected through competitive bidding process	Ofwat may require the wholesaler to supply, or run a competitive appointment, or require MOSL to divide amongst all eligible retailers	CMA will randomly allocate to retailers to achieve even distribution across all eligible retailers

The different processes

As has been shown repeatedly over the past 18 months, the SoLR provisions in electricity and gas are proven, and for domestic suppliers at least are very effective. They are less tested in water. The processes in the energy and water sectors are broadly as follows:

Electricity and Gas

- Suppliers must notify Ofgem 14 days before winding up or going into administration (though this is not always practicable)
- If they exit the market without having made provisions for the future supply of customers (such as arranging a trade sale beforehand), SoLR is activated
- Ofgem chooses to either:
 - Direct a supplier to act as SoLR; or
 - Run a competitive process to appoint one. This decision is based on the size of the customer base, as a competitive process may not be cost-effective for a very small one
- Assuming a competitive process is chosen:
 - Ofgem sends information on the failed supplier's customer portfolio to suppliers who have expressed an interest; it can also mandate that suppliers make offers
 - Potential SoLRs provide information on their capacity to take on customers, tariff and protections provided, and the level of costs they will seek to recover from the industry for fulfilling the role
 - Ofgem weighs up the SoLR offers and appoints one as the new supplier
 - Customers are transferred to the new supplier, which may submit a claim for costs. If approved, costs will be recovered by a levy on network charges

Water

- Retailers are obliged by their Water and Sewerage Services Licence to inform Ofwat if they become aware that they will not be able to satisfy their obligations. This allows Ofwat to revoke licences and suspend activities ahead of time
 - There is a similar process in Scotland, managed by WICS and the CMA
- In England & Wales Ofwat can direct that wholesalers take on retail duties for customers, can hold a competitive process for allocating customers to one or more retailers, or can direct MOSL to evenly divide customers between all eligible retailers
 - It can also choose a mix of solutions, for each of the wholesaler regions in the market
 - In the case of a competitive procurement, Ofwat will publish details of the customer base. Retailers can opt in or out, and make adjustments to their Scheme of Terms and Conditions
 - Ofwat will appoint one retailer in each wholesaler area as SoLR
 - In the case of an even division, MOSL will randomly apportion SPIDs to each retailer, attempting to keep a company's SPIDs together and SPIDs on the same site together, but prioritising an even division between retailers in each wholesaler area
- In Scotland, the only process is random allocation by WICS; each supplier receives the same number of SPIDs, though in cases of an uneven number, older retailers will attract more

SoLR to date

Between the energy and water sectors, SoLR processes have been triggered 14 times, with 12 of those events occurring since January 2018. Almost all of these have been competitive processes, with Ofgem's Authority Directions only being used for two suppliers who had around 80 and 500 customers respectively. It remains to be seen what route Ofwat will follow, though there are indications that it is undertaking a competitive process, with some retailers publicly opting not to participate in the process.

While SoLR in energy has been demonstrated to work effectively, there are some issues that industry parties are seeking to address, especially in the non-domestic sphere. Ofgem has been reluctant to separate out the domestic and non-domestic customers of a failed supplier. This means suppliers who only hold non-domestic licences cannot enter the SoLR process for these mixed batches, limiting the pool of possible SoLRs in the non-domestic space. While water does not currently have domestic customers and therefore does not face this problem, Ofwat has taken steps to avoid a similar limitation. Its process allows multiple SoLRs to be selected across the country, allowing retailers to construct the optimum offer under each set of regional wholesale charges. This means that Ofwat can choose between the best options to protect customers.

Figure 2: SoLR processes undertaken by Ofgem and Ofwat

Supplier/ Retailer	Sector	When	SoLR	Process	Customers
Electricity 4 Business	Energy	Oct 2008	British Gas	Competition	40k business
GB Energy	Energy	Nov 2016	Co-op Energy	Competition	160k domestic
Future Energy	Energy	Jan 2018	Green Star Energy	Competition	10k domestic
National Gas and Power	Energy	July 2018	Hudson Energy	Direction	80 business
Iresa	Energy	July 2018	Octopus Energy	Competition	90k domestic
GEN4U	Energy	Sept 2018	Octopus Energy	Direction	500 domestic
Usio Energy	Energy	Oct 2018	First Utility	Competition	7k domestic
Extra Energy	Energy	Nov 2018	Scottish Power	Competition	108k domestic, 21k business
Spark Energy	Energy	Nov 2018	Ovo Energy	Competition	290k domestic
One Select	Energy	Dec 2018	Together Energy	Competition	36k domestic
Economy Energy	Energy	Jan 2019	Ovo Energy	Competition	235k domestic
Our Power	Energy	Jan 2019	Utilita	Competition	31k domestic
Brilliant Energy	Energy	March 2019	SSE	Competition	17k domestic
Aquaflow Utilities	Water	March 2019	Not yet selected	-	74 non-domestic



The gas market also has an additional factor to consider: the gas shipper. Shippers are licensed entities handling the wholesale trading and contracts with network operators. In electricity, these duties are part of the supplier role, while in water, all network activities are carried out by the wholesaler. Sometimes gas suppliers also hold shipper licences to self-serve shipping activities, but many outsource this role to a third-party shipper.

Third-party shipping presents two potential issues. Firstly, during an SoLR, the third-party shipper continues to procure and allocate gas for the defunct supplier's customers, but may not be able to recover the costs of doing so. It may take days or even weeks for meter points to transfer to the SoLR and its associated shipper, meaning the original shipper incurs costs both for wholesale gas and network charges that it may struggle to extract from the administration process. Proposals are currently being developed to rectify this, perhaps by allowing third-party shippers to call upon an industry-wide levy to socialise the costs, similarly to SoLR.

Secondly, there are no "shipper of last resort" provisions. If a third-party shipper were to collapse, Ofgem would be placed in the unenviable position of having to orchestrate an ad hoc process. This could be problematic given how few shippers offer third-party services; furthermore, the shipper licence does not contain conditions that would allow Ofgem to mandate that a shipper pick up customers, like it can a gas supplier.

However, supply and transporter licence conditions set out that gas transporters may require that suppliers become liable for paying "all relevant charges for gas taken out of its pipeline system" and providing appropriate security. While arrangements have not been tested, by our interpretation this could cover liability for both network charges and imbalance costs.

In water, unbundling provisions have not yet been introduced: water production, water and waste water networks, and wastewater treatment and disposal all remain the responsibility of the regional wholesalers. This considerably simplifies arrangements with regards to SoLR. But with proposals in place to allow greater access for third-party water producers and waste water treatment, Ofwat will need to consider how these new market participants integrate into the SoLR process in the future. In Scotland, these new roles are not proposed to arise over the current planning horizon.

Conclusions

Well-tested or yet to be tried, all SoLR processes have gaps and loopholes. Furthermore, however well the processes are functioning, a supplier failing will typically pass costs onto the rest of the industry; costs which are ultimately paid by consumers. Ofwat's approach in water does provide it with a range of additional options that cover some of the holes which are becoming apparent in energy's SoLR processes, but this fundamental problem remains.

While it could be dealt with by strengthening credit requirements, that will increase costs for parties and restrict market entry. The most viable approach is therefore probably closer regulatory scrutiny of business plans and financeability.

Ofgem should soon be publishing the outcome of a call for evidence as part of its review of supplier licensing; a review that had long been trailed but has been given particularly poignancy by the raft of supplier failures over the past 18 months.

Considering the increasingly close co-ordination between the sector regulators recently, it is possible that Ofgem may take a leaf out of the water sector's book, where applicants looking to operate in the competitive market must demonstrate that they meet requirements on managerial competency, technical competency, and financial stability, as well as providing a business plan and projected cashflow statements for the first three years of operations.