Supplier of Last Resort in Electricity & Gas

Consultation Paper

CER/05/072

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1 Summary

1.1 Rationale

The purpose of this paper is to set out a number of approaches that might be adopted in relation to the Supplier of Last Resort (SoLR) function in each of the electricity and gas markets in Ireland together with the Commission’s initial preferences.

Its scope encompasses:

1. The necessary and appropriate responsibilities of the role and the parties on which the obligation could be placed;

2. The price control implications of the obligation. In other words, any additional price control that might be required to limit tariffs and/or to compensate the selected party for carrying out the role;

3. Practical matters regarding how the SoLR obligation should work including the mechanism that triggers it.

Section 2 of the paper sets out the legal background for a SoLR, defines a SoLR event, and progress to date on this issue. The following section considers a number of approaches for appointing a SoLR and its term of office. Section 4 discusses the costs and benefits of operating a SoLR role and how these costs might be recovered. The final section presents a high level analysis of the procedural issues in the SoLR process.

1.2 Commission’s Initial View

The Commission’s initial preferences can be summarised as follows:

1. The role of the SoLR should include the following:
   a. Provide the facility for all customers of exiting suppliers;
   b. Manage the process for transferring customers;
   c. Maintain supply to customers until they transfer;
   d. Provide the opportunity for customers to switch to other tariffs;
   e. Provide a clear separation between SoLR and other parts of its business.

2. SoLR rules should apply in all cases – regardless of the size of the supplier exiting the market.

3. The electricity and gas SoLR roles should be equivalent, but there should be separate SoLRs to reflect the specific requirements of each market.

4. All suppliers are given the opportunity to act as SoLR. A reasonable approach would be to test the market and, where interest is expressed, put in place a panel of suppliers willing to undertake the
role (perhaps through a competition). At any point in time there is one SoLR and the appropriate supplier is selected following an assessment of the SoLR event. For example, a particular supplier may wish to act as SoLR for industrial customers. This supplier would not be selected where the failing supplier sells electricity to domestic customers.

5. In the absence of interest from independent suppliers, separate SoLRS are appointed for the electricity and gas markets – PES for electricity and BGSE Supply for gas.

6. The position is reviewed after two years. At that time, and depending upon the level of interest, the Commission would consider introducing different SoLR arrangements if appropriate.

7. There is some restriction on the length of time that customers should stay with the SoLR. This period is no more than six months with the ability to swap to another tariff/price with that or another supplier after one month.

8. It is debatable if large customers should be subject to the same rules. One possibility would be for these customers to negotiate a new tariff with the SoLR or be free to choose another supplier immediately.

9. In relation to gas, there is no immediate requirement for a shipper of last resort. The transporter is in a position to undertake the necessary gas contracting and transportation duties until the SoLR has put in place the necessary arrangements (perhaps in a matter of days).

10. There is a case for fixing, in advance, the level of non-energy related costs that a SoLR can recover together with an estimate of allowable energy costs. These costs can be recovered through a SoLR tariff charge which may be linked to the host supplier’s tariff rates.

11. Any additional (allowable) energy related costs could be recovered, *ex post*, by the SoLR through an approved market charging mechanism.

### 1.3 Next Steps

Responses to this consultation should be submitted in writing or by e-mail and should refer, for the most part, to the high-level proposals and options raised in this paper. Comments should be received no later than by May 20th 2005. These should be addressed to [Niall Lawlor](#):

Commission for Energy Regulation  
Plaza House  
Belgard Road  
Tallaght  
Dublin 24

Comments received will be published on the Commission’s website. Any comments that are deemed confidential should be marked as such and, where possible, placed in an annex to the comments. While the Commission welcomes views on any area that relates to the subject matter, respondees
should note that only comments that have a material impact on the issue of SoLR will be addressed. Relevant responses to comments made will also be covered in the next published paper on this issue. Finally, following consideration of comments, the Commission will publish a decision on this issue before the end of Quarter 3 of 2005.
2 Introduction

2.1 Legislative Background


Regulation 21 of S.I. 60 of 2005 provides the legal basis upon which the Commission may appoint a supplier of last resort for electricity:

“(1) (a) The Commission may invite expressions of interest from licensed suppliers to act as supplier of last resort, that is to supply electricity in accordance with this Regulation.

(b) Following public consultation and subject to subparagraph (c), the Commission shall designate a licensed supplier to act as supplier of last resort, that is to supply electricity in accordance with this Regulation.

(c) Where the Commission is of the opinion that the public electricity supplier is the most appropriate licensee to supply electricity in accordance with this Regulation, it may designate the public electricity supplier as supplier of last resort under subparagraph (b)”

Under this Regulation the Commission may also specify the terms and conditions, including charging regime, under which the SoLR may supply to a final customer:

“(4) (a) the terms and conditions under which the supplier of last resort shall supply electricity to a final customer, including those in relation to -
(i) duration of supply,
(ii) termination of supply, and
(iii) price;

(b) the method for calculating the charges for the supply of electricity to a final customer;

(c) any other matters which the Commission considers necessary for the purpose of the supply of electricity to a final customer by the supplier of last resort”

Finally, this S.I. also defines a SoLR, in particular by defining the events that trigger customer transfer to the SoLR:

“(2) The supplier of last resort shall supply electricity to final customers of another licensed supplier where -

(a) a licensed supplier with whom final customers have a supply contract ceases or fails to supply electricity to those final customers in accordance with its contractual obligations; or
Equivalent legislation relating to the appointment of a SoLR in the gas industry has not been enacted. The proposals set out in this paper, in relation to the gas market, are without prejudice to such legislation. In the meantime, as the gas Directive 2003/55/EC addresses the subject of SoLR in much the same way as the electricity Directive 2003/54/EC, the Commission anticipates that national legislation transposing this directive will follow similar lines as that adopted in relation to electricity. Therefore, references to S.I. 60 of 2005 in this document are assumed to apply equally (in principle) to the gas market. Should this not be the case in the future the arrangements in place will be adjusted appropriately.

In addition, this document assumes that all necessary changes have been made to suppliers license conditions to reflect the requirements of the relevant electricity and gas legislation/Statutory Instruments.

### 2.2 Triggering of Supplier of Last Resort Event

Before developing a policy on the issue of SoLR it is necessary to define what is and what is not meant by the term Supplier of Last Resort.

#### 2.2.1 Supplier Exit

While practice varies internationally (see Appendix A), the main reason the SoLR process should be initiated is where another supplier has exited the market, as referred to by condition 20 (2) (a) of S.I. 60 of 2005. Supplier exit may manifest itself in a number of ways, namely via:

- **Unplanned exit**: e.g. a supplier exits the market due to insolvency.

- **Planned exit**: e.g. a supplier exits the market of its own free will (however, in such an event, the exiting supplier should use all available means to transfer customers to another supplier once timing of exit is known).

- **Serious licence breach and subsequent revocation of licence**: a supplier’s licence is revoked for continuous breaches of its licence conditions.

The SoLR role is distinct from ESB Public Electricity Supplier’s (PES) duty to supply, as specified by Regulation 18 of S.I. 60 of 2005. This latter duty applies when, in a fully competitive retail environment, a customer fails to contract with any independent supplier. These customers would continue to receive supplies on PES’ tariffs. In addition, the SoLR role does not extend to serving customers which another supplier no longer wishes to serve and seeks to transfer to the universal service provider or supplier with a duty to supply. Finally, the SoLR process is not related to the exit of a generator from the electricity industry, even though such an event may directly lead to
supplier exit. The SoLR process is triggered when the supplier leaves the market.

The scope of the SoLR role is discussed in greater detail in section 3 of this paper. Section 5 introduces the topic of the necessary procedures that need to be in place to ensure a smooth transfer of customers from the exiting supplier to the SoLR.

2.2.2 Specific Cases

In June 2004 the Commission published a consultation paper – *Transferring of Sites to Supplier of Last Resort for Safety Reasons* (CER 04/216)– regarding the transfer of defaulting customers to the SoLR where the defaulting customer cannot be de-energised for safety reasons. While the above consultation paper concerned electricity, the same concerns could be extended to gas.

As this issue has already been consulted on, it is not addressed further in this paper. The Commission will make a decision on this matter in conjunction with a decision on the general application of the SoLR as referred to above in section 2.2.1.

2.3 Progress to date

This paper is the first to address the issue of SoLR in the context of existing electricity and anticipated gas legislation.
3 Defining the SoLR Role

As a guiding principle, the Commission intends to take a practical approach in relation to the SoLR – one that is appropriate to the size of the markets and the number of suppliers interested in undertaking these roles.

There are several issues that must be resolved in determining which party should undertake the SoLR. These are:

1. The scope of the SoLR role and whether the same arrangements should apply to electricity and gas.

2. The methodology used to allocate this role and the obligations that this role would entail – specifically whether this should be mandatory or voluntary. Should it be a unique role held by one party? If the role is voluntary, can it be allocated to one or more parties?

3. The duration of the SoLR role.

3.1 Scope of the SoLR Role

The Commission’s view is that the role of the SoLR should include the following:

1. Provide the facility for all customers of bankrupt or exiting suppliers, or those that have had their license revoked to transfer to the SoLR;

2. Manage the process for transferring those customers, including registration, metering and billing arrangements;

3. Maintain supply to those customers until they transfer;

4. Provide the opportunity for those customers to switch to other tariffs/prices provided by the SoLR or other suppliers;

5. Provide a clear separation between business/financial activities of the SoLR and other parts of its supply business.

An additional issue to consider is whether a SoLR should be applied in all supplier failures/exits. For example, should it apply when only a small number of customers are involved? In practice this would be difficult, given that some judgement is required on what “small” means and how the arrangements would operate (i.e. if customers were transferred to another supplier, the terms this would take place upon and how this would differ from any other SoLR transfer) while maintaining the desired level of consumer protection. **The view of the Commission, therefore, is that the rules should be set so that they apply in all cases to minimise these complexities and risks.**

Another point to consider is that, as the electricity and gas markets are opened to full competition, suppliers may provide both electricity and gas. If
a supplier fails, this will create the need for a SoLR in both markets. Consequently, should a single SoLR mechanism apply in both markets or should there be separate SoLRs in each market. The Commission's initial view is that the electricity and gas SoLR roles should be equivalent, but that there should be separate SoLRs to reflect the specific requirements of each market.

3.2 Allocation of the SoLR role

It is important to allocate the SoLR role correctly to ensure the security of the market. The party undertaking the role must have sufficient financial security to allow it deal with an unexpected number of customers /volume of load transferring to it at short notice. It must be able to meet the energy purchases associated with these customers.

Appendix A describes a variety of the approaches that have been adopted internationally; and these include the following:

1. New Zealand: There is no formal SoLR role. The market decides how the transition of a failed supplier’s customers takes place.

2. England & Wales: Previously the distribution business in each area was responsible for providing a SoLR service (contracting with suppliers for the service). Currently, Ofgem selects, on a case-by-case basis, a supplier based on the circumstances of each failure.

3. Victoria, Australia. A failed supplier’s customers are allocated across remaining suppliers (although exactly how this is done this depends on the nature of the failure).

The Commission is considering three different kinds of approach for the Irish electricity and gas markets (consistent with S.I. Number 60 of 2005):

1. **Obligation**: A firm obligation is placed on one party, for a defined period of time, to carry out the role.

2. **Auction**: Parties compete, through an auction process, to provide the service at the lowest cost (having met certain minimum criteria).

3. **Case-by-case**: A SoLR is selected depending on the specific circumstances at the time of the SoLR event.

3.2.1 Obligation

This approach would apply where the Commission has taken the view that PES or another licensed supplier is the most appropriate licensee to supply electricity in accordance with Regulation 21 of S.I.60 of 2005. A similar approach would be adopted in the gas market.

Under this approach the Commission would apply the relevant licence conditions to oblige a specific party to provide the SoLR service. The obligation would define all of the logistical and financial conditions for providing the service. This type of obligation already exists in the gas supply
licence and will be included in the new generic electricity supply licence and could then be triggered in particular cases. The Commission is of the view that, if this approach were pursued, the obligations would be placed on ESB and BGÉ Supply in the first instance for a specified period of time (perhaps two years).

Alternatives are possible. Until recently in Britain, obligations were placed on the host distribution businesses. Distributors were required to establish a tender to provide the service, for which any supplier could compete. Ultimately, because distributors had the obligation to provide the service, the financial position of the supplier was, to some extent, a secondary concern. In the Irish context this approach would not be consistent with legislation.

The benefit of placing an obligation on a licensed supplier is that there is clarity in terms of defining where accountabilities lie. In addition, it can be argued that PES and BGE Supply are best placed to deal with the unknown volume of customers/load that may be involved in a SoLR event.

One disadvantage is that customers are returning to host suppliers who then have the opportunity of retaining these customers. Another concern with this approach is that it is potentially “one-size-fits-all”, in the sense that a single supplier would be appointed irrespective of the nature of the failure. So, for example, if the failing supplier provided dual fuel or only serviced part of the market, there would be no provision to appoint another supplier which had a portfolio of customers that could absorb those of the defaulting supplier. However, these are unavoidable consequences if no other licensed suppliers are interested in offering the SoLR service.

3.2.2 Auction

In this arrangement, the Commission (or a party appointed by the Commission) would hold an auction to allow suppliers compete for the right to be the SoLR. This approach has been taken in some US states.

There are a number of advantages to this approach. First, an auction is a good mechanism for establishing a market price for providing the SoLR service. The role of SoLR brings both costs and benefits. Clearly there may be some costs associated with a supplier stepping in at short notice and managing the administrative burden of transferring customers, managing their enquiries and ensuring that they are billed correctly. A successful auction approach will also draw out the benefits to a supplier or accessing a number of customers that, under normal circumstances, it would have needed to acquire on a commercial basis (and at a cost). The supplier benefits to the extent that it is able to retain these customers in the longer term. An auction may be one way of ensuring that the service is provided at least cost.

However, it is unclear if there is a sufficient level of interest in the auction. This in turn impacts on the calculation of a fair market price. This occurred in Texas where no parties bid in the auction. Another concern is that it may be difficult for bidders to calculate cost reflective bids as suppliers will not know the circumstances of a supply failure in advance (e.g. failure could occur in summer or winter). Bidders are likely to add premiums to their bid price to cover this risk which will increase the cost of providing the service. It
may be possible to manage this risk by operating some *ex post* cost recovery mechanism for reasonably incurred costs that could not be anticipated in advance of the SoLR event (see section 4.2).

### 3.2.3 Case-by-case allocation

This approach differs from the previous two in that the choice of SoLR is not determined in advance. Rather, depending on the nature of the supplier failure, the Commission would appoint a SoLR on a case-by-case basis.

Under this option, the Commission (or its representative) invites licensed suppliers to join a list of potential SoLRs where the supplier specifies the type of customer its business can support in a SoLR event. Alternatively suppliers may access the list by way of competition. Suppliers are not paid for being on the list and are required to provide the service when instructed. This could be included as a supply licence condition (as in the gas supply licence). In all cases, the Commission must be satisfied that the supplier can provide the service. When a SoLR event occurs, the Commission would consider the nature of the failure (e.g. the size of the failure and the customer base of the failing gas/electricity supplier) and then appoint the SoLR provider. The SoLR cost recovery and charging mechanisms are approved in advance (see section 4.2). Once appointed, the SoLR is required to manage the process of transferring customers.

This approach is flexible as it allows the Commission appoint a SoLR that best matches the nature of the failure. It also provides an opportunity for the SoLR role to be placed with a supplier other than PES and BGE Supply. This supports the promotion of competition in supply. *The Commission is of the view that a case-by-case approach to determining the SoLR is reasonable. In the absence of market interest the Commission is of the view that PES will be obliged to act as SoLR in the electricity market and BGE Supply in the gas market for a period of, say, two years. At this time the Commission would be prepared to, again, test the level of market interest.*

### 3.3 Duration of the SoLR role

The SoLR role should not be open-ended. At some point consumers must be able to change to regular tariffs offered by the SoLR or another supplier. In this context, two issues need to be separated; (a) the length of time before a customer can move away from SoLR tariffs and (b) the length of time a customer can remain on SoLR tariffs.

The question is – should a customer transferred to the SoLR tariff be able to move off this tariff within the standard change of supplier process or should there be some form of “lock-in” period? The answer to this question links in with cost recovery. It can be argued that some lock-in is required to allow the SoLR recover its costs of providing the service.

International experience suggests that a long lock-in period is uncommon. In Texas, where a premium is charged above regular tariffs for the SoLR service, there is no explicit lock in period. The SoLR continues to provide the service until such time as the customer selects another provider. Perhaps
the level of the premium (25%) is sufficient to encourage the customer to choose. In Britain, customers can move to another provider within normal change of supplier timescales. A shorter lock-in duration can be a useful incentive for the supplier. If the supplier handles the SoLR process well, customers may be more inclined to stay with the supplier in the longer term.

This must be balanced against the need to maintain market stability. Allowing customers to transfer from the SoLR immediately might make the role of the SoLR less attractive and may create a high degree of market churn. This was a consideration in Ofgem’s position in its approach to the TXU failure (see Appendix C).

The next question concerns the length of time that a customer is required to remain on the SoLR tariff. Maintaining the service for a reasonable length of time will allow customers choose their preferred supplier particularly where customers have a high degree of inertia. However other customers, particularly high consumption customers, may prefer to move off SoLR tariffs quickly. In Britain, the SoLR is required to maintain its service for six months, should customers choose not to switch from the SoLR.

Taking the two issues together, the Commission is of the view that customers should be allowed to swap from SoLR tariffs after one month. The maximum duration of the SoLR should, in the Commission’s view, be no more than six months. If the customer does not elect to change tariffs by this point, the customer should automatically be transferred to a default tariff. However, it is debatable if large customers should be subject to the same rules. One possibility would be for these customers to negotiate a new tariff with the SoLR or be free to choose another supplier immediately.

### 3.4 Specific SoLR Issues for Gas

The split of roles between shippers and suppliers in the gas market needs to be considered. Is the role of SoLR sufficient for securing supplies to customers or is a shipper of last resort required? The issue turns on whether the SoLR should be held accountable for maintaining transportation services (including nominations) for the failed supplier’s customers from the point of failure or whether this should be treated separately.

The shipper of last resort role does not exist in other jurisdictions. In Britain, rather that have such an obligation, suppliers are required to take on the responsibility to pay the charges (principally transmission and gas purchase costs) should its shipper fail. The supplier has 35 days in which to appoint a replacement. Moreover, if a SoLR is appointed, the shipper that provided a service to the failed supplier must follow Ofgem’s directions in continuing to provide these services to the SoLR. As the primary concern is to ensure that the system remains in balance, creating an extra link in the SoLR process could add unnecessary risk. The approach to shipper services needs to reflect the realities of the situation.

A mechanism of the following form could be adopted:
1. When a gas supplier fails, a SoLR is be appointed responsible for maintaining supplies to customers of the failed supplier from the point at which the transition takes place.

2. At a practical level the supplier may not be able to carry out shipper activities until gas contracting and transportation arrangements for inputs and off-takes are secured. The transporter could take on this responsibility until the supplier is able to contract for the service.

There is a question as to whether the transporter is allowed to purchase gas on its own behalf or if it will be required to conduct this through a third party – specifically another shipper. A further issue relates to whether the transporter should be responsible for overruns and scheduling charges during the interim period. **It is the Commission’s initial view that, given the very special conditions of a SoLR event, it may be appropriate to suspend these charges until the SoLR takes responsibility for shipper activities.** The expectation is that this would take place within a matter of a few days following the failure.

### 3.5 Overview

Overall the rules should be set so that they apply in all cases to minimise these complexities and risks. In addition the Commission’s initial view is that the electricity and gas SoLR roles should be equivalent, but that there should be separate SoLRs to reflect the specific requirements of each market.

The main questions raised in this section in relation to the role of the SoLR can be summarised as follows:

- **Scope of Duty of SoLR in the event of supplier exit:** What are the responsibilities of this role and should the role be shared amongst interested parties?

  The Commission’s view is that the SoLR role should be to:

  o Provide the facility for all customers of bankrupt or exiting suppliers, or those that have had their license revoked to transfer to the SoLR;
  o Manage the process for transferring those customers, including registration, metering and billing arrangements;
  o Maintain supply to those customers until they transfer;
  o Provide the opportunity for those customers to switch to other tariffs/prices provided by the SoLR or other suppliers;
  o Provide a clear separation between business/financial activities of the SoLR and other parts of its supply business.

- **Method of Allocation:** Should the SoLR be allocated via an obligation, auction process or a case-by-case approach?

  The Commission’s initial view is that it would like to give all suppliers an opportunity to operate as SoLR and that option 3 above (allocating the role of SoLR on a case-by-case basis) presents a reasonable way
forward. However in the absence of expressions of interest, the Commission would appoint separate SoLRs for the electricity and gas markets and that these would be PES for electricity and BGÉ Supply for gas. This position would be reviewed after a period of, say, two years. At that point, depending upon the level of interest, the Commission would consider amending SoLRs arrangements.

- **Duration of Role:** How long should the SoLR last and how long should the transferred customer stay?

  The Commission is of the view that there should be some restriction on the period that customers should stay with the SoLR. This period should be no more than six months with the ability to swap away from the SoLR after one month, reflecting the need to add some degree of stability into the market. However, large consumers may be allowed to negotiate a new tariff with the SoLR or be free to choose another supplier immediately.

- **Gas Shipper of Last Resort:** Should there be a shipper of last resort? Who has responsibility for gas purchase and transportation immediately after the SoLR event? Should the transporter be responsible for overruns and scheduling charges during the interim period?

  The Commission considers that there is no immediate requirement for a shipper of last resort and that the transporter is in a position to undertake the necessary gas contracting and transportation duties until the supply has put in place the necessary arrangements. The expectation is that this would take place within a matter of a few days following the failure.

  Finally, it is the Commission’s initial view that, given the very special conditions of a SoLR event, it may be appropriate to suspend the scheduling charges until the SoLR takes responsibility for shipper activities.

Respondents are invited to comment on the options and Commission views outlined listed in this section. If respondents consider the options and views should be amended or expanded, please provide specific suggestions and set out your reasons so that the Commission can fully consider your position.
4 SoLR cost recovery and tariffs

Two separate issues are addressed in this section – the net cost of operating the SoLR role and the recovery of the allowable costs.

4.1 SoLR revenue requirements

The benefits and costs of the SoLR role need to be carefully considered when considering whether or not a SoLR should be allowed additional revenues (see Appendix B).

4.1.1 Benefits

Clearly, there are benefits to the supplier that has obtained a number of customers that it would not have done otherwise. This could provide a significant benefit to the supplier if it were to retain them. Indications are that the value of a new customer could be anywhere between £186 (€270) and £310 (€450) in Britain. Evidence from Britain also suggests that suppliers are prepared to discount tariff for new consumers in the first year or two, particularly when they supply dual fuels. While the value estimates may differ in Ireland, they do exist and it is not to overlook this benefit.

4.1.2 Non-energy related costs

Then there are a number of cost categories to be considered. Depending upon the scale of the supplier the levels of most costs (excluding fuel) are likely to be small given that the supplier has robust systems already in place. Examples of these categories of cost include customer transfer through the change of supply process, communications with these customers about the SoLR event, billing and ensuring that the affected customers can change to another tariff or supplier.

All costs except energy supply are relatively simple to quantify. The incremental costs will depend on the charges for the change of supplier process and the SoLR’s internal costs. These will vary depending on the nature of the failure and the number of customers involved. If there are few customers, the costs will probably be insignificant. Otherwise, it should be straightforward to establish a set of benchmarks against which a potential SoLR’s costs are assessed.

4.1.3 Energy related costs

The cost of buying energy for affected customers is likely to be the largest component of cost and its level is influenced by the timing of the SoLR event and the total load of the customers involved. The calculation of allowable energy costs can be dealt with in two ways – ex ante or ex post.

Ex ante approach to cost recovery

Under the ex ante approach the Commission would approve a tariff that includes an estimate of the additional energy costs incurred by the SoLR.
The tariff could be set:

- reflecting the potential conditions of the failure in the tariff. The allowed costs could be linked to the timing and nature of the potential failure. A suite of tariffs could apply that would be known in advance and to which the SoLR would be bound. This may expose the SoLR to some risk (which would need to be reflected in the tariffs);
- applying a uniform premium to reflect additional energy costs and the risks to which the SoLR is exposed. In Texas, the SoLR tariff is set at 125% of the “price to beat”;
- using the current wholesale top up prices. This would be feasible given that prices are known in advance. Note that this will not be the case in proposed all island wholesale market;
- allowing no additional cost recovery. It would be assumed that the SoLR has a sufficiently diverse book of contracts to allow it absorb the risk of new customers. By implication, this means that the SoLR’s allowed costs would be no higher than those of the regulated tariff.

Setting the *ex ante* cost approach offers price certainty to customers. If the energy related elements of the tariffs are sufficiently well structured to reflect the circumstances of the failure, they could be reasonably cost reflective. The key disadvantage is that the outturn cost may be very different from the estimate. This approach places risk with the SoLR.

*Ex post* approach to cost recovery

In this case, the SoLR applies regulated tariffs and *ex post* there would be a separate mechanism for recovering any additional allowable costs. Setting allowed costs *ex-post* requires the SoLR to maintain clear records of the additional energy purchase costs involved and requires a judgement on how much of these costs should be allowed. Although the costs underlying the regulated tariffs could be used, this will need to reflect the sources of energy for the SoLR, which may not correspond to the regulated costs.

While this would require significant effort at the time, setting allowed costs *ex-post* would mean little up-front work to determine them. In many ways, this is suited to the low probability and random distribution of a SoLR event. This approach has the advantage of reducing the potential risk to the SoLR of the tariff receipts being less that its allowable costs. On the other hand affected customers, *ex ante*, are not clear about the tariff price level. This may impact on their initial decision to change supplier.

Setting the appropriate cost to be recovered is a matter of balancing these two elements; i.e. balancing the need to manage the SoLR’s risk and providing the customer with certainty.

4.2 Cost recovery mechanisms

Key to determining a suitable cost recovery mechanism is deciding whether the customers of the failed supplier should be protected from the
consequences of that supplier’s failure. It may be argued that it is no fault of
the customer that its supplier has failed. Alternatively it can argue that it
would create improved incentives for the consumer to take care about its
choice of supplier. From a customer perspective, when its supplier fails, it
should not face a significant increase in its tariff level.

In the light of this, the choice is to:

1. set the SoLR tariff above the standard regulated tariffs, to reflect the
additional costs (net of benefits) involved, based on an ex-ante
determination.

2. require the SoLR operate standard ex ante regulated tariffs with an ex
post regime to allow the SoLR recover any approved costs. This would
take the form of an industry wide charge (e.g. charged on the same
basis as use of system charges or perhaps an uplift on wholesale
energy prices).

Essentially, the choice is one of balancing risk between the SoLR and
consumers. A tariff above the regulated level means that the SoLR is
prepared to carry greater risk, assuming no ability to recover costs ex-post.
The tariff would probably include a risk premium. It may be difficult to
determine this premium, as it would depend upon the timing and customer
load involved in the SoLR event.

4.3 Overview

Costs associated with undertaking the SoLR role may vary depending on the
timing of the exit and the size and customer base of the supplier exiting the
market. Also of importance is how this cost is calculated and how it is
recovered in the market.

Principles for SoLR cost recovery and tariff-setting need to take account of
the following issues:

- **Calculation of SoLR net costs** – How can the benefits to a supplier of
  operating as SoLR be factoring into the calculations? It is
  straightforward to calculate non-energy related costs? Can these costs
  be benchmarked? Should energy related cost be determined ex ante or
  ex post?

- **SoLR cost recovery** – Should allowable SoLR costs be recovered ex
  ante, ex post or in some combination of both?

- **SoLR tariffs** – How should the tariff be structured and how should its
  level be determined? How should the level of SoLR tariff compare to
  standard PES and BGE tariffs?

The Commission is of the view that there is a case for fixing the allowable
costs of all non-energy purchase elements in advance, ex ante, together with
some estimate of allowable energy costs which would be net of benefits with
any additional energy costs recovered ex post. The scope of the relevant
allowable costs will need to be clearly defined. This approach provides an
appropriate balance between providing certainty to consumers at a difficult time for the market, maintaining confidence in the market arrangements overall and not exposing the SoLR to undue risk, in particular if the failure took place at a time of high system stress and prices.

Respondents are invited to comment on the options and Commission views outlined listed in this section. If respondents consider the options and views should be amended or expanded, please provide specific suggestions and set out your reasons so that the Commission can fully consider your position.
5 Mechanics of the SoLR

This paper concentrates on the high-level principles for designing a SoLR role in the electricity and gas markets. A subsequent paper will build on the points raised in this paper, the Commission's initial views and comments received from interested parties. This section gives a flavour of the procedural details that need to be developed.

In the following sections, we set out the key stages in the process and the high level issues associated with each. These are:

1. Ensuring the SoLR maintains the capability to provide the service;
2. Determining when the SoLR should be activated; and
3. Managing the process of transferring customers to the SoLR.

5.1 What information will be required of the SoLR?

The SoLR needs to fulfill its role when the time comes, and needs to convince the Commission that it is in a position to do so in advance of the event. This means collecting a range of information, some of which will be specific to the electricity and gas systems.

In Britain, where Ofgem operates a “case-by-case” approach, these data requirements are defined in full. They include the following:

1. General information about the supplier;
2. Access to sources of gas or electricity;
3. Evidence of having all necessary network access arrangements and trading credit cover arrangements in place for gas and/or electricity;
4. Evidence of being able to manage the change of supplier process and other components of the SoLR role (e.g. demonstrates that it has maintained the infrastructure and staff necessary to carry out its activities); and
5. Evidence that the MRSO/GPRO have/will have the necessary facilities in place to handle a large number of change of supplier events at the same time and that it can service the range of customers that might come to it through the SoLR.

5.2 Determining when the SoLR should be activated

The first step in this process will be a warning of default by the errant supplier – most likely through a failure to make a wholesale market or network charge payment. There are a number of possible sources of information about a failing supplier (e.g. the various gas and electricity operators such as GPRO and MRSO). Information from all of these sources
will provide an accurate picture of the failing supplier. It is difficult to give an exact time as which the SoLR role is activated. In making this decision consideration should be given to a number of different areas such as:

1. Has the supplier defaulted or is the supplier about to default on its payments?

2. Has the supplier has been placed in receivership? Is there a reasonable prospect that the business can be salvaged and sold as a going concern?

3. Should the supplier’s license be revoked if the supplier appears unable to operate as a going concern?

4. Is the pre-selected SoLR available to provide the service? Does the SoLR have all necessary arrangements in place?

### 5.3 Activating the SoLR

Once a decision has been made to implement the SoLR, a series of steps are taken to ensure that it operates smoothly. These may include the following:

1. The Commission, having selected the SoLR, will consider the size of the potential exposure resulting from the exit of the failed supplier.

2. When the SoLR is appointed, its first responsibility will be to notify its failed customers of the fact.

3. The SoLR must provide information to affected customers about their rights to transfer to other suppliers (together with the timescales involved).

4. The SoLR must manage the change of supplier process for its new customers and issue bills to them on a timely basis. This will include meter-reading activities (and any other estimated values required) to complete the transfer process. The volume of customer transfer may impact on the time taken to transfer affected customers.

### 5.4 Overview

SoLR procedures need to be comprehensive and practical for the purpose of keeping all customers informed of events and ensuring that a smooth transition from the exiting supplier to the SoLR takes place.

While this paper outlines some of the key areas that need to be addressed, the design of the detailed procedures required for the proper functioning of the SoLR process is beyond the scope of this paper. These will be addressed at a later date prior to any decision on this issue.

Respondents are invited to comment on the points raised in this section. If respondents consider the options and views should be amended or expanded, please provide specific suggestions and set out your reasons so that the Commission can fully consider your position.
Appendix A: International Comparisons

Internationally, a wide range of approaches has been taken to the SoLR issue. This section of the paper has been structured to reflect the core issues outlined earlier in the paper.

1. How the SoLR obligation is defined and the role allocated; and
2. How SoLR tariffs are set and costs recovered.

For comparison, we have selected a diverse set of environments; the UK, Australia (with the primary focus on Victoria), New Zealand (distinguished by the fact that it does not currently have a SoLR) and Texas. The comparison is presented in a tabular form.

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Issue: Allocation of the SoLR obligation</th>
</tr>
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<tbody>
<tr>
<td>Britain</td>
<td>Ofgem allocates the SoLR role on a case-by-case basis depending on the nature of the failure and its scope (i.e. the customer type affected and whether it is a single or dual fuel failure). Ofgem from a group of pre-qualified suppliers selects the chosen supplier. This contrasts with earlier arrangements where the host distributor was given the SoLR obligation. It discharged this through tendering for suppliers to provide the service. Ultimately, however, the distribution business was responsible for delivery.</td>
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<tr>
<td>Australia</td>
<td>In Victoria, suppliers hold the right based on a geographical split (defined as “host retailers”). There is a further subdivision between first and second tier suppliers (first being the “local” retailers). If one of the host retailers fails, its customers are allocated to all other host retailers in proportion to their respective market shares. While these arrangements applied initially to the electricity sector, consultation is currently in progress that may result in similar arrangements being applied to the gas sector. One approach under consideration is that gas suppliers may state a preference to take on customers in a particular location, with the remainder be allocated according to local retailers’ market share.</td>
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<tr>
<td>New Zealand</td>
<td>Consultation is currently underway on SoLR issues in New Zealand. At present, there are no SoLR arrangements and the approach is based on an “orderly transition” of customers from the failing supplier to another. If a supplier goes bankrupt, the receiver is responsible for ensuring an orderly transition – i.e. selling the customer base to another supplier. There are rules for allocating customers across existing suppliers in the event that the customer base cannot be sold. Given the high level of security required, the regulator and market views it as unlikely such an allocation will be needed</td>
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</table>
as customers are expected to be sold en-bloc.

Approaches under consideration include the appointment of a statutory manager to run the supply business in the period until a receiver is appointed. The legal arrangements mean that the government has to appoint the statutory manager, hence the need to ensure that this process takes place rapidly.

However, consultation is due to begin on whether a formal SoLR approach should be adopted as a safety net.

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Issue: How SoLR tariffs are set and costs recovered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Britain</td>
<td>The SoLR is paid any unrecoverable costs associated with providing the service through transmission use of system charges. Ofgem’s position is that such charges should be the exception rather than the rule. Rather, the charges made to the failed supplier’s customers should be cost reflective. Ofgem would make a case-by-case consideration of whether any additional revenue should be allowed.</td>
</tr>
<tr>
<td>Australia</td>
<td>In Victoria, an ex-ante approach is followed. The Essential Services Commission (which regulates the service) has developed a number of criteria that the price should reflect. The objective was to ensure that customers did not face exposure to a potentially volatile pool price. Potential SoLRs are required to submit intended tariffs in advance. The ESC is now reviewing this arrangement, in the context of placing gas supply into the arrangements. The logic is that the tariffs should be flexible enough to cope with a wide range of outcomes, be simple for consumers to understand, minimise the administrative costs of moving to the new tariffs and ideally insulate consumers from price volatility. In terms of price level, for small consumers, the ESC has proposed that this should be based on the “Standing Offer Tariff”</td>
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</table>
(which is broadly equivalent to the PES tariff) and the supplier is allowed to recover any additional costs through a one-off up-front fee. Customers will be locked into this tariff for a defined period that is to promote stability in the marketplace. The ESC does not intend to create a fixed tariff for large customers; rather it looks to the SoLR and the customer to agree terms. In the event that they cannot agree a tariff and no other supplier offers to provide energy to the customer, the ESC will determine the tariff.

| New Zealand | As there is no SoLR in New Zealand there is no SoLR. One concern in the current consultation on the SoLR is that it should not result in a tariff higher than that charged by incumbent suppliers – i.e. consumers should not suffer as a result of their supplier failing. |
| USA | In Texas, the SoLR tariff is limited to be no more than 125% of the “price to beat” tariff. |

The key messages from international experience on pricing is that suppliers are not willing to provide the SoLR if they are locked into a tariff that is unlikely to be cost reflective and where the risks may be difficult to identify. Consequently there is a very real tension in balancing cost-reflectiveness with protecting consumers from high prices in the event that their supplier fails.
Appendix B: Quantitative Analysis

Determining the values associated with SoLR activities is a difficult challenge. There are many dimensions in which the evaluation needs to be conducted. Therefore, at this stage, a detailed quantitative analysis would be highly problematic and of limited value.

Turning to energy purchase and other costs, the key factors will include:

1. **The timing of the supplier failure**: If this takes place in winter, the costs for the SoLR will be very different to the summer.

2. **The customer base**: The costs to serve will depend on the nature of the load. A “peaky” profile will be inherently more expensive than one that is flatter. The customer type will also be relevant (i.e. commercial, industrial or domestic) as well the level of consumption and payment method. Analysis of the load curves of these customers against a variety of electricity and gas price scenarios would be the most appropriate means of determining the likely costs of serving customers during a SoLR event. The simplest approach would be for customer types to be linked to certain tariffs, with some adjustment to reflect energy purchase costs at the time the failure occurred, possibly in the form of a mark-up on the relevant tariff;

3. **The fuel supplied**: Costs will differ depending on whether the failing supplier offered electricity, gas or both;

4. **Inherited contracts**: If the SoLR is able to transfer the outgoing supplier’s contracts to itself, this could have a substantial impact on cost of supply;

5. **Regulatory requirements for the SoLR service**: The level of regulatory requirements (for example the need to hold options to cover potential exposures) can impact on the cost of providing the service;

6. **Transmission and distribution charges**: The shape of the customer load will influence both. This is particularly so for gas in the case of large consumers;

7. **Change of supplier and incremental billing costs**: The SoLR will need to manage the change of supplier process for its new customers and be able to bill them. Given that the costs of the change of supplier process itself is recovered through DUoS charges, these costs relate to the supplier’s own internal business processes and systems. This is something that could be benchmarked.

On the benefit side, the issues will include:

1. **The customer type**: The likely degree of churn from the outgoing supplier’s customer base will influence its value. Specifically, the issue is how long the supplier is likely to be able to retain the customers transferred to it. If the churn rate is low, then the
customers will tend to be more valuable. The difficulty, as noted above, is how to unlock this value.

2. **The nature of the SoLR’s business**: The SoLR may be an energy only supplier or could provide a range of services. This may depend on the customer segment it serves. For example, if it serves large consumers, other services such as energy efficiency and management may be more important. Each of these elements will have a different value attached to them.

Some of the components described above can be assessed but many will be specific to the details of the particular situation. Consequently, analysis of any general case is unlikely to accurately reflect the facts of the particular case.

The most tractable information comes on the benefit side – specifically what a customer is worth to a supplier. There is some evidence from Britain on this. Ofgem has estimated that the value of a customer (based on “trade purchases” of customers from Seeboard, TXU and BGT) suggests a value for UK domestic customer of between £186 (€270) to £310 (€450). Based on conservative assumptions on churn, this results in an implied rate of return between 8 and 10%.

The position of non-domestic consumers is different given that their value depends on the nature of their load, the contract terms they are under, their size and likely switching rate – that is a rather more heterogeneous set of factors than for domestic consumers.
Appendix C: Case Study – TXU’s Failure in Britain

When TXU Europe ran into financial difficulties Ofgem was in the position of needing to decide if and when to declare a SoLR process for TXU’s domestic electricity and gas customers. Ofgem was concerned that, if necessary, it would need to act quickly in order to maintain customer confidence in the competitive electricity and gas markets.

Ofgem had already carried out a “dry run” of the SoLR process and had collected much of the pre-qualifying information that SoLR’s needed to provide. This included:

1. A register of potential SoLRs and contact details
2. Contracts for supply
3. Draft letters to customers

Therefore, both Ofgem and potential SoLRs understood the process and were well prepared. SoLR candidates were already compiling the additional information (such as prices and financial information) that Ofgem would require. However, at the point of a potential supplier failure the key issues for Ofgem were collection of data from TXU and the decision on when to invoke a SoLR process.

The collection of data from TXU would include metering and billing information on all customers, details of TXU’s trading and contract information and counterpart credit details. During the week before TXU’s eventual sale, Ofgem had required the company to supply this information.

A number of issues arose that made the process difficult:

1. TXU had never before attempted to extract the required data from IT and billing systems in the form that Ofgem required it. The data requirements were extremely large because of the size of the customer base and were to be extracted from multiple systems. Therefore data could not be provided within the timescales that Ofgem had set. Moreover, Ofgem had underestimated the scale and the complexity of the information that would be required to affect the last resort role.

2. TXU had a number of large contract and trading positions with counterparties who were also potential SoLRs. There was concern that if TXU were placed into administration, they would default on these contracts and thus affect the financial viability of the potential SoLRs. It was therefore critical for Ofgem to understand TXU’s counterparty credit positions. However there was no statutory obligation for TXU to provide this.

3. TXU’s priorities were on negotiating the sale of the company and on supplying relevant data for the data room - not supplying data to Ofgem.
It was in TXU’s interests to delay supplying the data in order to ensure that Ofgem could not declare a SoLR process which would remove any remaining value in the company.

In terms of the decision of when to invoke the SoLR process the key difficulty for Ofgem was in understanding the progress of negotiations for the sale of TXU. Whilst, technically, they could invoke the process as soon as one of the conditions of the Insolvency Act was met, they may have been open to legal challenge from the creditors if the administrators believed the company could be sold or could continue to operate in administration. They were therefore prepared for immediate discussions should administrators be appointed.