

Gas and Electricity Suppliers,
Electricity Distribution Network
Operators,
Gas Transporters and all other
interested parties

Email: solrlevyteam@ofgem.gov.uk

20 October 2023

Dear Colleague

Last Resort Supply Payment Claim from Octopus Energy

On 7 September 2023, Octopus Energy Limited (“Octopus Energy”) gave notice to Ofgem of its claim for a Last Resort Supply Payment (LRSP) in relation to acting as Supplier of Last Resort (SoLR) to customers of the former UK Energy Incubator Hub Limited (“UKEIH”).

Under Standard Licence Condition (SLC) 9.1 of the Supply Licence, SoLRs are entitled, provided Ofgem consents, to make a claim for a LRSP from each Relevant Gas Transporter and Electricity Distribution Operator. The claim from Octopus Energy included its calculation of the claim amount and information to support the calculation (outlined in Table 1).

This letter sets out the reasons why we are minded-to not grant consent to Octopus Energy’s claim for a LRSP.

We are minded-to not grant consent to Octopus Energy making a claim for costs incurred in complying with a Last Resort Supply Direction¹ relating to:

- Additional wholesale costs incurred as a result of commitments to supply energy to SoLR customers;
- other costs reasonably incurred on becoming a SOLR.

During winter 2021/22 we introduced a number of temporary changes to the LRSP claim process, which were designed to ensure that the SoLR process continues to protect consumers in volatile market conditions. This included the temporary introduction of a faster, multiple-claim levy process, which was intended to reduce the time taken for suppliers to submit claims and for us to make decisions on those claims. Our policy on assessing further claims under this temporary multiple-claim process was published on 21 September 2022². On 25 May 2023 we published a further consultation on whether to end or continue the temporary multiple-claim process. In the consultation decision, published

¹ <https://www.ofgem.gov.uk/publications/appointment-octopus-energy-limited-electricity-supplier-last-resort-uk-energy-incubator-hub-ltd> and <https://www.ofgem.gov.uk/publications/appointment-octopus-energy-limited-gas-supplier-last-resort-uk-energy-incubator-hub-ltd>

² <https://www.ofgem.gov.uk/sites/default/files/2022-09/Decision%20on%20the%20last%20resort%20levy%20claims%20true-up%20process.pdf>

on 24 August 2023, we set out our decision to maintain the temporary process until at least after winter 2023/24, at which point we would again review market conditions and consult on whether the temporary process should be ended.³

As part of that faster multiple-claim levy process, each of the SoLRs entered into a true-up deed with us. Under this True-up Agreement between Octopus Energy and Ofgem, Subsequent Levy Claims may be made following the Initial Levy Claim and before a final True-up claim. We are minded-to consider this claim to be a Subsequent Levy Claim for the purposes of the True-up Agreement. This would mean that the final True-up claim would happen next year, or in the years after. This will enable Octopus Energy to submit additional LRSP claims with supporting evidence for costs that have not yet been approved by Ofgem. As a result of this, under the terms of the True-up Agreement, we will require a final True-up claim to be submitted in the future. In the meantime, we note that obligations under the True-up Agreement continue to apply and will remain in place until a final True-up claim has been finalised.

The purpose of this consultation letter is to provide interested parties with an opportunity to make any representations to us, ahead of us making our final decision. We will take such representations into account in reaching our final decision and may make changes to our minded-to position in response to such representations, if we consider it appropriate to do so.

In addition, before we make our final decision we will conduct an additional assurance process in respect of the calculations contained in our minded-to position, the results of which may also be reflected in our final decision.

We expect to make our final decision in mid-December 2023.

Background

The SoLR process

Electricity and gas supply is a competitive activity in Great Britain. While competition has the potential to bring many benefits to consumers, in a competitive market, companies that are not operating efficiently may fail. This applies as much in relation to the gas and electricity supply markets as it does to other markets.

It is Ofgem's statutory duty to protect customers' interests when suppliers fail. When a supplier fails, our focus is to ensure continuity of supply for its customers and to minimise wider negative impacts on the market.

Ofgem can ensure continuity of supply to the failed supplier's customers and minimise these wider negative effects by appointing a SoLR, which is issued with a Last Resort Supply Direction requiring it to supply the failed supplier's customers at very short notice⁴.

Failed Supplier event

³ [Decision on ending the temporary Last Resort Supply Payment claim process | Ofgem](#)

⁴ The obligation for a supplier to comply with a LRSD derives from standard licence condition 8 of each supplier's gas and electricity supply licences and is intended to ensure a universal service for Great British energy consumers (for further information on this universal service, see Articles 3(3) of the EU Directives 2009/72/EC and 2009/73/EC).

On 9 July 2022, we appointed Octopus Energy as the SoLR for UKEIH gas⁵ and electricity⁶ customers. This followed an appointment process aimed at getting the best deal for consumers. We outlined the material factors behind our decision to appoint Octopus Energy as the SoLR to those customers in our decision letter published on 1 December 2022⁷.

Claim for Last Resort Supply Payment

Under SLC 9.1 of the Supply Licence, SoLRs are entitled, with Ofgem's consent, to make a claim for a LRSP from each Relevant Gas Transporter and Electricity Distribution Operator.

SLC 9.4 provides that the total amount of the LRSP must not exceed the amount by which the total costs (including interest on working capital) reasonably incurred by the SoLR in supplying customers under the Last Resort Supply Direction and a reasonable profit plus any sums paid or debts assumed by the SoLR to compensate customers in respect of any customer credit balances plus any additional (actual or anticipated) interest and finance costs associated with a financing arrangement approved under SLC 9.7C are greater than the total amounts recovered by the SoLR through charges for that supply.

SLC 9.6 makes clear that Ofgem may determine that an amount other than the one calculated by the SoLR is a more accurate calculation of the relevant amount and, in such cases, the amount specified by Ofgem must be treated as the relevant amount when the licensee submits its claim to each relevant electricity or gas network licensee in accordance with SLC 9.8.

LRSPs are paid for by the relevant gas and electricity network operators, who then recover the cost through charges to suppliers. SLC 38B of the Electricity Distribution Licence and Standard Special Condition A48 of the Gas Transportation Licence set out the details of this.

Our true-up decision process and methodology

During winter 2021/22 we introduced a number of changes to the process for making LRSP claims, which were designed to ensure that the SoLR process continues to protect consumers in the current market conditions. The changes included the temporary introduction of a faster, multiple-claims process whereby SoLRs are able to submit more than one claim in relation to each Last Resort Supply Direction.

The multiple-claims process involves SoLRs submitting an 'initial claim' for costs faced in serving SoLR customers (typically wholesale commodity costs) in the period immediately after appointment. Each SoLR entered a True-up Agreement with Ofgem to support this process. The True-up Agreements provide for the initial claims to be followed by an additional claim (or claims) in accordance with SLC 9. We refer to these additional claims as either a Subsequent claim or a final True-up claim. The true-up process is intended to

⁵ <https://www.ofgem.gov.uk/publications/appointment-octopus-energy-limited-gas-supplier-last-resort-uk-energy-incubator-hub-ltd>

⁶ <https://www.ofgem.gov.uk/publications/appointment-octopus-energy-limited-electricity-supplier-last-resort-uk-energy-incubator-hub-ltd>

⁷ <https://www.ofgem.gov.uk/publications/appointment-octopus-energy-limited-supplier-last-resort-uk-energy-incubator-hub-limited>

reconcile suppliers' initial and subsequent claims with actual costs incurred and determine any additional payments or repayments that should be made at the end of the multiple-claim process.

Following consultation, on 21 September 2022⁸ we published our policy on assessing these true-up claims and it has been applied to subsequent and true-up claims under the True-up Agreements.

In December 2022, Ofgem consented to SoLRs making Subsequent levy claims totalling £405m on the condition that these claims be treated as Subsequent levy claims under the True-up Agreements, and that the Agreements remain in place until a valid final True-up claim is made. As a result, SoLRs that submitted claims in 2022 under their True-up Agreements were still required to submit to Ofgem a final True-up claim for each Last Resort Supply Direction in respect of which they have a True-up Agreement.

In May 2023, we set out in an open letter our expectations for SoLRs' final True-up claims following the LRSP claims that were approved in December 2022 under the temporary multiple claim process.⁹

Under Supplier SLC 9.5, Ofgem must decide whether it is appropriate in all the circumstances of the case for the SoLR to make the claim notified to it in accordance with SLC 9.3.

Our process to reach our minded-to position included:

- a. A quantitative check of Octopus Energy methodology for each cost item claimed. This included determining how each total cost item was calculated based on data sent to us by Octopus Energy and ensuring these costs were in line with commitments Octopus Energy made at the time of its SoLR appointment;
 - b. A true-up and cross check of any evidence that may result in a change to the initial claim or subsequent claim made by the SoLR;
 - c. Undertaking validation of some assumptions with other data sources, where appropriate; and
 - d. A qualitative and quantitative assessment of the claim for costs related to wholesale and other costs in accordance with the relevant licence conditions and/or our criteria and methodology, set out below.
- **Additional:** whether the costs claimed are additional to the costs to the SoLR of existing customers. In addition, we consider whether these costs would have been expected at the time of the SoLR's bid and whether any commitments were given in relation to these costs in their competitive SoLR bid.
 - **Directly incurred as part of the SoLR role:** whether the costs were incurred as a result of taking on customers in an emergency situation as opposed to normal customer acquisition routes.
 - **Otherwise unrecoverable:** whether the SoLR could have recovered the costs through other means. It would not be appropriate for us to allow the SoLR to

⁸ <https://www.ofgem.gov.uk/sites/default/files/2022-09/Decision%20on%20the%20last%20resort%20levy%20claims%20true-up%20process.pdf>

⁹ [Update on the last resort claim process for 2023 | Ofgem](#)

claim for costs it could have recovered – or reasonably be expected to recover - through the administration process or customer charges, for example.

- **Economic:** whether the SoLR had made all reasonable efforts to avoid the cost in the first instance or absorb the cost.

Octopus Energy's claim

Octopus Energy indicated at the time of our SoLR appointment process that it would not waive its right to make a claim for a LRSP for additional costs incurred as a result of acting as the SoLR for customers of UKEIH.

The initial claim was consented to on 20 December 2022.¹⁰ Consistent with the terms of that consent and the True-up Agreement between the SoLR and Ofgem, we have taken that claim into consideration in reaching our minded-to position on this claim.

Summary of our minded-to decision

Based on the information available and consideration of the circumstances in which the claims for a LRSP by Octopus Energy was consented to, and in accordance with the True-up Agreement in relation to customers of the former UKEIH, Ofgem is minded-to not grant consent to Octopus Energy claiming a LRSP.

Under the Supplier SLCs we are required to consider on a case-by-case basis whether in the circumstances it is appropriate for a SoLR to make a claim for a LRSP. We have set out below our reasons for our minded-to position for this case. This should not be taken as setting a precedent for any future claims, which would also be considered on their merits and on a case-by-case basis, taking into account all relevant circumstances of the particular case.

Table 1: Summary table of initial claim, true-up and minded-to position on final claim amounts.

Item	Cost	Initial Claim Approved	This Claim as Submitted	Minded-to position on This Claim
1	Wholesale	N/A	£4,009,171.09	£0
2	Other Costs	£236,558.00	£350,000	£0
	Total			£0

Reasons for our minded-to decision

Cost category: Wholesale

In this claim we have analysed the information provided by the supplier, to:

- Assess whether costs being claimed for are consistent with the criteria set out earlier in this letter and our September 2022 policy;

¹⁰ [Decision on last resort levy true-up claims | Ofgem](#)

- Assess the reasonableness of assumptions made and decisions taken, including for example demand forecasting and hedging strategies, against the criteria we consider in assessing claims;
- Assess the specifics of the reported wholesale market trades, including trade date, contract type, price, and volume. Specifically, we have considered whether trade prices are consistent with market benchmarks and price assessments;
- Assess cost per MWh and cost per customer to facilitate comparisons between claims;
- Assess the amounts deemed to have been recovered from customer charges, including the applicability of various price cap allowances, and hence offset against the wholesale costs incurred.

Decision

Octopus has claimed for wholesale costs in relation to UK Energy Innovation Hub (UKEIH) of £4,009,171.09. Octopus has not submitted an audit¹¹ or declaration on this wholesale claim. As a result, we do not have the level of assurance we require in relation to the evidence provided to support this claim. Therefore, we are minded-to not allow Octopus any amount for wholesale costs. Despite the lack of audit and declaration we have carried out an assessment of Octopus' wholesale claim, explained further below. Based on that assessment, we would be minded-to allow Octopus to make a claim of up to £1,355,458.33 for wholesale costs if a satisfactory audit and declaration was provided (subject to consideration of other consultation responses). Our assessment is that Octopus' claimed amount is not fully consistent with our criteria and, were we to be minded-to allow any amount to be claimed, we would be minded-to reduce the amount claimed by Octopus by £2,653,712.76 This reflects the following adjustments:

- A deduction of £1,431,490.68 to adjust for incorrect gas volume figures. In its original submission, Octopus included gas volumes that were significantly higher than traded volumes for gas. However, during our engagement with Octopus following submission of its claim, Octopus identified that this was an error in its submission and resubmitted the claim to correct for this.
- In its resubmitted claim, Octopus also adjusted the electricity volume and electricity demand forecast, without providing a narrative to explain this change. We have used the electricity volumes and claim amount provided in its original submission dated 8th September 2023.
- A deduction of £810,470.47 to adjust for the time period claimed. Octopus' claim covered the period spanning the 9th July 2022 to 31st March 2023. This claim exceeds the 6-month SoLR direction period that we would usually allow costs to be recovered for, as set out in our September 2022 policy position.
- A deduction of £217,352.21 which reflects a change to the price comparator used in the claim.
- A deduction of £143,420.38 to adjust for the backwardation allowance introduced in the wholesale element of the price cap from cap period 9a onwards.
- A deduction of £50,979.02 for the retrospective backwardation allowances introduced during February 2022 and August 2022 to compensate suppliers for high costs incurred during cap period 7. These allowances were to be recovered by

¹¹ Octopus Energy submitted the results of an external audit to Ofgem after the claim submission deadline of 7 September 2023. However, due to the assessment timelines we have not had time ahead of publication of this minded-to position to consider these results as part of our assessment. We will assess the submitted audit during the consultation period, and take this into account for our final decision.

suppliers between April 2022 and September 2023. We have calculated a deduction amount for Octopus only from July 2022 onwards.

Table 2: Summary of claims and minded-to position for wholesale costs

Item	Cost	Initial Claim Approved	This Claim as Submitted	Minded-to position on This Claim
1	Wholesale costs	£0	£4,009,171.09	£0

Rationale for decision:

Gas Volume Adjustment

Through our analysis of Octopus' claim, we identified an inconsistency between the volume of gas that Octopus had claimed for, and the traded volumes and demand forecast they had provided for gas. The volume of gas that Octopus had claimed for was significantly higher than the traded gas volumes.

Following our findings, we engaged with Octopus and during this process Octopus were able to confirm that this inconsistency was an error in their submission data. Octopus resubmitted their claim with the correct gas volumes included. We have used these correct volumes in our analysis. The resubmitted gas volume numbers would result in a deduction of £1,431,490.68 to Octopus' original claim submission.

Electricity Volume Adjustment

During our assessment we identified that, in its resubmission to correct the gas volumes, Octopus had adjusted its electricity volume claimed and electricity demand forecast.

Octopus did not provide a supporting narrative to explain this change when it resubmitted its claim. Since Octopus did not provide a justification for this change we decided to proceed with the electricity volume included in its original submission. This would make the claim £40,282.47 lower than if we used the resubmitted data. Hence the remaining deductions are based on the resubmitted gas claim value but the original electricity claim value, amounting to a total of £2,577,680.41.

Claim Period Adjustment

Our view is that Standard Licence Condition 9.4 requires SoLRs to show that a contractual liability for costs has arisen during the period of its SoLR Direction (six months) and that the energy (to which those costs relate) has been/will be delivered to SoLR customers' premises during the period of that Direction.

Octopus submitted a claim which covers wholesale energy costs for a nine month period from 9th July 2022 to 31st March 2023.

Octopus provided us with a supporting narrative for its extended claim, which argued that it experienced unique and unavoidable costs due to when it was appointed SoLR. Octopus stated that when it was appointed SoLR the observation window for cap period 9b (which is January to March 2023) had already commenced. The price cap methodology assumes that suppliers can gradually hedge during this observation window. Octopus argued that as it

was appointed after this window had already started, it was not able to match the price cap methodology for this cap period. Octopus' extended claim covers cap period 9b.

It is our view that Octopus is not unique in being appointed as a SoLR during an observation period. We envisaged such a scenario when we assessed the options for our policy on the time period of claims in developing our September 2022 policy¹², and decided that on balance it would be in consumers' interest to limit the claim period to six months after appointment. We also consider that, more broadly, after the end of the six month SoLR direction, it is reasonable for the customers that remain with the supplier to be treated as 'normal' customers.

We therefore do not consider that Octopus has submitted sufficient evidence to warrant an exception to the six-month time period for wholesale costs. Allowing Octopus to claim for an extended time period would increase the costs to be recovered from consumers and could therefore have an adverse impact on current and future consumers.

We therefore consider that limiting recovery to costs incurred for energy delivered until the end of the six-month direction period, to be the most appropriate approach, balancing the case for SoLRs to recover costs for an extended period against the needs of existing and future consumers.

This would result in a deduction of £810,470.47 to the claim.

Price Comparator Adjustment

We use a price cap comparator to determine the amount of revenue that a supplier is expected to reclaim from customers through the wholesale portion of the price cap. The difference between the wholesale costs submitted by the supplier and the price cap comparator is the amount we consider is 'otherwise unrecoverable', which is one part of the test we apply to assess what costs are reasonable for suppliers to claim for under the SoLR Levy.

Octopus used its own methodology to calculate the price comparator in its claim. Octopus' methodology uses a weighted average of wholesale prices through the observation window period for price cap period 9a (P9a) and price cap period 9b (P9b) only up until the date it was appointed as SoLR for UKEIH (9th July 2022). For price cap period 8, it has taken the weighted average of wholesale prices across the entire observation window.

This methodology has produced a price comparator that is significantly lower than the relevant wholesale portion of the price cap for price cap periods 9a and 9b. This has inflated Octopus' claim substantially compared to the price cap comparator that we used.

Our view is that, since the price comparator is used to establish what a supplier has actually been able to recover through customer bills within a given period, the relevant allowance within the price cap should be used. We have replaced the price comparator that Octopus used with the direct fuel cost component for cap periods 8, 9a and 9b, as published in Annex 2¹³. This has reduced its claim and would result in a deduction of £217,352.21 to the claim.

We have taken a consistent approach in how we use price cap comparators in our assessments across SoLRs. We do not consider that Octopus has justified its use of an alternative comparator.

¹² [Decision \(ofgem.gov.uk\)](#)

¹³ [Annex 2 Wholesale Cost Allowance Methodology | Ofgem](#)

Backwardation Adjustment

Backwardation costs are a result of the difference between the index used to set the cap level and the way suppliers are able to purchase energy for their cap customers. When the market is in backwardation, the forward prices in the later nine months are lower than in the first three (the actual cap period). It brings the cap level below the cost to suppliers of purchasing that energy for customers (for that cap period).

In our decision published on 4 August 2022⁴ on changes to the wholesale methodology in the price cap, we decided to update the wholesale methodology to include ex-ante modelled backwardation costs, which would be calculated quarterly at each cap update. This approach provides suppliers with certainty on the allowance compared to an ex-post approach.

These backwardation costs would be recovered over a six month period with costs spread over six months relative to the gas and electricity demand in each quarter. We also decided to set a £9 deadband (£4 for electricity and £5 for gas £/customer/year) to ensure the wholesale methodology does not capture backwardation costs when the market is broadly stable.

As Octopus' claim includes cap periods 9a and 9b, we have added a £/MWh backwardation allowance amount to the direct fuel cost component price comparator value for the relevant quarters. This is because in addition to earning revenue from customers through the direct fuel cost component, Octopus would also recover backwardation allowances from their SoLR customers through the wholesale element of the price cap. The £/MWh backwardation allowance amount has been calculated post-deadband and post-six month recovery.

This would result in a deduction of £143,420.38 to the claim.

Retrospective Backwardation Adjustment

In February 2022 Ofgem introduced a retrospective allowance into the default tariff cap to allow suppliers to recover the systematic and unrecoverable backwardation costs incurred in cap period seven, beyond the normal basis risk inherent in the cap. An amount of £8 per customer (at typical consumption) was included within the cap for the year starting 1 April 2022, applied via an increase to the additional wholesale risk allowance component of the cap. In August 2022 a further allowance of £6 per customer was introduced, to be recovered in the year from 1 October 2022.

These allowances would have been recovered from all customers, SoLR and non-SoLR. Given this, we considered that the revenues collected by suppliers under this allowance should be deducted from claims made by SoLRs in relation to the costs of hedging SoLR customers' demand subsequent to taking on the customers of the failed supplier. In other words, the costs of purchasing wholesale energy for these customers should be reduced because suppliers were allowed to recover approximately £14 per customer through higher bills in later price cap periods.

Given the timing of Octopus' claim period, Octopus would have recovered a portion of these retrospective backwardation allowances from customers from July 2022 to September 2023. We calculated the deduction based on (a) the monthly demand forecasts provided by Octopus for July 2022 to September 2023 for gas and electricity and (b) the relevant £/MWh allowances, adjusted for UIG and line losses.

We calculated the relevant deduction based on our best view (given the information submitted by Octopus as part of its claim) of (a) the number of SoLR customers that remained with that supplier and (b) the annualised demand of those customers. We have used the same approach this year for our minded-to position.

This would result in a deduction of £50,979.02 to the claim.

Cost category: "Other costs"

We understand that other costs may have been incurred when undertaking activities as part of becoming a SOLR (for example, legal fees). We have used the criteria set out in our published decision on the last resort levy claims true-up process¹⁴ to assess whether it is appropriate for these costs to be recovered through a LRSP. The other costs that Octopus Energy has claimed are detailed below alongside our minded-to position.

Minded-to decision:

Octopus' claim includes £350,000 for costs that are anticipated in relation to acting as SoLR for former customers of UKEIH but have yet to be incurred. We consider that since the claimed amount is for costs that have not been incurred, it cannot be included in a claim for LRSP under SLC 9.4(a). We are minded-to not grant consent to this part of the claim.

Table 3: Summary of claim for other costs

Item	Cost	Initial Claim Approved	Subsequent Claim Approved in 2022	This Claim as Submitted	Minded-to position on claim
2	Administrator withheld funds	N/A	N/A	£350,000	£0

Next steps

The purpose of this letter is to provide the SoLR and interested parties with an opportunity to make any representations to us, ahead of us making our final decision on this LRSP claim. We invite any representations by 17 November 2023. Responses should be emailed¹⁵ to solrlevyteam@ofgem.gov.uk.

We normally publish all responses on our website. However, if you do not wish your response to be made public then please clearly mark it as not for publication. We prefer to receive responses in an electronic form so that they can be placed easily on our website.

We will take into account all relevant information, including any representations we

¹⁴ <https://www.ofgem.gov.uk/sites/default/files/2022-09/Decision%20on%20the%20last%20resort%20levy%20claims%20true-up%20process.pdf>

¹⁵ Although we prefer responses in electronic format, responses can be posted to the address below.

receive, and the results of our internal assurance of our assessment process in reaching our final decision on Octopus Energy's claim. We expect to make our final decision in mid-December 2023.

Yours faithfully,

Rohan Churm
Director, Financial Resilience and Controls