



Making a positive difference
for energy consumers

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

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Dear colleague

Decision on Last Resort Supply Payment Claim from Co-operative Energy

On 16 November 2017, we¹ published our minded-to position on Co-operative Energy Limited (**CEL**)'s intention to claim for a Last Resort Supply Payment (**LRSP**) additional costs they incurred in acting as a Supplier of Last Resort (SoLR).² We received 13 responses to our consultation. This letter confirms our decision to consent to CEL claiming a LRSP of up to £14.04m³. We also explain any additional factors we have taken into consideration, including representations made to us by interested parties in response to our consultation.

Our decision will allow CEL to recover a portion of the costs of protecting the credit balances owed by GB Energy Supply Limited (GBES) to the customers CEL acquired in line with commitments given at the time of appointment, and certain other costs incurred by CEL in complying with Ofgem's Last Resort Supply Direction (**LRSD**)⁴. We do not consent to CEL's request to include in its claim up to a further £0.86m, to cover IT migration costs which they consider were incurred in the course of acting as a SoLR. Our decision will enable CEL to recover up to £14.04m subject to the outcome of the GBES administration process (discussed further below).

In taking this decision, we have had due regard to Ofgem's principal objective of protecting the interests of current and future energy consumers,⁵ the relevant provisions of CEL's gas and electricity supply licences,⁶ Ofgem's "Guidance on supplier of last resort and energy supply company administration orders" (our "**Guidance**"),⁷ the terms of the LRSD and the particular circumstances of compliance with the LRSD.

¹ References to the "Authority", "Ofgem", "we" and "our" are used interchangeably in this document. The Authority refers to GEMA, the Gas and Electricity Markets Authority. The Office of Gas and Electricity Markets (Ofgem) supports GEMA in its day-to-day work. This decision is made by or on behalf of GEMA.

² <https://www.ofgem.gov.uk/publications-and-updates/last-resort-supplier-payment-claim-co-operative-energy>

³ Precisely, £14,039,783.

⁴ The LRSD consists of two documents, both dated 30 November 2016 and available here:

<https://www.ofgem.gov.uk/publications-and-updates/direction-appoint-cooperative-energy-gas-supplier-last-resort> and <https://www.ofgem.gov.uk/publications-and-updates/direction-appoint-cooperative-energy-electricity-supplier-last-resort>. Both directions entered into effect at 00:01 on 30 November 2016 and continued in force for a period of six months.

⁵ See section 3A of the Electricity Act 1989 and section 4AA of the Gas Act 1986.

⁶ See standard licence conditions 8 and 9 of both CEL's gas and electricity licences.

⁷ This was published on 21 October 2016 and is available here:

https://www.ofgem.gov.uk/system/files/docs/2017/09/solr_revised_guidance_final_21-10-2016.pdf. This guidance was supplemented with a decision on our approach to dealing with supplier insolvency and its consequences for consumers, which was published on the same day and is available here: <https://www.ofgem.gov.uk/ofgem-publications/105387>.

Background

The SoLR process

Electricity and gas is supplied through markets and on the basis of a competitive process in Great Britain. While competition has the potential to bring many benefits to consumers, a competitive process occasionally leads to companies failing. This applies as much in relation to the gas and electricity supply markets as it does to other markets.

When a supplier fails, our focus is to ensure continuity of supply for its customers and to avoid wider negative effects on the market. Such wider effects stem from the fact that, in practice, until the failed supplier's contracts have been transferred, or deemed contracts are established with a SoLR, there would be no practical way to prevent an existing customer from taking electricity or gas from the network. This will cause the network system operator to step in to perform a residual role of balancing the gas and electricity in the network. As the failed supplier will not be able to pay for the energy required to balance the networks in this way, these costs will fall to be mutualised across other industry participants. There is also the real risk that if a supplier fails without urgent intervention, consumer trust and confidence in the energy market would be materially damaged.

Ofgem can ensure continuity of supply to the failed supplier's customers and prevent these wider negative effects by appointing a SoLR to supply the failed supplier's customers at very short notice.⁸

The LRSP process

Once appointed, a SoLR may make a claim for a LRSP from relevant distribution networks where we have given our consent to the amount claimed. In November 2017, CEL notified us of its intention to claim for a LRSP consisting of the following elements:

- Item 1: Recovery of 70% of GBES customers' net credit balances (£10,979,815)
- Item 2: Emergency wholesale procurement (£1,269,801)
- Item 3: Cost of capital to fund credit balances (£1,790,167)
- Item 4: IT migration costs (£859,300)

The cost of protecting customers' credit balances has been partly (30%) funded by CEL.

In our November 2017 letter, we explained that we were minded-to consent to CEL claiming for items 1-3 only, and the factors behind our decision. For item 1, we intended to consent to CEL claiming the amount it requested from relevant distribution networks, appropriately adjusted, to take into account any sums awarded to CEL through the liquidation of GBES.

Our decision

We received 13 responses to our consultation, which we have summarised in the Appendix⁹. We received no representations that have led us to change our minded-to position.

⁸ The obligation for a supplier (such as CEL) to comply with a LRSD derives from standard licence condition 8 of each supplier's the 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). The duties of a SoLR are further described in our Guidance and the LRSD contains specific details of CEL's obligations to supply GBES' customers.

⁹ Non-confidential responses have been published on our website alongside this decision document.

Taking into account all of the information available to us and the specific circumstances of this case (which was the first SoLR process for 8 years and the first time the LRSP process has been tested), we consent to CEL claiming a LRSP of up to £14.04m¹⁰, subject to any amounts CEL is awarded through the liquidation of GBES.

We are making this decision in light of the broader market considerations and our wider statutory duties to protect both existing and future consumers. We acknowledge that this is an area that warrants further consideration and going forward in any future SoLR situation we would require suppliers seeking to be appointed the SoLR to provide additional information about their intentions regarding the recovery of any costs through any potential LRSP claim. We may also update our published SoLR guidance, to clarify our expectations of suppliers bidding to be appointed a SoLR and to help inform them as they prepare their bids.

We are satisfied that items 1, 2 and 3 represent no more than (and, indeed, only account for a proportion of) the total costs incurred by CEL in complying with Ofgem's LRSD, minus the total amounts recovered by CEL from GBES' former customers.¹¹ We note that CEL has excluded a number of costs from its claim, and, for example, has agreed not to claim for 30% of the costs of honouring GBES' customers' credit balances.

For the avoidance of doubt, we consider on a case-by-case basis whether it may be appropriate for any SoLR to make a claim for a LRSP and whether the costs it has incurred in discharging its duties under a LRSD are efficient. 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.

The amount we consent to CEL claiming from relevant gas and electricity distribution networks¹² respectively will be allocated in proportion to the total number of nationwide gas and electricity supply points, as reflected in our directions to CEL under its gas and electricity supply licences. We consider this apportionment to best enable broad socialisation of the claim costs in line with the intent of the SoLR regime to protect all consumers in the market, for example, through limiting the extent of unpaid industry bills of a failing supplier.

As per the supply standard licence conditions regarding LRSP claims¹³, CEL will be able to submit a claim to each relevant distribution network, based on the amounts we have consented to and each network's share of the total premises served by the relevant networks, in each fuel respectively. We expect CEL to do this on the basis of the data on customer numbers contained within the network companies' regulatory reporting packs. This has the advantage of being a data source that is transparent and consistent between gas and electricity.

Recovery of CEL's claim through network charges:

In our November letter, we consulted on recovery of any amount that we consent to CEL claiming, through network charges in 2018/19. On balance, we consider it appropriate for networks to recover the costs of LRSP made to CEL through charges from April 2018.

We recognise that there may be administrative inefficiencies of a one-off adjustment to charges for networks and their customers and broader benefits of giving network users more notice of the changes to their charges, by delaying charging adjustments to a later year. In addition, stakeholders have identified inconsistencies between network licence

¹⁰ Precisely, £14,039,783.

¹¹ This is the test set out in standard licence condition 9.4 of CEL's gas and electricity supply licences.

¹² The relevant distributors according to standard licence condition 9 of the electricity and gas supply licences are distributors in whose distribution areas there were premises supplied under the Last Resort Supply Direction, excluding independent distribution network operators and independent gas transporters

¹³ Standard licence condition 9

obligations regarding LRSP claims and broader network price control and charging regulatory obligations. We recognise that it may be beneficial to review both the supply and network licence conditions in relation to LRSP claims, in particular in relation to the timings and process for how claims are to be made and treated. However, given the timing of CEL's claim, and the low materiality of the costs relative to average network charges per customer, we consider it appropriate for distribution networks to comply with their licence obligations (to adjust their charges for start of the next regulatory year for any valid claim for a LRSP received during January) and recover the costs of making payments to CEL in 2018/19 from their customers through adjusting their charges from April 2018.

Broader points

As per our decision to use the SoLR arrangements as a safety net for consumers' credit balances, we consider this to be the option that is in the best interests of all consumers. We intend to keep this position under review as the retail market evolves based on the effectiveness of the arrangements in protecting customers of an insolvent supplier, ensuring value for all consumers, and maintaining confidence in the retail market.

We also acknowledge contributions from interested parties on our approach to financial regulation. We understand the importance of maintaining confidence in the market, and our consideration of the timing of any future review of our approach to licensing suppliers will take this into account, amongst other factors, including any implications of our planned work on reviewing the appropriateness of the broader regulatory framework for energy suppliers.

Yours faithfully,

Rob Salter-Church
Partner, Consumers and Competition

Appendix - Consultation responses

We received 13 responses to our letter, from suppliers, distribution networks and a consumer body.

Amount of CEL's claim

6 respondents supported our minded-to decision, with parties expressing views that our decision appeared consistent with commitments and expectations that CEL may have legitimately had during the appointment process, and supporting our approach to assessing the CEL's request. There was broad support amongst all respondents who commented on the amount of the claim, for our intention to consent to CEL claiming for Item 1 (recovery of 70% of GBES consumers' net credit balances), and our intention to exclude Item 4 (IT system migration costs) from the claim.

4 respondents specifically disagreed with allowing CEL to recover Item 2 (emergency wholesale procurement costs), on the grounds that these costs would have been expected at the time of SoLR appointment based on the information available at the time, and any risk of wholesale prices exceeding expected costs due to market volatility ought to have been factored into CEL's commitments at the time of bidding. These respondents highlighted the negative impact of consenting to CEL recovering these cost items through a LRSP on the effectiveness of the SoLR arrangements in protecting the interests of all consumers.

2 respondents specifically disagreed with allowing CEL to recover Item 3 (cost of capital), on the grounds that these costs would have been similarly predictable and ought to have been factored into CEL's commitments at bid. On the other hand, 2 suppliers considered these costs to be so closely related to the costs of protecting credit balances that they can be considered implicitly within the commitments CEL made at bid regarding funding credit balances through absorbing the costs and making a claim for a last resort supply payment.

Recovery of CEL's claim through network charges

Notice period for network charge adjustments

4 suppliers and one distribution network expressed concerns that the implication of our intention to make a final decision on CEL's claim in January that distribution network charges would be adjusted from April 2018, given that this leaves a short notice period relative to usual arrangements for setting network charges. These respondents suggested that this would create undue administrative burden and/or financial impacts, and that the LRSP arrangements are out of step with expectations from suppliers and shippers for predictable pricing. The 4 suppliers in question requested that network charge adjustments be delayed, for example, until 2019/20 or to allow for a full 15 months' notice period for charge adjustments in line with Distribution Code and Use of System Agreement (**DCUSA**) obligations for Use of System charges in electricity.

Allocation of CEL's claim across networks and their customers

The distribution networks who responded summarised their charging proposals to allocate the costs of any claim submitted to them by CEL amongst their customers. The electricity distribution networks in particular explained that their common charging proposal across the DNOs aimed to limit the consequential impacts on suppliers given the short notice period for adjusting charges, and to limit the potential for under or over collection of revenue from charges, in light of the time limits for making charge adjustments related to last resort supply payment claims in their licence conditions. The gas distribution networks also suggested that CEL's claim should be allocated to gas and electricity networks, respectively, based on the proportion of total supply points nationwide for each fuel.

Improvements to the process

Two respondents suggested further details were required within the regulatory framework on how distribution networks should adjust their charges to recover the costs of a LRSP to create clarity and transparency for stakeholders.

Two distribution networks suggested that Ofgem consider introducing a formal recovery mechanism within their allowed revenue licence conditions. Another distribution network suggested that for future last resort supply payment claims, Ofgem should review the last resort supply payment obligations in the distribution network licence in light of the 15-month notice period for adjusting Use of System charges in DCUSA.

One respondent also suggested that Ofgem review the process for last resort supply payments in order to minimise the potential for ongoing adjustment of network charges that may occur if a claim includes costs of protecting consumer credit balances, as a result of any ongoing liquidation of an insolvent supplier's assets.

Improving the SoLR appointment process

There was broad support from respondents for our acknowledgement that lessons can be learnt from last year's SoLR event and the first claim for a last resort supply payment. Respondents welcomed our commitment to consider revising our SoLR guidance, and some offered suggestions for how we should do this.

Two respondents suggested that suppliers' commitments to managing the costs of being a SoLR, including the costs of protecting credit balances, should be prioritised over protecting customers of an insolvent supplier financially in any SoLR appointment process given the redistributive effects of the levy and the potential for moral hazard amongst suppliers and their customers. Three respondents suggested Ofgem clarify its expectations on the circumstances in which claims under levy would be considered in order to facilitate confidence in the SoLR arrangements going forward.

Broader points

Two points were raised in relation to Ofgem policies regarding supplier financial issues that are broader in scope than the issues we put forward in our consultation. Two respondents raised questions on the legal basis and the policy impacts of using the last resort supply payment arrangements to protect consumer credit balances in the event of supplier insolvency. Three respondents suggested Ofgem review its approach to licensing suppliers to ensure their financial and/or operational capability and its approach to monitoring their performance in order to inform proactive regulatory intervention and provide incentives to entrants in the market to be financially responsible.