Making a positive difference
for energy consumers

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

Email: supplier@ofgem.gov.uk

Date: 07 December 2020

Dear colleague,

Last Resort Supply Payment claim from ScottishPower Energy Retail Limited

On 25 November 2020, ScottishPower Energy Retail Limited ("ScottishPower") gave notice to Ofgem of their intention to submit a final claim for a Last Resort Supply Payment ("LRSP"). ScottishPower is seeking to claim for costs incurred in acting as a Supplier of Last Resort ("SoLR") to former customers of Extra Energy Supply Limited ("Extra Energy").

As per Supply Licence Condition 9 (Claims for Last Resort Supply Payment), a Supplier of Last Resort (SoLR) may make a claim for a LRSP from relevant distribution networks where we have given our consent to the amount claimed[1]. ScottishPower's claim is for £13.6m[2]. This letter sets out that we[3] are minded-to consent to a claim from ScottishPower for a LRSP of up to £10.6m[4].

The purpose of this consultation letter is to provide interested parties with an opportunity to make any representations to us, ahead of making our final decision. We currently expect to make our final decision in January 2021.

Background

The SoLR process

[1] In accordance with Standard Condition 9 of the electricity and gas supply licences
[2] £13.635m.
[3] 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.
[4] £10.573m

Electricity and gas supply is a competitive activity in Great Britain. Competition has the potential to bring many benefits to consumers but 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 in light of supplier failure. When a supplier fails, our focus is to ensure continuity of supply for its customers and to minimise wider negative impacts on the market. These wider effects stem from the fact that if an energy supplier fails, its customers will continue to be physically supplied with gas and/or electricity, but the supplier will not be able to meet the costs of providing this energy.

In these circumstances, the costs of procuring the necessary electricity will be smeared across all suppliers and the costs of procuring gas will fall to the relevant shipper. There is also a real risk that if a supplier fails without urgent intervention, consumer trust and confidence in the energy market could be materially damaged.

Ofgem can ensure continuity of supply to the failed supplier's customers and minimise these wider negative effects by appointing a SoLR to supply the failed supplier's customers at very short notice[5].

Extra Energy SoLR event

In November 2018, Extra Energy confirmed to us that it was in severe financial difficulties, at which point we prepared to commence the SoLR process, to ensure consumers were protected. Following our standard process and published SoLR guidance, on 24 November 2018 we announced our decision[6] to appoint ScottishPower as the SoLR[7] for Extra Energy's gas and electricity customers. This followed a competitive process aimed at getting the best deal for consumers, in line with our principal objective to protect the interests of existing and future consumers and our published guidance.

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[5] 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). The duties of a SoLR are further described in our Guidance and the LRSD contains specific details of ScottishPower's obligations to supply Extra Energy's former customers.
[6] Appointment of Scottish Power Limited as Supplier of Last Resort
[7] Direction to appoint ScottishPower Energy Retail Limited as Gas Supplier of Last Resort and Direction to appoint ScottishPower Energy Retail Limited as Electricity Supplier of Last Resort

We outlined the material factors behind our decision to appoint ScottishPower as the SoLR in our decision letter published on 17 January 2019[8].

Claim for Last Resort Supply Payment

As set out in the gas and electricity supply standard licence conditions, a supplier may make a claim for any additional costs it incurs in complying with a Last Resort Supply Direction ("LRSD")[9] .

As part of their competitive bid to become a SoLR, a supplier will include whether they expect to make a claim for a LRSP, or whether it will waive this right, in whole or in part. As stated in our published guidance, our preference is for the SoLR not to make any claim, and we expect efficient SoLRs to be able to minimise their exposure to otherwise unrecoverable costs to reduce the costs smeared across the rest of the market through a LRSP.

In our guidance[10], we explain that we will decide on a case-by-case basis whether it might be appropriate for a SoLR to make a claim under these arrangements. We also explain that we would consider whether the amount of any claim or the reasons for any claim were reasonable. In that guidance, we note that, in certain circumstances, we may consider it appropriate to approve a claim where it relates to costs associated with the protection of customers who held a credit balance with the failed supplier.

ScottishPower indicated at the time of our SoLR appointment process that it would not waive its right to make a claim. ScottishPower committed to funding £10m of open and closed credit balances and said that it would claim for any balances above this £10m level and associated costs, for example to cover working capital requirements.

ScottishPower's claim for a LRSP payment is for £13.635m. The claim from Scottish Power includes its calculation of the claim amount and information to support the claim as outlined in Table 1 below.

[8] Appointment of Scottish Power Limited as Supplier of Last Resort
[9] Standard condition 9 of the electricity and gas supply licences
[10] Supplier of Last Resort: Revised Guidance 2016

Our decision process and methodology

Our process to reach our minded-to position consisted of:

- A quantitative check of the methodology for each cost item claimed. This includes determining how each total cost item was calculated based on data sent to us.
- Ensuring costs are in line with commitments made at the time of the SoLR appointment.
- Validation of assumptions with other data sources, where appropriate.
- A qualitative assessment of each claim item against our methodology criteria.

Our methodology is outlined in Annex 1.

Claim for a Last Resort Supply Payment

ScottishPower seeks consent to recover £13.6m[11]. This letter sets out the reasons why we are minded to consent to Scottish Power claiming a LRSP of up to £10.6m[12]. We also explain why we are not at this time minded-to consent to the recovery of up to a further £3m[13] of costs for consumer debt.

Our reasons for our minded-to position

On balance, taking into consideration all information available to us and the specific circumstances of this case, we are minded to consent to ScottishPower claiming a LRSP of up to £10.6m[14]. We are minded to make this decision in light of the broader market considerations and our wider statutory duties to protect both existing and future consumers.

Our position would enable ScottishPower to recover up to this amount from relevant distribution network licensees. This is subject to any costs recovered from the Extra Energy liquidation process.

[11] £13.635m
[12] £10.573m
[13] £3.062m
[14] £10.573m

For the avoidance of any doubt, we consider on a case-by-case basis whether it may be appropriate for any 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.

Supplier contribution

ScottishPower's claim is based on a total of £23.6m of additional reported costs, adjusted to reflect a commitment to self-fund £10m of the cost of refunding customer credit balances and associated costs. In submitting its claim ScottishPower has demonstrated to us that they have met their commitment to self-fund £10m of these costs.

Our minded-to position

We are minded-to allow ScottishPower to claim for the costs of refunding credit balances owed to former customers of Extra Energy and for certain other costs as detailed below. We are not minded to consent to the recovery of the cost of item 4, consumer debt.

Table 1: ScottishPower LRSP claim – minded to position

Item	Cost Category associated with SoLR	Cost claimed (£k)	Minded-to position
1	Recovery of customer credit balances	6,526	6,526
2	Service/Operational	2,547	2,547
3	Data quality	313	313
4	Consumer debt	3,062	0
5	Working capital	1,187	1,187
	Total	**13,635**	**10,573**

Credit balances

Scottish Power is claiming £6.5m for the costs of credit balances refunded to former domestic customers of Extra Energy for open and closed customer credit balances.

Our view

Our published guidance states that we may in certain circumstances approve a claim associated with costs incurred in repaying credit balances to customers who had a positive credit balance with a failed supplier. We are satisfied in this case (subject to the points discussed below) that the claimed amount is consistent with the relevant criteria and in particular, is consistent with ScottishPower's commitment in its SoLR bid.

We have considered whether the costs ScottishPower is seeking to claim for credit balances are otherwise unrecoverable; it may still be the case that ScottishPower is able to recover some of this claimed amount through the ongoing administration process for Extra Energy.

The current licence provisions related to LRSPs do not require us to make our decision on ScottishPower's claim ahead of the conclusion of the liquidation process. However, in our view delaying a decision until the conclusion of the liquidation process would introduce a disproportionate degree of uncertainty around the timing of any approved LRSP claim, and ultimately increase the future costs liable to by paid by energy suppliers and consumers.

Given the factors outlined above, we are minded to approve the claim, subject to the outcome of the Extra Energy liquidation process. At that point, the final amount ScottishPower can claim for credit balances would be adjusted to remove any sums recovered by ScottishPower through the liquidation process.

Service/Operational costs

As part of its claim, ScottishPower seeks to recover additional costs of £2.5m for customer service and billing costs in respect of the on-boarding of former customers of Extra Energy.

Customer service

ScottishPower's claim includes £1.4m for additional customer service costs associated with credit balances, including for the handling of a significant volume of customer enquiries and complaints, for which ScottishPower has provided a detailed account of how these costs were incurred.

A SoLR should take all practical steps to manage the on-boarding process as efficiently as possible and minimise the costs that may then be passed on to consumers via the industry levy. While the costs ScottishPower are seeking to recover for this element of the claim are material, we are broadly satisfied that it is reasonable for Scottish Power to recover these costs taking into account the nature and volume of the work necessary to on-board customers following the failure of Extra Energy and the data quality and other issues which ScottishPower encountered. We are therefore minded-to agree, on balance, to ScottishPower's claim for the additional costs of customer service for former customers of Extra Energy.

Billing

ScottishPower has claimed £1.1m for costs associated with billing former customers of Extra Energy. This includes the cost of producing approximately 197k final domestic bills.

At the time it was appointed ScottishPowerunderstood that the administrator would undertake the steps necessary to establish final account positions and produce final bills for customers. However, the nature of the systems' arrangements that Extra Energy had in place meant that the administrator was unable to take control of and access Extra Energy's billing platform to establish final account positions and arrange for customer bills to be issued. As a result, the administrator was required to arrange for a 3rd party provider to undertake the issuing of customer bills and did not have the capacity to produce customer bills where there was a credit balance, or debit balance of less than £30.

ScottishPower considered that it was essential for bills to be issued to all former customers of Extra Energy to allow it to validate the credit balance data provided by the administrator and to ensure that its claim for a LRSP was accurate. ScottishPower say that it made every effort to negotiate with the administrator on the need for these bills to be issued and for the cost to be met by them, but was unsuccessful. ScottishPower therefore agreed to pay the costs for each bill produced.

Our view

While we accept that there can be legitimate costs to access the billing system of a failed supplier, we are concerned at the scale of the billing costs for former customers of Extra Energy. As ScottishPower say, it is important that a claim for a LRSP is based on accurate information. The LRSP mechanism is intended to protect the interest of energy consumers by enabling a supplier to recover valid additional costs incurred in acting as a SoLR, which typically include refunded credit balances and certain costs associated with on-boarding customers. It is important that former customers of a failed supplier are provided with an accurate final credit or debit position with the failed supplier, and that a claim for a LRSP is supported by an accurate calculation of the final credit balance position. In this particular case, we are minded to accept that the costs incurred were necessary. However, we expect SoLR suppliers to be able to demonstrate that they have minimised costs to consumers, including engaging constructively with the administrator to the benefit of customers.

We are therefore minded-to consent to this cost, taking account of all the circumstances, including the importance of providing customers with an accurate final bill.

Data Quality

ScottishPower has claimed £313k for costs incurred in relation to data quality and completeness encountered throughout the SoLR process. ScottishPower say issues with data quality impacted its ability to register customers and return credit balances in a timely manner. The cost claimed includes IT work, managing and resolving issues relating to incorrect meter reads, account set-up issues, erroneous transfer issues, billing, meter reading, and complaints.

Our view

We recognise that a SoLR supplier can face differing levels of challenge with data quality and we have typically allowed recovery of these costs in other LRSP claims. We consider that the work undertaken by ScottishPower was required to ensure that the data for former customers of Extra Energy was both complete and accurate, a necessary condition for the successful on-boarding of customers and resolution of customer enquiries. We are therefore minded-to consent to the recovery of this cost.

Debt Costs

ScottishPower is claiming £3.1m to cover the cost of additional debt relating to certain former customers of Extra Energy. ScottishPower inform us that they made forecasts for debt being accrued by former Extra Energy customers upon transferring to ScottishPower, based on experience of customers acquired through its usual gains process. ScottishPower's claim is for the additional cost of debt incurred over and above this forecast. The claim here includes the cost of debt follow up work, the cost of debt and the cost of working capital associated with this debt. ScottishPower say that key factors in the claim for debt are:

- Data quality issues and the time taken to verify outstanding credit balances led to a significant delay in returning customer credit balances. ScottishPower say that the delay resulted in levels of consumer debt significantly greater than it would have expected compared with a similar group of customers with no data quality issues, with no delays in billing or in the return of credit balances. The delay in the return of credit balances, which ScottishPower say was outside their control, meant customers were reluctant to pay bills until their credit had been returned to them and that this led to higher than forecast levels of debt.

- ScottishPower say that market information indicated a high level of Extra Energy customers were on a direct debit payment method. In practice ScottishPower was able to set up only 56% of customers on the direct debit payment method, resulting in a higher than forecast proportion of customers paying by cash. As a result, levels of debt were higher than forecast.

ScottishPower says that it has made significant efforts to recover the additional debt for which it is claiming over and above normal debt recovery activities. These include actions to mitigate data quality issues and to maximise the capture of Direct Debit details. ScottishPower explain that this additional work includes outbound calling, a bespoke communications campaign and bespoke debt collection activity on ScottishPower's behalf. In respect of the debt costs ScottishPower say that it includes customers where ScottishPower was unable to bill until more than 3 months after they had come on supply; customers who left ScottishPower prior to ScottishPower being able to issue them with an initial bill due to data quality issues; customers with a credit balance due where there was a significant delay in the return of the credit balance which ScottishPower say was outside of its control and customers for whom ScottishPower were unable to access data to allow a Direct Debit payment method to be set up.

ScottishPower consider that the additional debt is a cost that was unexpected and unforeseeable on the basis of the information available when they volunteered for appointment as the SoLR. ScottishPower also considers that the claim for debt meets the tests that Ofgem applies to LRSP claims, namely that the consumer debt is:

- additional to the costs that it would have incurred in servicing existing customers
- directly related to the SoLR role (the debt relates to former customers of Extra Energy)
- is otherwise unrecoverable (ScottishPower say that they carried out debt recovery work above and beyond normal debt recovery processes in an effort to collect debt)
- was unavoidable (ScottishPower say the debt is directly linked to poor data quality and delays in the administration process)
- efficiently incurred (ScottishPower say they have balanced the costs of additional debt recovery work against the benefits of debt ultimately recovered).

In volunteering for the appointment as SoLR ScottishPower say it deliberately did not limit the scope of any claim it would make for additional costs. ScottishPower also say that while they expected only to make a claim in relation to credit balances and associated costs, they noted that if exposed to costs unexpectedly they might make a further claim.

ScottishPower also notes that Ofgem is minded to consent to costs related to other parts of the LRSP claim which ScottishPower say were a result of the same unexpected circumstances, ie poor data quality and issues and delays in the administration process, including in returning credit balances. In addition, while agreeing that consumer debt is a commercial matter for suppliers to pursue, ScottishPower say that consumer debt arising directly from the SoLR process should be treated in the same matter as other costs faced by a SoLR, i.e. where there is consumer debt arising from unexpected circumstances, then ScottishPower is entitled to be paid for this debt through this LRSP claim.

Our view

We consider that consumer debt is different to credit balances and other costs faced by a

SoLR when on-boarding customers and is a commercial matter for the SoLR to manage. In making its bid for appointment as the SoLR ScottishPower said that it would make a claim for LRSP to cover credit balances and associated costs, for example to cover working capital requirements. ScottishPower added that it may make a further claim for a LRSP if exposed to additional costs which were unforeseeable and unexpected based on the information provided.

We consider that a claim for consumer debt goes beyond the reasonable scope of the basis on which ScottishPower was appointed and the costs that it indicated it may claim. Consumer debt is a commercial consideration and we would expect a supplier bidding for a SoLR appointment to have accounted for this in the bid, along with other commercial factors such as forecasts for margins and retention of customers.

Our published guidance[15] does not list costs that can or cannot be recovered by a SoLR when making a claim for a LRSP. However, it states that we would consider whether the amount of any claim, or the reasons for any claim, were reasonable and that we may, in certain circumstances, consider it appropriate to approve the claim where it relates to costs associated with the protection of customers who held a credit balance with the failed supplier. While we note that certain costs, including the cost of debt, are typically factored into supplier tariffs, we do not consider that the wider industry should pay for the cost of debt for these customers in this case. Indeed, in our view consenting to a claim for debt costs could increase the potential costs of supplier failure faced by existing and future consumers if it lessens the incentive on a SoLR to collect debt effectively, in the knowledge that debt that could not be collected could be recovered as part of a LRSP claim. We are therefore minded not to consent to the claim for consumer debt.

We welcome responses from stakeholders on whether our position strikes an effective balance between providing an appropriate framework for SoLR's to recover additional costs and protecting the interests of existing and future energy consumers.

<u>Working capital</u>

[15] Supplier of Last Resort: Revised Guidance 2016

ScottishPower is claiming £1.2m[16] for the cost of working capital used to fund the costs of making capital available to fund the SoLR, which it has incurred since October 2018. This does not include a claim for working capital for consumer debt, which ScottishPower has included separately as part of the claim for consumer debt. ScottishPower's claim is based on the cost of capital for the Iberdrola Group.

Our view

In the period between being appointed as SoLR and recovering the costs to which we consent, ScottishPower will have incurred costs in making capital available to fund the costs associated with the SoLR process. ScottishPower set out in their SoLR submission that they expected their claim for a LRSP to include these costs. We are minded-to agree that the methodology used to calculate this element of the claim is appropriate.

Next steps

The purpose of this letter is to provide interested parties with an opportunity to make any representations to us, ahead of us making our final decision. We invite any representations by **13 January 2021**.

Responses should be emailed to supplier@ofgem.gov.uk[17]. 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 receive, in reaching our final decisions.

Yours faithfully,

Lesley Nugent
Deputy Director, Retail Directorate

[16] £1.187m
[17] Although we prefer responses in electronic format, responses can be posted to the address below.

Annex 1

Our methodology criteria for SoLR levy claims are as follows:

•**Additional**: whether the costs claimed are additional to the costs to the SoLR of serving 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. Although the SoLR is generally expected to know or predict the costs they will incur in serving a new customer base and take these into account in their competitive bid, there may be cases where this is not possible.

•**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. It would not be appropriate for us to allow the SoLR to claim for costs they would have incurred through a normal acquisition route.

•**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 claim for costs it could have recovered through the administration process or customer charges, for example.

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

•**Efficient**: whether the SoLR has taken all reasonable steps to reduce the magnitude of any unavoidable and unrecoverable costs incurred, and therefore the total amount claimed.