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

Email: supplier@ofgem.gov.uk

Date: 29 January 2021

Dear colleagues,

Decision on Last Resort Supply Payment claim from ScottishPower Energy Retail Limited

On 7 December 2020, we[1] published our minded-to position[2] on a claim by ScottishPower Energy Retail Limited ("**ScottishPower**") 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**"). We received two confidential responses to our consultation.

This letter confirms our decision to consent to ScottishPower claiming a LRSP of up to £10.6m.[3] Our decision will allow ScottishPower to recover the costs of protecting the credit balances owed to former customers of Extra Energy, and certain other costs incurred in complying with the terms of the Last Resort Supply Direction ("**LRSD**").[4]

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

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[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
[2] Consultation on a Last Resort Supply Payment Claim from Scottish Power Energy Retail Limited
[3] £10.573m
[4] 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.
[5] Supplier of Last Resort: Revised Guidance 2016.

As per Supply Licence Condition 9 (Claims for Last Resort Supply Payment), a SoLR may make a claim for a LRSP from relevant distribution networks where we have given our consent to the amount claimed.[6] ScottishPower's claim is for £13.6m.[7] This letter sets out the reasons for our decision to consent to a claim from ScottishPower for a LRSP of up to £10.6m.[8]

Background

The SoLR process

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.[9]

[6] In accordance with Standard Condition 9 of the electricity and gas supply licences
[7] £13.635m.
[8] £10.573m
[9] 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 Article 27 of the Directive (EU) 2019/944, as retained in domestic law). 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.

Claim for a 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 LRSD.[10]

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 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, 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.

Our decision

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.[11] We have taken this decision in light of the broader market considerations and our wider statutory duties to protect both existing and future consumers.

Our decision will enable ScottishPower to recover up to this amount from relevant gas and electricity distribution network licensees. This is subject to any costs recovered by ScottishPower from its claim from the Extra Energy liquidation process. For the avoidance

[10] Standard condition 9 of the electricity and gas supply licences.
[11] £10.573m

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 decision. 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.

Our reasons for our decision

Our decision will allow ScottishPower to recover the cost of refunding credit balances owed to former customers of Extra Energy and for the cost incurred in relation to service/operational work, data quality and interest on the cost of working capital. We do not consent to the recovery of the cost of item 4, consumer debt.

Table 1: ScottishPower LRSP claim – decision

Item	Cost Category associated with SoLR	Cost claimed (£k)	Decision (£k)
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

ScottishPower is claiming £6.5m[12] for the costs of credit balances refunded to former domestic customers of Extra Energy for open and closed customer credit balances.
Our 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.

[12] £6.526m

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 the commitments made by ScottishPower in its SoLR bid.

We have considered whether the costs ScottishPower is seeking to claim for credit balances are otherwise unrecoverable; we consider that it should be possible for ScottishPower to recover some of this claimed amount through the ongoing administration process for Extra Energy. We expect a SoLR making a claim for a LRSP to have taken all reasonable steps to make and pursue a claim from the administration/liquidation of the failed supplier for the cost of outstanding credit balances.

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 consent to the claim for the cost to refund credit balances, 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 account for any sums recovered by ScottishPower through the liquidation process.

Service/Operational costs

ScottishPower's claim includes £2.5m of costs for customer service and billing costs in respect of the on-boarding of former customers of Extra Energy.

<u>Stakeholder views</u>

While fully supporting the ability for SoLR suppliers to make claims for a LRSP, one respondent considers that ScottishPower's claim is beyond what can reasonably be expected from a supplier acting as a SoLR. In particular, the respondent is concerned at the level of the operational and data costs claimed by ScottishPower, which it considers should be significantly lower, even allowing for extenuating circumstances.

The same respondent recognises that ScottishPower had to issue bills that it was expecting Extra Energy's administrator to issue, and that ScottishPower should be able to claim back an efficient level of cost for billing. However, the respondent considers that the amount claimed for billing is excessive, and that the claim should be commensurate with the costs that a supplier incurs in issuing a standard monthly or quarterly bill. The respondent suggests that the claim should be for around £1 per customer, especially where bills have been sent by email.

<u>Our decision</u>

We have sympathy for the respondent's concerns about the level of operational costs claimed by ScottishPower. A SoLR faces a range of costs and can incur legitimate costs to access the billing system of a failed supplier. In taking our decision, we stress that 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.

However, after very careful consideration of the circumstances of this case and all of and the information available to us, and on a fine balance, our decision is to consent to the recovery of ScottishPower's claim for service/operational costs. As noted in our December 2020 letter, ScottishPower incurred unforeseen costs when billing customers – for example those with credit or debit balances less than £30. Due to the circumstances of the failure of Extra Energy, ScottishPower did not have direct access to Extra Energy's billing platform and relied upon the arrangements put in place by the administrator with a third party billing provider. As a result the billing costs were in excess of those usually incurred by suppliers when issuing monthly or quarterly bills.

While we consider that the billing costs are high, our decision on balance to consent to the recovery of the service/operational costs claimed by ScottishPower reflects the volume of the work necessary to on-board customers, the data quality and other significant issues which ScottishPower encountered.

Data quality

ScottishPower has claimed £313k for costs incurred in relation to data quality and completeness encountered throughout the SoLR process. 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 decision

We recognise that a SoLR supplier can face differing levels of challenge with data quality. 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. Our decision is, therefore, to consent to the recovery of this cost.

Consumer debt

ScottishPower's claim includes £3.1m to cover the total cost of additional debt relating to certain former customers of Extra Energy. This is for debt over-and-above the forecast that ScottishPower made for debt being accrued by former Extra Energy customers upon transferring to ScottishPower, based on experience of customers acquired through its usual gains process. The claim includes the cost of debt follow up work, the cost of debt and the cost of working capital associated with this debt. Our December 2020 letter set out, in more detail, the circumstances of the claim for debt costs.

Stakeholder views

One respondent agreed with Ofgem's minded-to position on consumer debt. The respondent considers that a claim for additional bad debt goes beyond the reasonable scope of a LRSP claim and any additional bad debt costs should be factored into a supplier's SoLR bid.

In making its claim for these costs, ScottishPower has noted it considers that consumer debt is no different from other costs incurred by a SoLR and considers that Ofgem's position on debt is inconsistent with its minded-to position to consent to the other costs which ScottishPower has claimed. They have also noted that, in bidding for the SoLR appointment, ScottishPower did not place a limit on the value of the claim it would make and said that it may make a claim for any unexpected costs. ScottishPower considers that the claim for debt is consistent with the criteria that Ofgem uses to assess claims.[13]

ScottishPower have suggested that, if Ofgem's decision is that it is unlikely to allow a LRSP claim for debt costs, future SoLRs will be incentivised to "price in" an additional margin of error for bad debt (to cover unforeseen circumstances). They consider that this would result in worse outcomes for consumers (by suppliers potentially bidding with higher rates in respect of all SoLR appointments), rather than allowing a mechanism by which unforeseeable debt can be recovered from the industry levy in appropriate cases, thus avoiding the need for it to be priced in to the bids made by SoLRs.

Our decision

We consider that consumer debt is different to the other costs that ScottishPower has claimed which are directly related to the obligation to refund customer credit balances and to the work necessary to validate and migrate customer data from Extra Energy to ScottishPower's system, to allow ScottishPower to comply with the terms of the LRSD.

We recognise that ScottishPower did not place a limit on the value of the claim that it reserved the right to make, and indicated that it may make a claim for any unexpected costs. However, we continue to consider that the claim for consumer debt is outside the reasonable scope of the basis on which ScottishPower was appointed as the SoLR and the reasonable scope of any LRSP claim. While we do not set out in advance the costs that a SoLR may or may not claim, as noted above, our expectation is that a claim will be principally for the cost of credit balances and costs associated with migrating customers from the failed supplier to the SoLR.

In making a decision, we are able to have regard to a wide range of factors, including (for example) our view of whether it is reasonable that the wider industry should fund the commercial risks associated with the cost of debt. Taking account of all of the circumstances of the case and having regard to our duty to protect the interests of consumers, we do not consider that the claim for debt is a reasonable cost to be recovered via the industry levy.

[13] Namely: additional, directly related to the SoLR role, unavoidable, otherwise unrecoverable and efficient.

While we are open to a range of costs forming part of a claim for a LRSP, we consider that a decision not to consent to the recovery of consumer debt sets the most appropriate balance between the ability of a SoLR to recover legitimate and efficient costs and protecting the interests of consumers. We do not consider that our approach should lead to potentially worse outcomes for consumers (i.e. suppliers potentially bidding with higher tariffs being charged to consumers in respect of all SoLR appointments), and note that only a single respondent has raised this as a concern.

Nor do we consider our decision on the claim for debt to be inconsistent with our decision on the claim for the other costs claimed by ScottishPower. Our decision to consent to the recovery of service/operational and data quality costs is finely balanced and we do not consider that a decision to consent to some of the costs in the claim means that we are bound to consent to all of the costs claimed by ScottishPower.

For the above reasons our decision is that we do not consent to the recovery of ScottishPower's claim for the recovery of consumer debt.

Interest on the cost of working capital

ScottishPower is claiming £1.2m[14] for the cost of working capital used to fund the costs of making capital available to fund the SoLR, which it has incurred. 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.

<u>Our decision</u>

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 consider that the methodology used to calculate this element of the claim is appropriate and our decision is to consent to the recovery of this cost.

[14] £1.187m

Appointment of a SoLR

One respondent noted its concern that the SoLR process may allow a supplier to underbid its true level of anticipated costs when submitting a bid only to seek to reclaim these via a claim for a LRSP, thus making a bid appear more competitive. If true, the respondent considers this would be a significant distortion to the competitiveness of the SoLR process and that Ofgem should take steps to remedy this for future SoLRs. In particular, the respondent recommends that Ofgem should ask all suppliers to explicitly state how much they will seek to claim for operational and working capital costs as part of the SoLR bidding process, and for those suppliers to be held to these numbers – allowing for extenuating circumstances – once they make a claim.

The same respondent considers that working capital costs should not be claimed via the industry levy but should instead be factored into any bid made by a supplier to be appointed as a SoLR. The respondent considers that some suppliers will factor working capital into their bid and any supplier looking to claim working capital via a LRSP could make a bid seem more competitive than it is. The respondent argues that if Ofgem is to accept a claim for working capital as part of the SoLR bidding process, then it should be explicitly capped at a maximum value and any amounts should be offset against the amount of customer credit balance costs a supplier is willing to absorb.

As part of the process of appointing a SoLR we ask suppliers to confirm whether they are content to waive a claim for costs and, if not, to set out the costs they anticipate they may claim. When a claim is received we expect a SoLR to not just claim up to the costs in the bid but to justify the costs actually incurred, while allowing for extenuating circumstances.

We are, however, grateful for comments on the SoLR appointment process. We will consider these as we move forward to ensure the SoLR regime remains effective in allowing SoLR suppliers to recover the reasonable and efficient costs they have incurred while protecting the interests of gas and electricity consumers who ultimately pick up the costs claimed via their energy bills.

Recovery of LRSP claim

ScottishPower will be paid the amounts specified in the gas and electricity consents published alongside this decision, by the relevant licensed gas and electricity network companies. This will be recovered by the relevant gas and electricity distribution networks allocated in proportion to the total number of nationwide gas and electricity supply points. 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 standard conditions of the gas and electricity supply licence regarding LRSP claims, ScottishPower will be able to submit a claim to each relevant distribution network operator, based on the amount we have consented to and each network's share of the total premises served by the relevant networks, in each fuel respectively. We expect ScottishPower to do this on the basis of the customer numbers contained within the network companies' regulatory reporting packs. This has the advantage of being a data source that is transparent and consistent as between gas and electricity.

Yours faithfully,

Lesley Nugent
Deputy Director, Retail Directorate