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for energy consumers

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

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Dear colleague

Last Resort Supplier Payment Claim from Co-operative Energy

On 4 October 2017, Co-operative Energy Limited (CEL) gave notice to us of their intention to submit a claim for a Last Resort Supply Payment.¹ On 13 November 2017, CEL submitted its final calculation of the amount it intends to claim for and information to support that calculation. CEL is seeking to claim certain additional costs they incurred in acting as Supplier of Last Resort (SoLR) to customers of the former GB Energy Supply Limited (GBES). A SoLR may make a claim for a Last Resort Supply Payment from relevant distribution networks where we have given our consent to the amount claimed.

This letter sets out the reasons why we are minded to consent to CEL claiming a Last Resort Supply Payment of up to £14.04m². We are minded to allow CEL to recover a portion of the costs of protecting the credit balances owed by GBES to the customers CEL acquired in line with commitments given at the time of appointment, and certain other SoLR related costs. We do not consider it appropriate to consent to CEL's request to include in its claim up to a further £0.86m, to cover IT migration costs which they consider relate to them acting as a SoLR.

Our minded-to position seeks to strike an appropriate balance between protecting the interests of consumers as a whole by minimising the amount claimed from the wider industry, while ensuring our SoLR process and customer safety net continue to operate effectively in protecting consumers and maintaining industry and consumer confidence in the retail market arrangements.

The purpose of this minded-to letter is to provide interested parties with an opportunity to make any representations to us, ahead of us making our final decision. We currently expect to confirm our final decision in January 2018, to enable the agreed amount to be recovered through relevant network charges in 2018/19.

The SoLR process

The SoLR process ensures that customers will continue to be supplied in an orderly fashion if their energy supplier goes out of business. The SoLR appointment process takes into account, among other factors, any measures offered by a potential SoLR to protect credit balances of the failed supplier's customers.

¹ In accordance with standard condition 9 of the electricity and gas supply licences.

² Precisely, £14,039,783.

On 29 November 2016, we appointed CEL as the new supplier (SoLR) for GBES's gas and electricity customers following GBES's failure.³ 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 guidance⁴. This was the first SoLR event in 8 years, and the first since we updated our guidance on our SoLR arrangements to include protection of customers' credit balances.

At the time of GBES' failure, initial information indicated the amount of customer credit balances to be protected was around £25m. After unbilled consumption was taken into account, this amount reduced considerably, to around £15m. The GBES administration process is ongoing and we expect CEL to seek to continue to seek to recover customers' credit balances through this process in an effort to minimise the final amount claimed for from the wider industry.

Claim for Last Resort Supply Payment

As set out in the gas and electricity supply standard licence conditions⁵, a supplier may make a claim for any additional costs they incur in complying with a Last Resort Supply Direction (LRSD).⁶

As part of their competitive bid to become a SoLR, a supplier will include whether they expect to make a claim for a Last Resort Supplier Payment, or whether they wish to waive this right. As stated in our revised guidance, our preference is for the SoLR to not 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.

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.

CEL indicated at the time of our SoLR appointment process that it would not waive its right to make a claim. It stated that it would make a claim for recovery of a portion of credit balances, and did not make any other commitments in relation to use of the levy. CEL has now submitted a claim for recovery of credit balances, and certain other costs. CEL's claim consists 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.

Factors relevant to our decision

In making this decision, we considered the following factors:

³ Further background and the reasons for our decision to appoint CEL as the SoLR for GBES's customers are set out in this letter: https://www.ofgem.gov.uk/system/files/docs/2017/01/2016-12-23_qb_energy_coop_solr_decision_letter.pdf

⁴ https://www.ofgem.gov.uk/system/files/docs/2017/09/solr_revised_guidance_final_21-10-2016.pdf

⁵ Gas and electricity supply licence standard condition 9. Claims for Last Resort Supply Payment

⁶ We may make a Last Resort Supply Direction in accordance with gas and electricity supply licence standard condition 8: Obligations under Last Resort Supply Direction

- **Additional:** whether the costs claimed for are additional to the costs to the SoLR of serving existing customers. In addition, we considered 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 to some extent 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 given these costs would have been avoided through the SoLR process.
- **Otherwise unrecoverable:** whether the SoLR should be able to recover any of the costs it has claimed for through other means. It would not be appropriate for us to allow the SoLR to claim for costs it could have recovered through the failed supplier's liquidation or from customer charges, for example.
- **Unavoidable:** whether the SoLR had made all reasonable efforts to avoid incurring the cost in the first instance or to 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.

In reaching our decision as detailed below, we carried out a number of steps to assess the claim and supporting evidence that CEL submitted to us, including:

- a quantitative check to determine whether the total amounts claimed under each cost category were calculated correctly based on the data presented to us by CEL, and in line with any commitments given by CEL and information available on GBES' customers at the time of CEL's appointment as the SoLR
- validating, where possible, key assumptions against other recognised data sources
- a qualitative assessment of each claimed cost against the criteria identified above.

Our decision

On balance, 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 levy process has been tested), we are minded to consent to CEL claiming a Last Resort Supply Payment of up to £14.04m.

Our minded-to-decision would enable CEL to recover a portion of the costs of protecting the credit balances owed by GBES to the customers CEL acquired, and other SoLR related costs. CEL would not be able to recover costs associated with their IT migration. It would enable them to recover up to this amount through relevant network charges in 2018/19, subject to the outcome of the GBES administration process (discussed further below).

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. We acknowledge that this is an area that warrants further consideration ahead of any future SoLR process and/or potential levy claim, and may require us providing more detailed guidance to inform potential SoLR bids and potential SoLRs' expectations around costs being sought through the levy.

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 on the levy. We have set out below why, in this case, we are minded to consent to a portion of the claim being made. 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.

Reasons for our decision

Item 1: Recovery of 70% of GBES consumers' net credit balances (£10.98m)

Our published guidance sets out that we may in certain circumstances 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. We are satisfied in this case that the claimed amount is consistent with the relevant criteria above, and in particular, is consistent with CEL's commitment in its SoLR bid to directly cover the costs of a portion of consumers credit balances (30%), and seek the remaining portion (70%) through the levy.

One of the criteria we considered is whether the costs are otherwise unrecoverable, and as set out above, it may still be the case that CEL is able to recover some of this claimed amount through the ongoing administration process for GBES. The licence provisions related to Last Resort Supply Payments require us to make our decision on CEL's claim ahead of the conclusion of the administration process.⁷ We are therefore minded to approve this element of the claim, subject to the outcome of the GBES' liquidation process. The final amount we consent to CEL claiming from relevant distribution networks shall be appropriately adjusted, to take into account any sums awarded to CEL through the liquidation of GBES or that would be awarded to CEL through the liquidation process, were it not for our consent.

Item 2: Emergency wholesale procurement cost (£1.27m)

In acting as SoLR to GBES, CEL faced a large increase in their customer numbers and, as such, it needed to source energy in the wholesale market to meet this increase in demand in short timescales. This element of CEL's claim is for the additional cost of emergency wholesale procurement which CEL undertook immediately after it was appointed as the SoLR to restore its normal wholesale market risk level. The cost CEL have claimed for is relative to the costs that CEL would have incurred if they had had the opportunity to procure relevant customers' supply⁸ through normal acquisition routes and in accordance with CEL's standing hedging policy.

While we consider that these types of cost might have been anticipated at the time of CEL's bid, we did not explicitly ask suppliers about their broader assumptions on any future levy claims, other than in relation to credit balances during the competitive SoLR appointment process, and no commitments were made from any suppliers in relation to these types of costs. We accept that, in this case, it is reasonable to allow this element of the claim, given the general circumstances of the case.

Item 3: Cost of capital (£1.79m)

This cost is related to item one above, ie the portion of the costs of protecting consumers' credit balances we are minded to allow CEL to recover through the levy. This element of CEL's claim represents the temporary cost of providing the funding for the 70% of GBES consumers' net credit balances not directly funded by CEL until payments are received from relevant network distributors. CEL volunteered to fund 30% of customers credit balances; in the period between being appointed and receiving funding through the industry levy for the remaining 70% of customers' credit balances, we acknowledge that CEL will have incurred costs in making that capital available.

⁷ The effect of the relevant licence and related provisions is that CEL must notify us of its intention to make a claim within 1 year of us issuing a Last Resort Supply Direction; we may consent to the amount notified, or have a period of 3 months to determine an amount other than the amount calculated by CEL.

⁸ The cost relates to wholesale procurement for supplying former GBES customers on variable tariffs only. CEL have not claimed for any costs of hedging actions they have taken in relation to fixed tariff customers (which were more than 60% of GBES' portfolio) in order to minimise the amount of its claim .

We recognise that our guidance on where it may be reasonable to recover credit balances though the levy, is high level and does not explicitly consider potentially related costs, such as the temporary cost of capital. We accept that, in this case, it is reasonable to allow this element of the claim, given the general circumstances of the case.

Item 4: IT System migration costs (£0.86m)

This cost category relates to the costs that CEL would incur in a bulk transfer of GBES customers from the former GBES systems (on which they continue to be served) to CEL's primary systems. CEL has included these costs in its claim on the basis that these are additional costs associated with being appointed as a SoLR.

CEL committed at the point of its appointment as SoLR to maintaining GBES's systems in the short-term (to minimise service disruption to GBES's customers), and we understand that CEL's intention at the time of their SoLR bid was to migrate all customers to their existing systems in due course as part of a normal customer acquisition process, ie. when retaining customers at the end of their existing fixed term deals.

Whilst CEL may have incurred costs which were unforeseen at the time of their bid as a result of their commitment to serve former GBES customers on the existing systems, their subsequent decision to migrate customer data from GBES' systems to its existing systems en masse may result, over time, in operating cost-efficiencies rather than additional costs. We also do not have any evidence to suggest that the migration is required directly as a result of CEL's responsibilities in taking on the SoLR role.

We therefore do not consider that this element should be appropriately included within CEL's approved claim.

Next steps

The purpose of this minded-to 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 **14 December 2017**. Responses should be posted to our London office at the address below, or emailed to supplier@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 receive, in reaching our final decision on CEL's claim. We currently expect to confirm our final decision in January 2018, to enable the agreed amount to be recovered through relevant network charges in 2018/19.

The CEL claim is the first Last Resort Supply Payment that Ofgem has had to consider since the SoLR arrangements were introduced in 2001. As is to be expected for this kind of process, there are certain lessons and improvements we will incorporate into the SoLR process going forwards. We will also consider whether a further update to our SoLR guidance, in relation to Last Resort Supply Payment claims, once we have made our final decision.

Yours faithfully,

Rob Salter-Church
Partner, Consumers and Competition