

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

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Date: 14 December 2018

Dear colleague,

Last Resort Supplier Payment Claim from Octopus Energy Limited

On 14 December 2018, Octopus Energy (Octopus) gave notice to us of their intention to submit a claim for a Last Resort Supply Payment.¹ Octopus is seeking to claim certain additional costs they incurred in acting as Supplier of Last Resort (SoLR) to customers of the former Iresa Limited (Iresa). 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 Octopus claiming a Last Resort Supply Payment of up to £13.8m.² We are minded to allow Octopus to claim for the costs of protecting the credit balances owed by Iresa to the customers Octopus acquired, in line with commitments given at the time of the SoLR appointment, and certain other costs incurred as part of undertaking the role of a SoLR.

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 currently expect to make our final decision in January 2019, to enable the agreed amount to be recovered through relevant network charges in 2019/20.

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 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

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

² Precisely, £13,797,946

be smeared across all suppliers and the costs of procuring gas will fall to the relevant shipper. 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 minimise these wider negative effects by appointing a SoLR to supply the failed supplier's customers at very short notice.³

Iresa SoLR event

On 31 July 2018, we appointed Octopus as the SoLR for Iresa's gas and electricity customers following Iresa's announcement that it had ceased trading. 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.

At the time of Iresa's failure, we received 14 submissions from suppliers, setting out the terms they would offer to customers if they were to be appointed as the SoLR. We outlined the material factors behind our decision to appoint Octopus as the SoLR in our decision letter published in August 2018.⁴

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 they incur in complying with a Last Resort Supply Direction (LRSD).⁵

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 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.

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.

Octopus 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 credit balances of (then) existing Iresa customers - Octopus also agreed to honour former customers credit balances, and to absorb these costs themselves. Octopus further stated

³ The obligation for a supplier (such as Octopus) 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 Octopus's obligations to supply Iresa's customers.

⁴ https://www.ofgem.gov.uk/system/files/docs/2018/08/supplier_of_last_resort_decision_document.pdf

⁵ There are related provisions in the electricity distribution licence and gas transporters licence, which are the subject of an ongoing consultation: <https://www.ofgem.gov.uk/publications-and-updates/informal-consultation-modification-electricity-distribution-licence-recover-costs-associated-appointing-supplier-last-resort>

it would seek to recover costs for Additional Working Capital, Transitional IT and Operations costs and Transitional Communications costs. Octopus has now submitted a claim for recovery of these costs. Octopus' claim consists of the following elements:

Table 1: Octopus Energy SoLR Levy Claim

Item	Cost Category associated with SoLR	Cost item to be claimed by Octopus Energy (£)
1	Credit balances	11,495,902
2	Capital cost for additional working capital to fund SoLR event	1,637,064
3	Transitional IT and Operations	591,630
4	Transitional Communications	73,351
Total		13,797,946

Our decision process and methodology

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

- A quantitative check of Octopus' methodology for each cost item claimed. This included determining how each total cost item was calculated based on data sent to us by Octopus and ensuring these costs were in line with commitments Octopus made at the time of its SoLR appointment
- Undertaking validation of some assumptions with other data sources, where appropriate
- A qualitative assessment of each claim item against our methodology criteria

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 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.
- **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.

Our minded-to decision

On balance, taking into consideration all information available to us and the specific circumstances of this case, we are minded to consent to Octopus claiming a Last Resort Supply Payment of up to £13.8m. 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 Octopus to recover up to this amount through relevant network charges in 2019/20. This is subject to any costs recovered from the Iresa liquidation process.

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 Last Resort Supply Payment. 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.

Reasons for our minded-to decision

Cost item 1: Recovery of Iresa customers' credit balances (£11.5m)

Our published guidance sets out that we may in certain circumstances consider it appropriate to 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 that (subject to the points discussed below) the claimed amount is consistent with the relevant criteria and in particular, is consistent with Octopus' commitment in its SoLR submission.

As expected, Octopus has honoured closed balances (i.e. amounts still owed to former customers) and is not seeking to claim for these through the levy. This is in line with SoLR supply licence conditions at the time of their claim and the commitments made by Octopus under the Iresa SoLR process.⁶

We have considered whether the costs Octopus is seeking to claim for credit balances are otherwise unrecoverable; it may still be the case that Octopus is able to recover some of this claimed amount through the ongoing administration process for Iresa. The current licence provisions related to Last Resort Supply Payments require us to make our decision on Octopus' claim ahead of the conclusion of the liquidation process. Given this, we are minded to approve this element of the claim, subject to the outcome of the Iresa liquidation process. At this point, the final amount Octopus can claim would be adjusted to include costs recovered through the liquidation process.

We would also note that the credit balance figure Octopus is seeking our consent to claim for includes an estimated value per account on 35% of accounts, where the customers have not yet agreed the final account/credit balance position (at the point immediately prior to Octopus being responsible for these customers). Whilst we are minded to consent to the amount Octopus has provided based on this estimate, we would expect Octopus to have provided the final, agreed amount in time for our final

⁶ We have since changed arrangements to enable both open and closed balances to be claimed through the levy. The link to this decision is below:

https://www.ofgem.gov.uk/system/files/docs/2018/11/solr_licence_changes_decison_letter_0.pdf

decision (and if not, our decision may be conditional upon future adjustment to the claim amount, once the actual figure is known).

Cost item 2: Capital cost for additional working capital to fund SoLR event (£1.6m)

In the period between being appointed as SoLR and receiving funding through the industry levy, Octopus will have incurred costs in making capital available to fund costs associated with the SoLR process. Octopus set out in their SoLR submission that they expected their claim for a Last Resort Supply Payment to include these costs.

We are minded to agree that the methodology used to calculate this element of Octopus' claim is appropriate. The calculation includes costs incurred over the course of a number of months to reflect actual costs incurred.

Cost item 3: Transitional IT and Operations costs (£592k)

This item relates to the costs incurred in transitioning Iresa's customers, and the particular challenges faced in the circumstances of this case. Octopus set out in their bid to be a SoLR that they expected their claim for a Last Resort Supply Payment to include these costs, and their estimate at the time is within the range of the claim since made.

These transitional IT and operational costs were primarily incurred due to having to manage issues associated with the Iresa proprietary system, in particular some extremely significant challenges associated with data quality. The primary driver for these costs was to establish a process and systems to verify customer account positions. Due to issues with the quality and availability of information in Iresa's systems, Octopus was required to rebuild multiple accounts, incurring greater costs than initially expected in transitioning Iresa's customers.

We are minded to agree that the approach taken by Octopus was appropriate. We understand it was aimed at ensuring customers were not disadvantaged, while at the same time seeking to minimise costs claimed through the levy by seeking, as far as possible in the circumstances, to verify actual account positions.

Cost item 4: Transitional Communications costs (£73k)

This references the costs of communicating with customers to verify account positions, i.e. related to the Item 3 costs above. The cost included the development of a digital tool to manage communications. We are minded to accept this cost and satisfied that it was an efficient method of verifying accounts, that would have otherwise been expected to be a longer and more expensive process. It should also be noted that Octopus managed to keep these costs to c. 15% of their initial bid estimate.

Summary

On balance, we are minded to consent to Octopus Energy claiming a Last Resort Supply Payment of up to £13.8m, which includes the associated capital costs. We are minded to agree that the method used to transition Iresa customers utilised an efficient system. We are also minded to agree that had Octopus not used this technical solution, they would have incurred more cost, particularly given some issues with Iresa proprietary data. Although the credit balance calculation includes an estimate for a portion of some accounts, we believe the methodology behind this calculation is a fair reflection of remaining account balances.

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 **11 January 2019**. Responses should be emailed to supplier@ofgem.gov.uk.⁷

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 Octopus' claim. We currently expect to confirm our final decision in January 2019, to enable the agreed amount to be recovered through relevant network charges in 2019/20.

We recognise the short time period for consultation and appreciate efforts to respond over the Christmas period. We are following this timetable in order that, if we grant consent, Octopus' claim can be paid, and recovered, in the 2019/20 charging year. This requires us to have made a final decision before 31 January 2019. We want to ensure Octopus' claim can be recovered in the next charging year to mitigate further costs that may otherwise be incurred, particularly those relating to working capital. This will ensure that costs are kept lower for consumers. Hence, we consider it appropriate in this case to consult for 4 weeks.⁸

Yours faithfully,

Philippa Pickford

Director, Future Retail Markets, Consumers and Markets

⁷ Although we prefer responses in electronic format, responses can be posted to the address below

⁸ Information on our consultation policy is available on our website:

<https://www.ofgem.gov.uk/consultations/our-consultation-policy>