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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,

Decision on Last Resort Supply Payment Claim from Octopus Energy Limited

On 14 December 2018, we¹ published our minded-to position on Octopus Energy Limited's (Octopus) claim for a Last Resort Supply Payment (**LRSP**) for additional costs they incurred in acting as a Supplier of Last Resort (SoLR)².

We received 6 responses to our consultation, including one consolidated response on behalf of three licensees. This letter confirms our decision to consent to Octopus claiming a LRSP of up to £13.2m³, a reduction of £639k from the figure given in our December 2018 minded-to letter. We also explain additional factors we have taken into consideration in making our decision, including representations made to us by interested parties in response to our consultation.

Our decision will allow Octopus Energy to recover the costs of protecting the credit balances owed by Iresa Limited (Iresa) to the customers Octopus acquired in line with commitments given at the time of appointment, and certain other costs incurred by Octopus in complying with Ofgem's 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,⁵ the relevant provisions of Octopus'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-octopus-energy>

³ Precisely £13,158,974.

⁴ The LRSD consists of two documents both dated 31 July 2018 and available here: [direction-appoint-octopus-energy-limited-gas-supplier-last-resort](#), which took effect on and from 05:01 hours on 1 August 2018 and continues in force for a period of six months; and [direction-appoint-octopus-energy-limited-electricity-supplier-last-resort](#) which took effect from 00:01 hours on 1 August 2018 and continues in force for a period of six months.

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

⁶ See standard licence conditions 8 and 9 of both Octopus'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 can lead 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. On 14 December 2018, Octopus notified us of its intention to claim for a LRSP consisting of £13.8m⁹ consisting of the following elements:

Cost item 1	Credit Balances	£11,495,902
Cost item 2	Capital cost for additional working capital to fund SoLR event	£1,637,064
Cost item 3	Transitional IT and Operations	£591,630
Cost item 4	Transitional Communications	£73,351

In our December 2018 letter¹⁰, we explained that we were minded to consent to Octopus claiming for up to £13.8m, and the factors behind our decision.

Our decision

We received 6 non-confidential responses¹¹ to our consultation¹², which we have summarised in the Appendix to this decision.

⁸ 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 Octopus's obligations to supply Iresa's customers.

⁹ Precisely £13,797,946.

¹⁰ <https://www.ofgem.gov.uk/publications-and-updates/last-resort-supplier-payment-claim-octopus-energy>

¹¹ Non-confidential responses have been published on our website alongside this decision document.

¹² <https://www.ofgem.gov.uk/publications-and-updates/last-resort-supplier-payment-claim-octopus-energy>

We received no representations from stakeholders that have led us to revise our approach to assessing the LRSP claim submitted by Octopus. However, as noted earlier, and as explained below (in the section on credit balances), the quantum of the claim we approve is lower than we stated in our minded-to letter.

Table 2 – revised claim		
Cost item 1	Credit Balances	£10,932,930
Cost item 2	Capital cost for additional working capital to fund SoLR event	£1,561,063
Cost item 3	Transitional IT and Operations	£591,630
Cost item 4	Transitional Communications	£73,351
Total		£13,158,974

We are satisfied that items 1, 2, 3 and 4 represent no more than the total costs incurred by Octopus in complying with Ofgem’s LRSD, minus the total amounts recovered by Octopus from Iresa’s former customers.¹³ Taking into account all of the information available to us and the specific circumstances of this case, we consent to Octopus claiming a LRSP of up to £13.2m¹⁴, subject to any amounts Octopus is awarded through the liquidation of Iresa and any necessary adjustment to reflect the final, agreed figure for the value of the cost of protecting 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.

Octopus will be paid the amount specified in our Direction by relevant gas and electricity distribution networks¹⁵. 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 supply standard licence conditions regarding LRSP claims¹⁶, Octopus 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 Octopus 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.

Stakeholders views

Cost of Credit Balances

In our December 2018 letter we noted that cost item 1 (credit balances) included an estimated value per account for 35% of customer accounts where the customer had not yet agreed the final account/credit balance position (at the point immediately prior to Octopus

¹³ This is the test set out in standard licence condition 9.4 of Octopus’s gas and electricity supply licences.

¹⁴ Precisely, £13,158,974

¹⁵ 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.

¹⁶ Standard licence condition 9.

being responsible for these customers). We said that we would expect Octopus to provide the final, agreed amount in time for our final decision and if not that our decision may be conditional upon future adjustment to the claim, once the actual figure is known.

A number of respondents commented on this aspect of the claim. One respondent considered that a claim based on 35% of estimated accounts was not a sufficiently robust basis on which to make a decision and that Octopus should be required to substantially improve on this position before the Authority made its final decision. Another respondent supported our minded-to position with the caveat that there is future adjustment to the claim once the estimated bills are finalised.

The percentage of accounts where Octopus has estimated the credit balance has now fallen to 9% and the claim for the cost to protect customers credit balances has fallen from £11,495,902 to £10,932,930 – a reduction of £562,972. As noted below, our decision is conditional upon Octopus adjusting the final amount claimed to reflect the final, agreed credit balance for all relevant customer accounts. The claim submitted by Octopus for the capital cost for additional working capital to fund the SoLR has also decreased. The revised LRSP claim is therefore as set out in Table 2 above.

Cost of capital for additional working capital

In the period between being appointed as SoLR and receiving funding through the industry levy, Octopus will incur 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. In our December 2018 letter we said that we were 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.

A number of respondents have commented on this aspect of the claim. While recognising that the SoLR may regard the information as commercially confidential, a number of respondents consider that Ofgem should provide more information on the cost for additional working capital in order that it can be validated as representing good value for money. One respondent argued that more information on the claim and Ofgem's assessment would help industry to ensure that they are producing reasonable estimates when making SoLR applications. One respondent considered that the claim for cost of capital for additional working capital was too high and should be closer to 3% rather than 10% of the capital costs.

Our decision to agree the claim for working capital takes into account the fact that the SoLR was appointed following a competitive process and information received from Octopus both at the time of the bid and the submission of the LRSP claim. In terms of the publication of information, it is important that we strike the right balance between providing sufficient transparency and protecting commercially sensitive information. We believe our approach strikes the right balance between ensuring the effectiveness of the SoLR process, and protecting the interests of consumers. We will keep our approach under review and look to identify opportunities to share more information on the costs incurred by a SoLR and our assessment of those costs where it is appropriate to do so.

Recovery of Octopus claim through network charges

In our December 2018 letter, we consulted on our proposed decision to enable recovery of any amount that we consent to Octopus claiming, through network charges in 2019/20. A number of respondents raised issues on the impact of the LRSP claim on the arrangements for setting distribution charges for 2019/20 and on setting customer tariffs.

One respondent asked that the recovery should be delayed until 2020/21 in order to give time to enable the additional costs to be fed into their fixed term tariff. One respondent noted that changes to the Electricity Distribution Licence had been proposed by Ofgem that

would allow a LRSP claim to be made without the need to change tariffs for the upcoming year, but that these changes are still subject to consultation. As a result the respondent noted that any valid claim made by Octopus would require electricity DNOs¹⁷ to seek a direction from Ofgem to dis-apply the 15-month notice period required for any changes to Distribution Use of System (DUoS) charges as set out in SLC13 and clause 19.1 of the DCUSA. Another respondent noted that such a direction could mean that the costs are not reflected in the default tariff price cap for a particular period and suppliers would have to utilise the headroom provided for under Ofgem's default tariff cap methodology. The respondent considers that the headroom allowance may not be sufficient and that additional costs caused by supplier failure could result in other suppliers failing.

We recognise the importance of ensuring that there is as much notice as possible of changes to charges. We note that the costs associated with this claim are unlikely to make a significant impact on individual suppliers given the way in which they will be recovered from all suppliers. We further consider that it is important for SoLRs to be able to recover LRSPs in a timely fashion to avoid detriment to customers. This is because we think a delay could potentially deter some potential SoLRs from submitting bids to take on customers and also could result in increased working capital costs that need to be recovered from the LRSP costs.

We have therefore decided that it is appropriate for distribution networks to recover the costs of making payments to Octopus in 2019/20 from their customers through adjusting their charges from April 2019. We therefore expect electricity DNOs to seek a relevant direction from Ofgem. We note that the recent changes proposed to the electricity distribution licence should, if implemented, reduce suppliers' exposure to changes in network charges at short notice in the future as any non-material claim would be dealt with through a pass-through mechanism – thus bringing the arrangements into alignment with those that apply to gas distribution.

Broader issues

A number of respondents raised concerns on the SoLR process, on suppliers' operating strategies and on the implications of supplier failure. In November 2018 we consulted¹⁸ on reforms to the supplier licensing regime. Under these proposals supply licence applicants will need to demonstrate to us that they have adequate resources to enter the market, understand their licence obligations and have a plan to meet them, and that they are a 'fit and proper' person to hold a supply licence. We also sought stakeholders' initial views on options on the ongoing monitoring of all licenced suppliers.

We will take account of all comments received on these issues as we move forward in conducting our supplier licensing review.

Yours faithfully,

Philippa Pickford,

Director, Future Retail Markets, Consumers and Markets

¹⁷ Different arrangements apply to gas distribution licensees.

¹⁸ <https://www.ofgem.gov.uk/publications-and-updates/supplier-licensing-review>

Appendix

We received 6 non-confidential responses to our consultation of 14 December 2018, from suppliers, distribution network companies and a consumer body. We have published the responses on our website¹⁹.

Three respondents agreed with our minded-to position to consent to all of Octopus's LRSP claim. Two respondent challenged aspects of the claim. A number of respondents took the opportunity to highlight concerns on the SoLR process, on suppliers' operating strategies and on the implications of supplier failure.

Cost item 1: Credit Balances

One respondent noted that 35% of customer accounts had not had a final account agreed by the consumer. The respondent considers this does not form a robust enough basis for the claim and that Octopus should be required to substantially improve on this position before the Authority makes its decision. One respondent supported our minded to position on this aspect of the claim but noted that the amount claimed for credit balances is significantly more per customer than the previous SoLR claim from Co-Operative Energy (by the respondent's estimate, the Octopus claim averages £128 per customer versus £69 per customer for Co-Operative Energy). The respondent considers this may have been due to Iresa's policy of holding onto significant amounts of customer credit, and their demands for one-off payments shortly before their failure. The respondent supports the protection of credit balances when suppliers fail, but given that cost of this protection is recovered from all other consumers, notes that it is important these costs are limited as much as possible.

Cost item 2: Capital cost for additional working capital to fund SoLR event

Two respondent questioned the amount claimed for the cost of additional working capital. One respondent considers that the cost of funding additional working capital is too high. Another respondent considers that Ofgem could provide more information to support the £1.6m claimed for the capital cost of additional working capital as the respondent is unable, on the basis of the information presented, to tell whether this represents good value for consumers or not. While recognising that borrowing costs etc. may be seen by the SoLR as commercially confidential, the same respondent believes that a claim on consumers' money needs to be transparently justified.

Cost item 3: Transitional IT and operations

One respondent noted their expectation that a SoLR would factor into its bid the costs associated with transitioning customers from the failed supplier's systems to its own systems, and so in most cases there would be no claim from the industry levy for such costs. The respondent noted, however, the poor data quality within Iresa's systems caused significant challenges for Octopus, and recognised that it may have been difficult for Octopus to factor this into their initial submission to act as SoLR. The same respondent noted that, based on its own experience of acting as SoLR in recent months, poor data quality may often be a significant challenge for a SoLR, and that the information provided by Ofgem in the initial request for information may not always be sufficient to understand the actual level of activity and additional costs that will need to be incurred. The respondent therefore agreed with Ofgem's minded to position to consent to Octopus' claim for transitional IT and operations costs. The respondent also notes that the lack of transparency on the LRSP claim and the methodology used means that that they are unable to validate the costs themselves.

One respondent noted that significant additional costs in this area were a result of the proprietary billing and account management systems that Iresa were using and poor data quality. The respondent notes that in some other recent SoLR events, the gaining supplier has been able to negotiate with the old supplier's system providers or administrators to

¹⁹ <https://www.ofgem.gov.uk/publications-and-updates/last-resort-supplier-payment-claim-octopus-energy>

gain transitional access to the supplier's system. The respondent considers that Ofgem should seek to facilitate this access wherever possible and technically feasible, as it should reduce costs, assist with the transfer of accounts, and ensure consumers get an accurate and timely final credit position with the old supplier.

Recovery of LRSP claim through network charges

One respondent noted that changes proposed to the electricity Distribution License proposed by Ofgem would not be in force in time to allow the LRSP payment to be made without the necessity to change tariffs for 19/20. The respondent therefore proposed that the same process used successfully for collecting and paying the Coop Energy Limited LRSP claim should be used again. The respondent noted that this would require electricity DNOs to obtain a direction from Ofgem to deviate from the approved pricing methodology as covered by SLC13 and that the notice period prescribed under clause 19.1 of the DCUSA.

One respondent argues that if there is less than 12 months' notice of increases to network charges, suppliers will have insufficient time to ensure that their fixed term contracts reflect the additional costs. The respondent is also concerned that such a direction could mean that the costs are not reflected in the default tariff price cap for a particular period and therefore suppliers would have to utilise the headroom provided for under Ofgem's default tariff cap methodology. The respondent considers that the headroom allowance may not be sufficient and that additional costs caused by supplier failure could result in other suppliers failing. In deciding whether to grant a derogation, the respondent believes that Ofgem must consider the impacts on suppliers to prevent one SoLR event forcing other struggling suppliers into another.

One supplier respondent strongly urged Ofgem to postpone the collection of the LRSP claim until 2020/21 so that the additional cost could be factored into customers' fixed term tariffs. Under Ofgem's current proposal the respondent says they will be unable to reclaim this additional charge in the short-term from its customers, who are predominantly on fixed tariffs for at least 12 months, which means that this cost will need to be borne by the respondent. The respondent considers that this is not the way that the industry levy is designed.

Transparency and timescale

One respondent considered that greater details of the winning SoLR bid should be disclosed, and at a time closer to the SoLR event. The respondent considers that having more information on the costs that an SoLR would be seeking to recover and the indicative timings, would enable them to account for potential levies in advance to support accurate forecasting of future tariff rates, and to absorb these additional costs over a longer period, with a lower impact on customers.

One respondent noted that the frequency of SoLR events in recent months has left a considerable amount of uncertainty for suppliers, who it considers have insufficient information about the potential value and timing of a Last Resort Supply Payment (LRSP) claim to aid financial planning. The respondent is concerned that changes to the SoLR rules that became effective on 1 January 2019, will lead to additional uncertainty by allowing SoLR to submit LRSP claims up to five years after the SoLR commenced, unless Ofgem notifies a different timescale when appointing the SoLR. The respondent urges Ofgem to notify suppliers of the precise deadline granted in respect of any particular LRSP at the earliest opportunity, together with full details of what the SoLR is expecting to claim for as stated in their SoLR RFI response, including the percentage of credit balances that the SoLR has indicated they will seek to recover in any LRSP claim.

One respondent considers that more transparency in the SoLR process is needed to allow a reasonable assessment of SoLR claims. While appreciating the need for commercial confidentiality, the respondent considers that it is difficult to objectively assess the overall value for money of the claim without a greater understanding of the nature of the rival bids. As regards the appointment of Octopus to act as the SoLR for Iresa, the respondent

considers that Ofgem did not give sufficient explanation to allow an understanding of whether it was the bidder that sought to make least use of the Safety Net. The respondent considers this point to be a highly material consideration and would welcome greater clarity from Ofgem on this in any future SoLR decisions. The respondent remains firmly of the view that minimising socialised costs should be given more weight in any SoLR decision than securing the best replacement tariff for affected customers and notes that in practice, the customers of a failed supplier can mitigate the negative consequences of being put on a sub-optimal tariff by simply switching away from their new supplier, while the wider population of all consumers cannot mitigate the negative consequences of having to pay for the Safety Net.

Other issues

In its response to a consultation on a previous SoLR event, one respondent expressed concern about the trade-offs that were being struck between protecting the consumers of the failed supplier, and protecting the consumers of other suppliers from smeared bad debt. The respondent considers that Ofgem's decision letter on Co-operative Energy's LRSP claim suggested that a minority of alternative SoLR bidders would have been willing to make less use of the Safety Net than Co-operative Energy was, and that it may have been chosen despite this because it was willing to honour the tariffs that GB Energy had offered to the customers who were being transferred, and other bidders may not have been. The respondent suggested that 'given the redistributive effects of SoLR, with the consumers of other suppliers picking up the tab for a financially unsustainable business, it appears preferable to them that consumers of other suppliers are protected from smeared debt preference to honouring the unsustainable tariffs of a failed supplier, if that trade-off has to be made in any future SoLR'.

One respondent noted that a number of suppliers that have taken action to increase the credit balances of their customers, by either increasing direct debits, delaying refunds or taking one-off payments. The respondent has, however, seen tariffs emerging that require significant credit upfront, and is concerned that growing credit balances could ultimately lead to increased bills for all consumers in the event that these suppliers fail. The respondent notes that Ofgem's Supplier Licensing Review consultation asks for early views on limiting consumer credit balances, but considers action on this may be required more urgently.

One respondent considers that the amount suppliers can claim back through the LRSP now seems to be making trade deals unattractive and that Ofgem must take this into consideration as part of its review of the supplier licensing regime. The same respondent considers that the impact of some suppliers' operating strategies can result in vulnerable customers subsidising those who are wealthy enough to afford to benefit from a cheaper price by paying up to a year in advance. If such suppliers fail, the respondent notes that the credit balances those customers have with that supplier will be safe, but will be funded by all customers, including those that are vulnerable and less well-off. The respondent welcomes Ofgem's proposals in the Supplier Licensing Review consultation to restrict suppliers from offering terms which incentivise customers to maintain credit balances. The respondent urges Ofgem to speed up its review of energy industry entry and exit rules in order to provide better protection to customers from the impacts of supplier failures.

One respondent notes that the number of Supplier of Last Resort events in 2018 has caused considerable disruption for suppliers and customers. The respondent welcomes Ofgem's Supplier Licensing Review consultation but believes Ofgem should have acted more promptly in view of the warnings from stakeholders that a number of suppliers were struggling to stay in business.