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Dear Sir/Madam

Response to 'Consultation: our proposed approach to dealing with supplier insolvency and its consequences for consumers'

Thank you for providing us with an opportunity to comment on your proposed approach to dealing with supplier insolvency and its consequences for consumers. This submission is entirely non-confidential and may be published on your website.

The consultation focuses on the specific issue of credit balances, highlighting that in the event of insolvency consumers with credit on their accounts are likely to be treated as unsecured creditors. As a consequence, it is possible that they may not receive all (or indeed any) of these monies back from the failed supplier. You set out three possible ways in which these consumers could be protected:

- Option 1: an enhancement of the existing Supplier of Last Resort ('SoLR') rules setting out that the cost of a rescuing supplier honouring those credit balances could be met through applying a levy on all suppliers. This would not actually introduce a new power as this could already be done under SoLR rules, but it would more clearly highlight that this option is on the table.
- Option 2: requiring suppliers to ring fence consumer funds such that they were not included in the company's assets for the purposes of insolvency. This would ensure these funds were protected, at the cost of severely reducing available working capital. You consider that this could increase supplier (and by implication, consumer) costs, dampen competition and, possibly, result in some market exit.
- Option 3: requiring suppliers to enter into insurance or bonds with a third party to ensure that, in the event of default, credit balances can be repaid. You consider that this option has similar strengths and weaknesses to Option 2.

You sought views on stakeholders preferred option, and also floated a range of issues for consideration of which we consider the most important is whether credit protection should be applied to all consumers or only some. We provide views on these matters in the remainder of this letter.

The need for credit balance protection, and our preferred option

Most energy consumers, perhaps three-in-four, will have credit balances on their account at least part of the time.

The most common payment method is direct debit, accounting for around 56% of households.[1] Direct debit customers typically pay a flat monthly amount while their consumption varies with season. This smoothing effect will mean that they typically build up credit surpluses in the summer while becoming in arrears over the winter months.

A further 16% of households are on prepayment meters ('PPMs').[2] While PPMs are often initially installed as a debt management tool[3], the majority of PPM users are not actually in debt to their supplier.[4] Most PPM balances are credit balances.

Whatever their payment method, consumers will have made payments in good faith, in anticipation of receiving a contracted service in return. It is likely that many will not even be aware that there is a question mark as to whether these funds are at risk; we have not seen a major domestic supplier failure where credit balances have been forfeit since market opening. Likewise, experience in other regulated public utilities have not thrown up examples of insolvency leading to lost credit.[5]

There are constraints on consumers ability to wholly manage this exposure. PPM is often not a choice. Further, in some circumstances it may aggravate consumer detriment if PPM customers were discouraged from building up a credit balance, for example by increasing the risk of self disconnection during winter periods. While paying by direct debit is a consumer choice, it is the lowest cost to serve payment method, and competition in the marketplace has evolved around the best deals being available to direct debit customers.

As a consequence, any precedent of a supplier going down leaving consumers with credit balances forfeited could have severe consequences on both consumer well-being and confidence in the marketplace. Aside from direct financial loss to those consumers with the affected supplier, it may result in indirect financial loss and inefficiency costs to all consumers, both from the deterrent effect it may have on switching (eg a wish to stick with suppliers who might be perceived as 'too big to fail') and through discouraging consumers from managing their household bills cost effectively (eg avoiding having 'risky' credit balances or using payment methods like direct debit).

Further, there is no easy way in which consumers can adequately assess the risk of supplier failure; insolvency is often an unforeseen event (indeed, it is invariably in a failing company's best interests to avoid creating a public perception that it is in trading difficulties, as this is only likely to hasten its demise).

[1] 'Energy: the debate. Ofgem roundtable report on payment differentials,' Ofgem. http://tinyurl.com/hg8dmnq
[2] Ibid.
[3] This accounted for 60% of PPM installations in 2014. http://tinyurl.com/zqcf2qq
[4] Ofgem's social obligations reporting suggests only 7% of electricity PPM customers, and 10% gas PPM customers, were repaying debt in Q4 2014. http://tinyurl.com/zy9ggrs
[5] Probably the highest profile example of a regulated UK utility going bust is Railtrack in 2002. This did not affect any consumers with credit balances (i.e. advance tickets purchased before its demise remained valid).

For this combination of reasons we agree with Ofgem that it is important that consumers credit balances are protected in the event of supplier insolvency and that action is needed to ensure this is in place.

We regard all three of the options on the table as imperfect, but consider that Option 1 is the most preferable of the three.

For all three options, no cost/benefit analysis has been published. We think this is likely to be because of the difficulties involved in this given the highly uncertain nature of possible supplier failures (for all Options), the multiplicity of possible alternative supplier financing models (under Option 2), and the current absence of relevant insurance products (under Option 3). We recognise those constraints, although note that it makes it hard for stakeholders to fully judge the potential impacts of the three models on consumer bills and on competition in the market. We expect that you may receive more detailed evidence on the costs of Options 2 and 3 from market participants through this consultation, and would welcome your providing greater detail on these costs in any subsequent consultation or decision paper.

Notwithstanding this, we are persuaded by the qualitative case you make that either Option 2 or 3 is less desirable than Option 1 because of the likelihood that the costs associated with either form of protection may be significantly higher and could either dampen competition or precipitate market exit/discourage market entry. You make a plausible case that the side effects of applying either medicine could be worse than the injury it is trying to tackle.

Option 1, using discretion under SoLR rules to apply an ex post levy on all suppliers, and only if needed, would appear to markedly reduce the upfront costs that suppliers incur (and by extension, that they pass on to consumers) compared to those ex ante options. In common with all three options, it would provide necessary protection for consumer credit balances and therefore is preferable to a ‘do nothing’ approach.

Option 1 is nonetheless imperfect, for the reason that the ability of Ofgem to use its discretion under SoLR rules may mean there is some uncertainty on how any individual case may be handled. We fully recognise why you would wish to include that discretion; the consequences and materiality of, say, a Big 6 supplier going bust would be entirely different to that of a small supplier with only a few thousand customers going under. There may also be a reasonable argument that upfront prescription could hamper the ability to find a voluntary trade sale that avoids appointing a SoLR in the first place. It is possible that wise use of discretion could result in a better outcome for consumers than prescribing in advance what balances will be protected.

But discretion is also problematic because it may reduce trust and cause consumer distress. It could also potentially result in consumers being out of pocket compared to Options 2 and 3 if a decision was taken not to protect credit balances in an individual case.

As an advice provider, we would expect to field calls from worried consumers in the event of a retail energy supply bankruptcy and our ability to give sound advice would be constrained if it was unclear how any discretion would be applied. In extremis, if discretion was applied in such a way that many consumers found their credit balances were forfeit, or if a decision was left hanging for a protracted period such that consumers could not tell if they were protected or not, this could result in very similar consequences to those associated with having no protection at all - eg that consumers would stick to 'too big to fail' large incumbents and might be deterred from using direct debit or building up a PPM surplus for winter etc.

To mitigate these weaknesses in the Option 1 model, we would like to see SoLR guidance strengthened in two areas.

Firstly, we would like the guidance to establish an expectation that all consumer credit balances would be protected by default (eg that discretion will not be used to constrain protection except in truly exceptional circumstances - we talk about what these might be in the next section.)

Secondly, that Ofgem should commit to very rapidly providing advice and guidance on if/how discretion is being applied should it use these provisions. This will be essential to allow advice providers to provide adequate advice to consumers in what will naturally be a worrying time for them.

Who should be covered by credit balance protection

Your consultation highlights that options on the table could include protecting all credit balances, or only those up to a certain threshold (rather akin to the limited protection provided by the Financial Services Compensation Scheme ('FSCS')). It could also be limited to certain types of customer.

Our preference is that protection is provided to the entirety of all customers credit balances. We think this would maximise consumer confidence in the market, and provide appropriate protection against an event, supplier default, that they have no control over.

We recognise the argument made for a FSCS style limit, and that it may be prudent for consumers to avoid building up excessive credit balances. But no evidence has been brought forward in the consultation to suggest where such a threshold should be set and to judge the relative balance between protection and costs that would arise from a threshold.

We also think it would be hard to apply discretion to which types of consumers are protected in a 'clean' way that avoids unintended consequences. For example, while PPM users are more likely to be financially vulnerable than those on other payment methods, this is a generalism rather than a hard and fast rule - there are also affluent customers on

PPMs and poor ones paying through other methods. The Priority Service Register may also provide an informative, but imperfect, guide to vulnerability.

We suggested in the previous section that we would only wish to see discretion used to constrain credit protection in exceptional circumstances. What we envisage here is circumstances of acute systemic risk. In practice, we think it is more likely than not that small suppliers will enter insolvency than large ones as they typically have fewer high-margin sticky customers and may be less experienced and capable of riding out wholesale price volatility. Were a small supplier to go under owing a few million pounds we would expect the supply industry to be able to absorb those costs. Indeed, this may also be the case if a medium sized or larger supplier went bust.

However, we do recognise the possibility, however remote, that supplier insolvency could affect a very large supplier and that its exposed credit balances could be an order of magnitude bigger. If this exposure was so large that it could not be absorbed by other suppliers without having a deleterious domino effect, eg causing knock on insolvencies, there could be a case for constraining credit repayment as the least worst option on the table.

But we would stress that we think such a situation is unlikely. In any event, we consider that the onus would be on Ofgem to demonstrate that the adverse consequences of ensuring credit protection were worse than the (in their own right, severe) consequences of not doing so. The loss of consumer confidence if credit balances are lost could be extremely damaging to public trust in an essential service.

Other issues

While we have concentrated our arguments on the matters explicitly consulted on - the approach to SoLR, in instances of distressed market exit - we note that there may also be room for improvements in processes of market entry that could stop, or reduce the likelihood that those provisions are ever needed. In practice, the hurdles for gaining a supplier licence are very low indeed, and the expansion of 'supplier in a box' services have made some of the service delivery systems hurdles lower too. While this may maximise the chances of market entry, it may also result in a lack of preparedness for market operation in some cases. Our experience is that while some of the best examples of operational competence we see originate from new or recent market entrants, many of the worst examples also originate from the competitive fringe too. There may therefore be a case for increased 'hand-holding' of new market entrants to ensure that they are aware of their responsibilities and that they have a robust model with a reasonable chance of surviving market turbulence. This upfront regulatory investment would come with a cost, but this cost may well be lower than the damage that could be caused by suppliers failing to deliver for consumers in the market, or failing and leaving the market in a disorderly fashion.

We hope you have found this submission helpful. We would be happy to discuss any matter it raises in more detail if you would find that useful.

Yours sincerely

Rich Hall

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