By email only
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Your ref:
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Dear Rob

Consultation: proposed approach to dealing with supplier insolvency and its consequences for consumers – 13 June 2016

We provide our comments on your proposals for the Supplier of Last Resort (SoLR) arrangements in the attachment. Neither they, nor the contents of this letter, are confidential.

In summary, we believe none of the options put forward is satisfactory. There are potentially better solutions that Ofgem has not considered, and we set these out in our full response; they involve credit arrangements and the building up of an industry fund.

Of the options you suggest, we consider that option 1 generally provides a better outcome for the interests of consumers. However, it essentially involves future customers meeting the cost of supplier default; therefore, there are a number of steps that should be taken by Ofgem before it is adopted. Ofgem should:

- ensure that suppliers, where there is any potential doubt about their finance, take all steps to return credit balances;
- require all suppliers to return credit surpluses to direct debit customers;
- encourage full participation in the industry programme to ensure the return of credit balances by suppliers to their former customers;
- consider developing the Prepayment Debt Assignment Protocol to deal with credits; and
- clearly explain to all consumers the use of the levy and how it will work; and that they will be paying for it.

We would be happy to come to talk to you about our alternatives or any of the other content of our response.

Yours sincerely

Rachael Ridler
cc: Gerald Jago

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Consultation: Ofgem's proposed approach to dealing with supplier insolvency and its consequences for consumers

npower's responses to consultation questions

Q1: Do you agree with the approach to SoLR and energy administration set out in our revised guidance?

Yes, largely, in respect of process.

Ofgem's existing SoLR powers mean it is able to nominate another supplier to take on the customers of a failed supplier, provided it is satisfied this will not prejudice the new supplier's responsibilities in relation to its existing customers. The guidance, last updated in 2008, describes the process.

The revised draft guidance published as part of the consultation essentially introduces two additional considerations. One relates to the process for seeking approval for the appointment of an administrator under Energy Supply Company Administration Rules 2013; and the other to the treatment of customer credit balances held by the failing supplier.

The policy intent of the energy administration changes is to ensure there are fit-for-purpose provisions to deal with failing large suppliers. It is therefore sensible to consider the possibility of appointing a SoLR in the first instance, which is the process described in the guidance.

We will deal with the credit balance issue below. However, there are two further points we would like to add here. One is a key point about supplier fitness: whilst it is not possible to prevent all supplier failures, methods of limiting them would be: rigorous monitoring of a company's operations and financial health; and a more detailed scrutiny by Ofgem of the financial robustness of licence applicants and their proposed business models. This would include the history of the directors involved and whether they were 'fit and proper' persons in line with directors' responsibilities under the Companies Act.

The second point is in relation to Ofgem's statement that it is likely to allow potential SoLRs between four to six hours to provide a response to the information request. Whilst we appreciate the urgency of this type of situation Ofgem should allow suppliers a more reasonable amount of time (at least 24 hours) to respond.

Q2: Do you agree with our preferred approach (option 1 - no further action, i.e. case by case use of SoLR powers) to protect consumer credit balances?

We would be particularly interested in hearing your views on the following factors in relation to each option: effects on innovation and potential barriers to entry, increased regulatory burdens, impact on customer behaviour, proportionality.

In part.

Of the options considered, on balance option 1 would better serve the interests of consumers. However, Ofgem should only pursue this option if it has first thoroughly considered the alternatives

suggested by npower, as described later in the document, and also fulfilled the requirements listed below under 'important precursors'.

In addition, Ofgem should consider the inherent weakness that there would seem to be no guarantee to a SoLR that any claim for repaying customers' credit balances would be approved by Ofgem in whole or in part.

Important precursors

The enactment of option 1 for the levy should only be considered after the following steps have been taken:

- first, following early signs of potential insolvency, Ofgem should make specific enquiries regarding customer credit balances and assurance that all steps have been taken to return these. In the absence of sufficient evidence, Ofgem has the power to take action through Provisional and Final Orders;

- second, npower and other suppliers, following discussion with DECC, have agreed to return credit balances for direct debit customers in excess of £5 where there is a valid meter read. This has the effect of protecting credit balances against default. Ofgem's first action should be to encourage full participation by all suppliers, and to consider any supplier's refusal to participate in the context of Standards of Conduct and the requirement to treat customers fairly;

- third, in agreement with Ofgem, npower and several other suppliers have made substantial efforts to return the credit balances of their former customers. The "Funds Reunited" programme has several elements to it. Monies ultimately unreturned are not taken to profit but go to a Good Deeds fund. Ofgem must encourage full participation by all suppliers in this and question non-participation by any supplier; in particular for suppliers at risk of default, in relation to the honouring of liabilities;

- fourth, npower and other participating suppliers are working to make the Prepayment Debt Assignment Protocol operate more effectively. In this mechanism, customers in debt are more able to switch suppliers by moving the debt balance from the losing to gaining supplier. The scheme could potentially be developed for credit. This may require the holding of some monies flowing through the Prepayment Meter Infrastructure Provider system in escrow, as it is customer money. Ofgem should require the development of such a scheme. npower would be happy to support an industry wide initiative or otherwise provide a "straw man" draft proposal for how it might work;

- fifth, if there are serious plans to use the levy as consulted on, Ofgem should make transparent to consumers: how it will work, including the intended use of Ofgem's discretion; the time it will take to recover their money; and the possibility of a levy on future consumers.

Option1

Summary of current arrangement and proposed change

Option 1 involves carrying on with current arrangements, meaning claims under the industry Levy by suppliers of last resort will continue to be assessed by Ofgem on a case-by-case basis. However, Ofgem now proposes that claims made explicitly in support of addressing the loss of consumer credit balances may fall into the circumstances which Ofgem would approve as a claim. This could mean that the SoLR would be compensated for repaying a consumer's credit balance.

Ofgem has said that its continuing preference will be to appoint SoLRs who intend to make no claim on the industry levy and our assumption is that this will also include any commitment by suppliers to reimburse credits.

Discussion

Suppliers will not know in advance the cost of transferring customers; and even if they know in advance that a claim for credit balances would be met they would probably not know whether it would be met in whole or in part. If they decide to make a payment they would also have to do so ahead of recovery via the DNO. Whilst larger suppliers may have been willing to meet the costs of customer acquisition for the anticipated commercial benefits (having some idea of the broad costs) it is unlikely to be the case for unidentified and unquantified credit balances; and for all suppliers, regardless of size, this will increase the financial risk for a supplier taking on customers as a SoLR. As the proposals stand currently therefore we foresee two possible practical impacts:

- Smaller suppliers will be less likely to want to volunteer to become SoLRs
- Without more certainty all suppliers will be less likely to volunteer to reimburse credit balances

Therefore, whilst we understand Ofgem's policy objective we consider that these proposals may not achieve it; additionally, there will potentially be unintended consequences for the commercial market, as described below.

Effects on innovation and potential barriers to entry

The financial implications of appointment could be a serious consideration for any supplier deciding whether to volunteer under the SoLR process. Ofgem recognises that the uncertainty of the approach may itself carry an additional cost for suppliers.

Smaller suppliers that may be able to grow their customer base significantly and quickly through this process would be less likely to wish to become a volunteer SoLR; or, if they did, make any arrangements to meet credit balances. The proposal then may be considered to be biased towards larger suppliers, leading to an inhibiting of competition and the development of new suppliers.

Proportionality

In relation to the Levy overall, npower would argue that the true SoLR cost is incurred through gaining the new customers. This is because in taking on x number of new customers, the SoLR will need to adjust its hedging strategy accordingly in order to purchase energy for its growing customer

base. The short notice period given to a SoLR means the supplier may need to purchase this energy quickly, often on the spot market, increasing costs significantly. It therefore seems equitable to suggest that if the SoLR promises to also repay the consumers' credit balances, an additional cost which the supplier is not obliged to refund, there should be certainty that in all cases suppliers would be compensated for this in its entirety through the Levy. If this is not the case, the financial risk of volunteering to become a SoLR may become too great for many suppliers to even consider.

Impact on customer behaviour

npower agrees that this option does not directly affect competition or market dynamics to the same degree as the other options available. This means that the future effect on consumer behaviour is diminished.

Increased regulatory burden

The option is described at high level and there is no indication as to how it would work in detail or in practice; for example: the level of evidence required from suppliers to support claims; presumably there would be no access to customers' previous accounts and therefore the level of credit would not be known; how could we be sure that the credit was based on an actual meter reading - estimated readings have a significant impact on credit balances? Moreover, assessing credit balances would be an additional piece of analysis to be undertaken in an already challenging timescale (proposed as 4-6 hours).

Option 1 therefore would require, probably significant, additional regulatory guidance and support.

<u>Option 2</u>

Summary of proposed change

Option 2 proposes ring-fencing or establishing trust arrangements for consumer balances or payments. We do not support this suggestion for several related reasons and in summary agree with Ofgem that it would tie up working capital, thereby affecting smaller suppliers more significantly; and would potentially impact competition and the level of prices and customer bills.

Discussion

Effects on innovation and potential barriers to entry

The problems with ring-fencing consumer credit balances become evident, for example, if a group of customers is in a credit position for an upcoming winter. Using the current model this credit could be used by the supplier to purchase wholesale fuel for a given period of time. This is a mutually beneficial arrangement for both supplier and consumer; it benefits the supplier as they are able to purchase fuel ahead of demand, meaning a more commercially focussed hedging strategy can be utilised; and it benefits the consumer as the supplier is able to purchase energy at a more competitive price.

However, if suppliers were unable to utilise the consumer credit balances as a consequence of a ring-fencing arrangement, then the benefits to both the consumer and supplier automatically cease. This would be harmful to both supplier and consumer. Suppliers would be more limited in the

amount of fuel they can purchase ahead of consumption, meaning higher procurement costs with inevitable pass through to the consumer through increased bills or tariff charges.

Proportionality

The effect of ring-fencing consumer credit balances would have a different level of impact on suppliers, and then consequently their consumers, depending on the supplier's size and market share.

As an example, a small supplier with only a few customers may rely heavily on consumer credit balances to finance the purchasing of energy for these customers ahead of demand, with the benefits described above. However, a larger supplier is more likely to have higher financial capital and therefore be less likely to rely so heavily on consumer credit balances.

It is key to note the importance of responsible supplier behaviour. A supplier in financial distress is subject to directors' liabilities and should therefore be conscious of the accumulation of consumer credit balances, if there is the prospect of inability to pay. This is to say that npower recognises that a supplier should not rely solely on consumer credit balances to fund business transactions.

The priority, therefore, should be not to mitigate the cost to consumers defaulted on, but to avoid or minimise the default in the first place.

It is indeed quite possible for a company to finance its working capital, for example for IT and directors' salaries, by advanced customer payment through direct debit and prepayment. This is not illegal per se. However it *is* illegal for company directors to take in money from any party, where there is substantial risk of default, without making those parties fully aware of the risks. Under insolvency practice it seems right that customers are the most senior creditors external to the company but in practice they still fall behind company directors and do not benefit the seniority relative to the other creditors. Ofgem can resolve this.

Ofgem used to have a financial integrity test before granting a supply licence. We understand the rationale behind why this no longer happens, but it does indicate that Ofgem considers that it has the power to take action with suppliers who are at risk of insolvency. Obvious examples are requiring the supplier to return credit balances as required or the ring fencing of credit balances. Inadequate financial resource to do this indicates inappropriate and possibly illegal conduct by the company.

Effects on innovation and potential barriers to entry

Ring-fencing could act as a definite barrier to entry for new suppliers and would have a harmful effect on smaller suppliers with a smaller customer base who would be unable to compete with larger suppliers. Thus, requiring a supplier to ring fence customer credit balances reduces its cash flow liquidity and may actually contribute towards its financial distress.

Impact on customer behaviour

The reduction in size of the competitive market space as a result of the above could have a damaging effect on customer choice and customer behaviour, thereby reducing switching and dampening competition in prices.

Increased regulatory burdens

As recognised by Ofgem this option would inevitably result in an increased regulatory burden for Ofgem. Amongst other things, Ofgem would need to ensure there was no gaming of the apparent level of balances in order to avoid the arrangement. However, it would have a similar impact on suppliers. Strict rules and regulations, including around accounting, would need to be developed and managed in order to ensure that all suppliers were compliant, particularly if as is suggested cover were to be restricted to vulnerable customers only. These arrangements would be costly. npower does not consider that this would be a cost-efficient use of resource, or equally one which would be easy to monitor.

Option 3

Summary of proposed change

Option 3 proposes suppliers adopt insurance/bonding arrangements. This would involve them paying a third party, usually an insurance company, a set amount, so that in the case of insolvency the insurance company would be able to repay some or all consumer credit balances. npower agrees with Ofgem that it would lead to additional costs, affecting pricing and profitability, and could have a potential impact on competition. In addition, Ofgem notes in the guidance document that its principal objective is to protect the interests of existing and future consumers. This option does not protect the interests of future consumers as it is they who will be helping to pay for the historical credits of existing customers. npower does not consider that ultimately option 3 is a viable suggestion, for the reasons developed below, but acknowledges that overall it may have fewer disadvantages than option 2.

Discussion

Effects on innovation and potential barriers to entry

It is important to note that the key issue in relation to option 3 is that there will be a significant increase in costs for the supplier. We think this is problematic as it will inevitably act to dampen competition, form a barrier to entry for new market participants and also unequally affect smaller suppliers. It will also have the effect of forcing current or future customers to pay to protect the historical credits of existing customers; and therefore does not fulfil Ofgem's principal objective of protecting the interests of both existing and future customers.

Proportionality

Suppliers more likely to fail include new entrants, suppliers with a smaller customer base and those with an already strained financial reputation or position. Their customers are at greater risk of losing their credit balances and are most in need of protection. As insurance premiums are provided on the risk of failure they will be more expensive for this group of suppliers.

Increased regulatory burdens

Option 3 does have fewer disadvantages than option 2 for suppliers in respect of potential changes in regulation and the burden this could bring. As the insurance would be offered by an independent third party, the process needed to govern and manage the agreement would be determined

externally and therefore not by the supplier. Ofgem acknowledges that its monitoring provisions would likely be significant.

Overall, option 3 is therefore a more attractive proposition for suppliers than option 2 as it means that it would be a less onerous obligation to implement.

Impact on customer behaviour

If this option led to a reduced number of suppliers, consumers would have less choice available to them when selecting a supplier. This means again that we could see a reduction in competition in the market and the consequential impact of that as described above.

npower's alternative option 1

Summary of proposal

This option would extend the existing role of credit cover currently provided by suppliers and shippers; it would require the lodging of an extra ring-fenced portion of credit cover, which could act as a method to cover customer credit balances in the way in which Ofgem is encouraging suppliers to facilitate through the consultation.

Discussion

Effects on innovation and potential barriers to entry

In the current market, suppliers and shippers already lodge credit cover with electricity and gas transporters for their transportation charges. It is therefore a method that is understood and as a result should have little impact on innovation. Whilst the cost is not known at this stage, one might assume the increase in the cost of cover could be relatively small.

Proportionality

Costs would be proportional to a supplier's portfolio and therefore it would not proportionately disadvantage smaller suppliers.

npower notes that a key advantage of this method is that regardless of how the additional charge is calculated, it could be adjusted seasonally. This would be beneficial as the amount a supplier paid could be adjusted to account for periods when balances are more likely to be higher or lower.

Importantly, this method is not reliant on other market participants, which means that one supplier's failure to act responsibly does not affect other suppliers who have acted more sensibly.

Increased regulatory burdens

The arrangement would require little involvement from Ofgem, nor significant regulatory oversight. It is simply an extension of something that already exists.

The only involvement by Ofgem would be in relation to the analysis of credit balances and the calculation of the total to be met through additional credit cover. Having established the level of credit balances in the industry Ofgem could decide to calculate each supplier's additional cover in a number of ways. One method would be to use a simple calculation of customer MPRNs x £x. This

would result in the total value to be secured by credit cover. An alternative would be for Ofgem to take the average customer credit balance and multiply it by the number of MPRNs in a supplier's portfolio.

Impact on customer behaviour

This method would give customers confidence that in the case of a SoLR event they could be sure of the return of their credit balances through whichever bank or credit security was used by their supplier to lodge the cover. Therefore, consumers would be more encouraged to participate in the market and in particular through new, untested suppliers.

npower's alternative option 2

Summary of the proposal

It is inequitable to require customers (or, indeed, some customers, as the levy claim is made only to those distributors in whose areas the failed supplier supplied customers) and suppliers to pay retrospectively for a failed supplier's obligations. As in the insurance based option above, this does not achieve Ofgem's principal objective to protect the interests of existing and future consumers. One way of overcoming this would be to ensure that there is a fund already available that could be drawn on if necessary: a fund that is built by suppliers as they acquire customers. Essentially, this would mean that all customers pay their contribution at the point of changing supplier. As suppliers gain customers an increasing amount of funding would be available in an industry-wide SoLR fund. A levy applied across the entire market at a given point in time would be unfair as new suppliers (historically those most likely to fail) would not have contributed but could still benefit.

Discussion

Effects on innovation and potential barriers to entry

Such a fund would mean that any supplier would be able to protect customer balances and therefore the range of potential voluntary SoLRs could increase. This could be beneficial to smaller suppliers seeking to grow their customer bases, and to Ofgem who would have a wider pool of volunteers.

We do not anticipate that this option would be a significant burden on suppliers and therefore would not create a potential barrier to entry. New, innovative suppliers would still be able to enter the market as now.

Proportionality

This option could reduce supplier failure because it would help prevent new suppliers from gaining customers on unsustainable net margins; it would also mean that all customers contribute more equally to resolving the problem as, whenever they switch, a payment into the fund would be triggered. The effect on all suppliers would also be equal as the contribution per customer would be set at the same level and not according to the supplier's financial strength, size, etc.

Increased Regulatory Burdens

The proposal might mean a slight increase in regulatory involvement, as Ofgem would have to agree a suitable tariff to charge suppliers for each customer they acquired. As a consequence, an arrangement would need to be established which allowed suppliers to make payments. Equally, suppliers would have to ensure that the correct payment was made. However, the bulk of any additional work could be allocated to one of the existing industry bodies. Indeed, a hybrid of this suggestion might be that all distributors could begin now to collect the payment from suppliers in relation to their switching customers and start to build up a sum of money to kick start the scheme.

Impact on customer behaviour

Imposing a Levy on customer gains could potentially help to open up the market, because it would give customers greater confidence that their money is protected and therefore increase the propensity for them to choose new, smaller suppliers. It could also help increase the levels of switching generally, by creating greater confidence in the market overall.

There is no perfect solution; and whilst our alternative options attenuate somewhat the difficulties described above in relation to options 2 and 3, they do not entirely overcome them. However, we believe they would at the very least merit further consideration by Ofgem.

Q3: Do you consider that there is other information which would help you decide whether to volunteer to be a SoLR and on specific terms? If so, what is this information and from whom should it be sought?

Yes

We would first just stress how important it is to have as much detail as possible about the type and size of the portfolio of customers. Of course, we appreciate the difficulties for Ofgem in obtaining this information because of the circumstances and timescale.

For non-domestic customers, credit score details of the portfolio in question would greatly help pricing decisions, and potentially reduce the risk premia that suppliers may have to incorporate into their SoLR price submission.

In addition, from a pricing perspective it would be of assistance if portfolio data could be split by domestic, micro business and industrial/commercial larger customers where possible.

Finally, we would need to know in advance whether credit balances could be claimed through the industry levy and the level of claim to be allowed.

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