Impact Assessment

Supplier Licensing Review – ongoing requirements and exit arrangements

Division:	Consumers & Markets	**Type of measure:**	Retail Competition measures
Team:	Industry codes and licensing	**Type of IA:**	Qualified under Section 5A UA 2000
Coverage:	Full coverage	**Contact:**	licensing@ofgem.gov.uk

We welcome views from stakeholders on the draft impact assessment. Please see the Supplier Licensing Review consultation document for instructions on how to respond to the consultation.

Contents

What is the problem under consideration? Why is Ofgem intervention necessary?

Under our Supplier Licensing Review, we are reviewing our approach to licensing and regulating suppliers to raise standards around financial resilience and customer service.

We launched this review to address a number of issues in the energy retail market, including but not limited to:

- Suppliers risk management, and planning practises and approach to growth.
- The regulators ability to monitor potential financial instability in the market in order to manage supplier failure effectively.
- The broader market impacts of a supplier failure.
- The relationship of suppliers with financial instability with Ofgem as the regulator.

To clarify, in a competitive market, we would expect some suppliers to fail. We want to ensure that if this happens, consumers are protected and wider market impacts are minimised. Therefore, to build on our new entry requirements, we are proposing new ongoing requirements on all active suppliers, and provisions to better manage potential supplier exit, to mitigate against the risks and impacts of potential supplier failure.

What are the policy objectives and intended effects including the effect on Ofgem's Strategic Outcomes

As part of the Supplier Licensing Review project, we have developed a number of outcomes-based principles to help us drive policy development and produce a cohesive set of reforms.

Our baseline assessment outlines that we do not currently believe these outcomes are being met by the energy retail market. Our outcomes-based principles are:

- Suppliers adopt effective risk management, are adequately prepared and resourced for growth, and bear an appropriate share of their risk.
- Suppliers maintain the capacity and capability to deliver a quality service to their customers, and foster an open and constructive dialogue with Ofgem.
- Maintain proportionate oversight of suppliers, and ensure that effective protections for consumers exist in the event of failure.
- Facilitate effective competition and innovation through our licensing regime.

What are the policy options that have been considered, including any alternatives to regulation? Please justify the preferred option

When considering implementing policy in each area, we have considered a variety of options. We have summarised these in the summary table below, which collectively represents our minimum to maximum options:

- **Option A** – Our minimum intervention option imposes the least cost on industry but also realises limited benefits for consumers. This option would marginally impact supplier behaviour.
- **Option B** – Our medium intervention option imposes a more balanced cost on industry and realises some benefits. This option would impact supplier behaviour.
- **Option C** – Our maximum intervention option imposes the most cost on industry but also realises larger benefits for consumers. This option would significantly impact supplier behaviour.

We summarise our list of preferred options, which we believe are a balanced package of reforms that take into account the potential costs imposed on suppliers as well as the benefits that reforms under each policy area will bring. This impact assessment treats each policy area separately for the purposes of examining the different options outlined in the policy consultation.

A key trade-off underpins our approach to assessing options as part of this impact assessment. As the regulator, we want to discourage market participation by suppliers who are poorly behaved and harm consumers, without discouraging participation from suppliers who will benefit consumers. We have reflected this in our assessment of the costs and benefits below, which we have categorised under the different policy areas outlined in the consultation.

Preferred option - Monetised Impacts (£m)

Business Impact Target Qualifying Provision	NA
Business Impact Target (EANDCB)	NA
Net Benefit to GB Consumers	-£16m to 39m
Wider Benefits/Costs for Society	£4.12m to 23.5m

Explain how the Net Benefit was monetised

The net benefit to GB consumer figure outlined above provides a range for the consumer savings over the next 10 years as a Net Present Value (NPV) calculated with a discount rate of 3.5%. The figure takes the average cost imposed on consumers during a SoLR event (further information on this can be found in Table 2.4). The range presented assumes there will be between 1 to 4 SoLR events per year over the next 10 years. This is a broad estimate and taking into account the increase in SoLR events over the past few years as well as the introduction of our enhanced entry requirements. This figure demonstrates benefits if Ofgem were to require suppliers to protect a proportion of credit balances. This NPV figure only considers the monetised costs and benefits associated with our proposals to require protections in place for credit balances and government schemes and not the other policy areas as the impacts of these are hard to monetise.

Preferred option - Hard to Monetised Impacts

Describe any hard to monetised impacts, including mid-tem strategic and long-term sustainability factors following Ofgem IA guidance.

We expect that this package of reforms will ultimately result in improved quality of service for consumers and lower mutualised costs imposed on consumers as a result of improved financial stability amongst suppliers. We also expect these proposals will impose some costs on industry participants that will ultimately be passed onto consumers through higher tariffs. As part of our consultation, we have invited industry to provide more quantitative evidence about what these costs might be. Ultimately, we believe the benefits to consumers outweigh these costs, as we expect these proposals to address some market failures we have identified within the market, resulting in further long-term benefits for consumers.

Key Assumptions/sensitivities/risks We make the assumption that costs associated with our policy proposals are passed from suppliers onto consumers through higher tariff prices. For any one supplier, there is a risk that these proposals could place an additional burden on their business, particularly with regards to our reforms outlining proposed cost mutualisation protections. Some of our proposals could also potentially discourage new entrants as they place additional burdens on suppliers. There would be a distributional cost across suppliers as a result of implementing these reforms, which may change depending on a suppliers' size and business model.

Will the policy be reviewed? No	**If applicable, set review date: N/A**

Is this proposal in scope of the Public Sector Equality Duty?	**No**

Table 1: Summary table for all options

Policy area	Option A (minimum intervention)	Option B (medium intervention)	Option C (maximum intervention)	Preferred options
Cost mutualisation protections	**Protect a proportion of credit balances and scheme costs** Cost: £34m Benefit: £18m to £73m Net benefit: -£16m to 39m • This requirement would protect consumers from some costs as a result of supplier failure. • This requirement could discourage new entrants from entering the market.	**Protect all credit balances** Cost: £ 69m Benefit: £37m to £147m Net benefit: -£32m to £78m • This requirement would protect consumers from some costs as a result of supplier failure. • This requirement could discourage new entrants from entering the market.	**Protect all credit balances plus additional protection** Cost: £276m Benefit: £102m to £409m Net benefit: -£174m to £133m • This requirement wold protect consumers from the majority of costs as a result of supplier failure. • This requirement could discourage new entrants from entering the market. • This requirement would significantly influence suppliers' business models.	**Protect a proportion of credit balances and scheme costs** • This option would incentivise suppliers adopt effective risk management and ensures that effective protections for consumers in the event of failure. • The overall costs imposed on consumers as a result of supplier failure would decrease. • This intervention could decrease current market distortions leading to improved market confidence. • This option recognises there is a distributional cost across suppliers in securing this protection.
Milestones/ Trigger points	**Additional powers at trigger points** • Better data quality in the event of failure, resulting in lower costs for consumers.	**Customer number milestone assessments** • Improved quality of service for consumers. • Reduction in number of compliance breaches.	**Customer number milestone assessments and additional powers at trigger points** • Additional costs to suppliers in preparing for assessments. • Improved quality of service for consumers.	**Customer number milestone assessments and additional powers at trigger points** • This option would ensure suppliers have the capacity and capability to deliver a quality service for their customers. • These options would allow us to maintain proportionate oversight of suppliers, only

	• Possible reduction in number of compliance breaches. • Ability for Ofgem to take early action when suppliers reach a defined financial status resulting in improved quality of service.	• Additional costs to suppliers in preparing for assessments.	• Better data quality in the event of failure, resulting in lower costs for consumers. • Possible reduction in number of compliance breaches. • Ability for Ofgem to take early action when suppliers reach a defined financial status resulting in improved quality of service.	applying to new market entrants and suppliers who are experiencing financial difficulty. • There will be an administrative costs for suppliers in preparing for these assessments.
Fit and proper requirements	**No change**	**Self-assessed fit & proper requirement** • Improved quality of service for consumers. • Additional costs to suppliers in preparing for assessments.	**Ofgem assessed fit and proper requirement** • Improved quality of service for consumers. • Administrative costs placed on the regulator. • Additional costs to suppliers in preparing for assessments.	**Self-assessed fit & proper requirement** • Would allow Ofgem to maintain proportionate oversight of suppliers. • Places less of an administrative burden on both the supplier and the regulator.
Living wills	**Living will for larger suppliers** • Improved SoLR process. • Reduced burden on smaller suppliers.	**Living will for at risk suppliers** • Improved SoLR process. • Reduced burden on 'good' suppliers.	**Living will for all suppliers** • Improved SoLR process. • Improved market confidence. • Additional costs for all suppliers in preparing a living will.	**Living will for all suppliers** • Would help ensure that effective protections for consumers exist in the event of failure. • Would impose an additional cost on all suppliers to prepare and maintain a living will, however, we do not envisage this to be a large cost.

				• Could improve market confidence as all suppliers have plans in place in the event of failure.
Independent audits	**No change**	**Broad powers for Ofgem to require suppliers to undertake independent audits** • Improved oversight of suppliers. • Improved quality of service for consumers. • Additional costs on some suppliers who undertake an audit.	**Ofgem to conduct an independent audit review** • Improved oversight of suppliers. • Improved quality of service for consumers. • Additional costs on some suppliers who undertake an audit. • Additional costs to the regulator who conduct the audits.	**Broad powers for Ofgem to undertake independent audits** • Would allow Ofgem to maintain proportionate oversight of suppliers and ensure they maintain the capacity and capability to deliver a quality service to their customers. • There may be a distributional impact across suppliers, as it could be relatively more expensive for smaller suppliers to carry out an independent audit. Ofgem would take a proportionate approach when using these powers.

1. Context

This chapter explains the context for the impact assessment, including the background to the problems the Supplier Licensing Review is seeking to resolve and the principles we have applied as part of our policy development.

Problem under consideration and rationale for intervention

1.1. This section below defines the problem under consideration by the Supplier Licensing Review (SLR). Specifically, we analyse how supplier failure events as a result of poor supplier behaviour can affect the consumer experience and impose additional costs, as well as the overall effect this is having on the market.

Background

1.2. The retail energy market[1] ("the market") is very different to when we last reviewed our approach to licensing. The number of suppliers now operating in the market has increased significantly in the last half decade.[2] The market share of the six largest suppliers has steadily decreased and as noted in our recent State of the Market report, medium and small suppliers now supply around 30% of consumers.[3]

1.3. This has brought benefits to consumers through increased price competition and pressure on incumbent suppliers to improve their customer service offering. However, in parallel with this, we have also seen an increase in the number of supplier failures and inadequate customer service provision in certain cases. Some market entrants grew at speed when they were not fully prepared or resourced to be a responsible market participant.[4] This, coupled with poor customer service provision, has required Ofgem to

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[1] The GB retail energy market refers to the retail supply of electricity and gas to domestic customers in Great Britain.
[2] Ofgem, Retail market indicators, July 2019.
[3] Ofgem, State of the Market Report 2019, September 2019.
[4] Internal Ofgem case studies.

undertake a number of compliance or enforcement actions.[5] Supplier financial difficulty and poor customer service are often interrelated.

1.4. There are a number of reasons why a supplier can fail, depending on each individual case. For example, this can include the suppliers risk management strategy, the withdrawal of key partnerships, failure to adequately prepare for Renewables Obligation (RO) payments or poor behaviour leading to compliance or enforcement action being undertaken by the regulator. This, combined with external market factors, such as suppliers' exposure to wholesale market price shocks in 2016 and 2018[6], has resulted in sixteen suppliers failing since November 2016.

1.5. In a competitive market, we would expect some suppliers to fail. However, we want to ensure than when this happens that the negative impacts on consumers are minimised. Unlike other sectors, energy is an essential service and as such, we need to ensure continuity of supply for consumers. In doing so we aim to protect those consumers directly affected by the failure of their supplier, while minimising impacts to other industry participants and the market generally.

Market failures

1.6. Similar to other markets, there are a number of market failures within the energy retail market that can inherently have a negative impact on consumers. These market failures can incentivise suppliers to behave in a certain way, limit consumer choice, and can steer some suppliers towards a position of financial instability. There are two main market failures that signal for intervention under the SLR:

1.7. **Moral Hazard** - Moral hazard refers to the incentive for market participants to take excessive risk where they will benefit from winning but not bear the full cost of losing. In the case of energy suppliers, they are able to do this because some of the debts accrued by suppliers are mutualised across industry in the event of market exit[7,8] which can weaken the incentive on suppliers to prudently manage their finances and minimise costs in the event of

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[5] See Table 2.1 in our baseline assessment below.
[6] Ofgem, State of the Market Report 2018, October 2018.
[7] This is a feature of the Ofgem safety net, which protects consumers in the event of a supplier failure. Ofgem, Ofgem safety net: If your energy supplier goes out of business.
[8] While companies leave other market participants worse off in many other sectors when they fail, there are usually other market participants who operating in credit. The problem for the energy sector it is often consumers that are in credit as they have paid for their energy in advance.

failure. This excessive risk-taking can be further encouraged by the fact that suppliers are able to utilise customer credit balances to finance their operations. We have seen that customers of failed suppliers appear to have higher credit balances at the point of failure than customers of typical suppliers, which may then be mutualised across industry with the costs being subsequently passed onto consumers.

1.8. **Adverse selection** - Adverse selection refers to a situation when either the seller or the buyer has an informational advantage, and exploits this at the expense of the other. In the case of energy suppliers, consumers value a supplier that is able to offer them a cheap tariff and a good consumer experience. Part of the latter is, for example, avoiding being forced to move to another supplier as this may cause disruptions. A responsible supplier will be able to offer both cheap prices and effective risk management (therefore avoiding failure), but consumers are only able to compare tariffs. This gives an advantage to the riskier suppliers, as they are able to offer cheaper tariffs (by offering tariffs that are unsustainably low or not designed to make a profit) and therefore take customers away from suppliers with better risk management.

1.9. As the sector regulator, we want to discourage market participation by firms that would harm consumers, without discouraging participation by firms that would benefit them. We explore how these market failures incentivise poor supplier behaviour below, and the impacts these can have on consumers. We then look at the impacts of supplier market exit on consumers, as well as the wider impacts this can have on the market more generally. To clarify, our proposals here do not aim to fix these market failures, but to protect consumers from some of the detrimental effects they have on the market.

Consequences of poor supplier behaviour

1.10. In this section, we look at the impacts poor supplier behaviour can have on consumers as well as market dynamics. We outline the poor behaviour we have seen from suppliers that could be caused in part by the market failures outlined above, as well as how this can be exacerbated as a supplier approaches failure.

Poor supplier behaviour as a result of moral hazard

1.11. Incentives as a result of the moral hazard can have direct impacts on consumers. For instance, the incentive for some suppliers to take excessive risk can result in some suppliers taking a high-risk approach to pricing leading to a rapid acquisition of customers, who can base their decisions on who offers the cheapest tariff in the market. When this is coupled with other factors such as poor or inadequate resourcing, it can result in poor customer service for consumers.[9]

1.12. Some suppliers are able to offer such tariffs by recklessly utilising existing credit balances to maintain cash flow, and subsequently take consumers from suppliers with more sustainable business practises. While using credit balances for working capital is not wrong in principle, excessive use of credit balances to sustain offering such low tariffs could deter suppliers who have more sustainable business practises from entering into the market, or encourage other suppliers to deploy similar excessively risky strategies. Subsequently, this could lead to a 'race to the bottom' that incentivises responsible suppliers to deploy increasingly reckless practises.

1.13. In addition, suppliers who need to increase their working capital may also take an excessively risky or reckless approach to hedging in order to save money. We saw that eight of the supplier failures occurred during a cold autumn and winter period when wholesale prices were high (October 2018 to March 2019), which may suggest that these suppliers took excessive risk by hedging insufficiently. This is because under-hedging can lead to large profits if the wholesale price upon delivery is lower than the agreed tariff price. Suppliers are able to do this because they can utilise customer credit balances to finance operations if their risk-taking does not pay-off.

How adverse selection impacts consumer choice

1.14. Consumers are currently encouraged to switch supplier to get the best deal. Consumers can be encouraged to do this for a number of reasons including finding a tariff at the lowest price or choosing a supplier they believe to reflect their values. However, consumers cannot adequately assess whether a supplier is likely to suffer from financial difficulty and subsequently failure. They may be able to use a proxy such as Citizens Advice star ratings, but there is still an element of information asymmetry.

1.15. This information asymmetry could result in adverse selection that hinders consumers' ability to effectively choose a responsible supplier, which could result in

[9] To clarify, rapid customer acquisition does not lead to poor customer service, but rather lack of adequate resourcing to support this growth.

disengagement from the market. This inability for consumers to choose means that they do not always have the agency to choose a supplier who is not behaving poorly.

1.16. In addition, adverse selection can also affect investors in the market, who are also unable to differentiate between suppliers who have a sustainable business model and those which do not. This can lead to higher financing costs for new entrants, ultimately resulting in price increases for their customers. This also allows the "type" of supplier who cannot manage their risk effectively to continue to operate in the market for longer, as they continue to secure capital from both investors and customers.

Resulting impacts on consumers if a supplier approaches failure

1.17. This poor level of customer service can worsen as a supplier finds itself in a position of financial difficulty. As noted above, suppliers can engage in excessively risky behaviour that in the short term can lead to a rapid acquisition of customers. This rapid acquisition of customers can result in a poor quality of service if a supplier is not prepared for such an increase in consumer numbers.

1.18. In general, we have seen numerous failed suppliers perform much worse than average regarding the number of complaints they have received, having long call waiting times, as well as slow resolution of complaints and inaccurate billing. A number of consumers have also had cases lodged with the Energy Ombudsman that can be unresolved because their supplier subsequently failed. These outcomes highlight that when suppliers grow too quickly or are in financial distress, they cannot provide an adequate service to their customers.

Effects of supplier failure events

1.19. In this section, we look at the effects that market exit can have on consumers directly.[10]

1.20. When a supplier fails, Ofgem runs the Supplier of Last Resort (SoLR) to ensure continuity of supply for the customers of the failed supplier. Ofgem runs a competition for existing suppliers to bid to take on the customers of the failed supplier, and chooses one of

[10] Market exit is a normal occurrence in any competitive market, and supplier failure can occur for a number of reasons. Our licensing and regulatory regime does not seek to prevent this, rather we are focussed on limiting consumers' and other suppliers' exposure to the costs of failures.

these suppliers to become a SoLR. This process is usually smooth for the majority of consumers. However, problems can arise during this process, such as the customer data being held by the failed supplier being of poor quality. Subsequently, the SoLR struggles to contact the customer, or does not have accurate consumption information, or know the customers’ credit balance position. It can take months to resolve such issues, which can be disruptive for consumers. The time it takes to move consumers from their supplier to a SoLR can also be longer than a traditional switch governed by existing regulations.[11]

1.21. In addition, there is the potential for confusion about who the customer should contact for information about their situation or to put things right.[12] Consumers’ debt balances can be dealt with differently depending on whether the supplier or an appointed administrator holds the debt. Citizens Advice have estimated that more than 32,000 people have been affected by existing debt issues following the failure of a supplier and although Ofgem protect the credit balances of the consumer, failures can still have direct impacts on consumers including causing them distress, long waiting time for refunds and additional complications for consumers on prepayment meters.[13]

1.22. This means that consumers may also be provided with multiple contacts or be chased for debt when overall they may have a credit balance position. In addition, administrators can employ Debt Collection Agencies to recover debts. Although administrators and these agencies are subject to a number of rules and regulations, these are not the same as an energy supplier.[14] This distorts the market as it means that some consumers experiences cannot be directly influenced by the regulator.

1.23. Overall, we believe that the SoLR process is beneficial for consumers as it ensures security of supply, but disruption during this process can lead to consumer detriment.

[11] Ofgem, Ofgem Licence guide: Switching, February 2019.
[12] Ofgem provide advice regarding this on our website.
Ofgem, Ofgem safety net: If your energy supplier goes out of business.
[13] Citizens Advice, Picking up the pieces, June 2019.
[14] As noted by Citizens Advice in their ‘Picking up the pieces’ report, administrators often ask for payments from customers of the failed supplier as quickly as possible, often with only up to 3 months allowed for payment. In contrast, a Big 6 energy supplier allows an average of 3 years to repay a debt.

Wider impacts of supplier failure

1.24. In this section, we look at wider impacts supplier failure can have on the market, including the distributional impact of cost mutualisation and the impact on market confidence as a result of failure.

Disproportionate allocation of costs as a result of mutualisation

1.25. Under Ofgem's safety net, which is employed as part of a SoLR event, consumers' credit balances are reimbursed by an appointed SoLR. While this is beneficial to consumers, is not without its consequences as other suppliers within the market will ultimately pick up the costs of credit balances and other debts accrued by the failed supplier. Some other costs, such as the costs of unpaid Renewables Obligation amounts, are also mutualised. As mentioned previously, this creates a moral hazard, as suppliers could engage in risky practices, knowing that they will not bear the costs of all debts accrued in the event of their failure.

1.26. This could have a varied impact across consumers in the market, as consumers who have not switched to suppliers who have failed (and reap the benefits of an unsustainably low tariff offering) must honour the credit balances of those that did. In addition, undue delays with the SoLR process itself can increase the costs of mutualisation across all consumers, as the SoLR takes longer than necessary due to suppliers being uncooperative.

Impacts on market confidence as a result of multiple SoLR events

1.27. The competitive dynamic of the market may be undermined if confidence in switching to smaller and newer entrants is reduced. This would make it more difficult for newer entrants and existing smaller suppliers, who enter the market with more sustainable market offerings, to 'win-over' consumers. Similarly, the competitive dynamic of the market may be altered by moving the suppliers focus away from marketing and pricing and towards preparing a bid for a large number of consumers as a result of a SoLR.

1.28. An increasing number of supplier failures could also reduce consumer confidence in the market overall. This extends beyond consumers who experience a supplier failure first hand to all consumers who hear about an increasing number of failures in the market. If continued supplier failure results in undermining overall confidence in the market, consumers could be deterred from engaging in the market and switching in order to get the best deal. A reduction in switching overall would have a negative impact on competition and could increase prices for consumers.

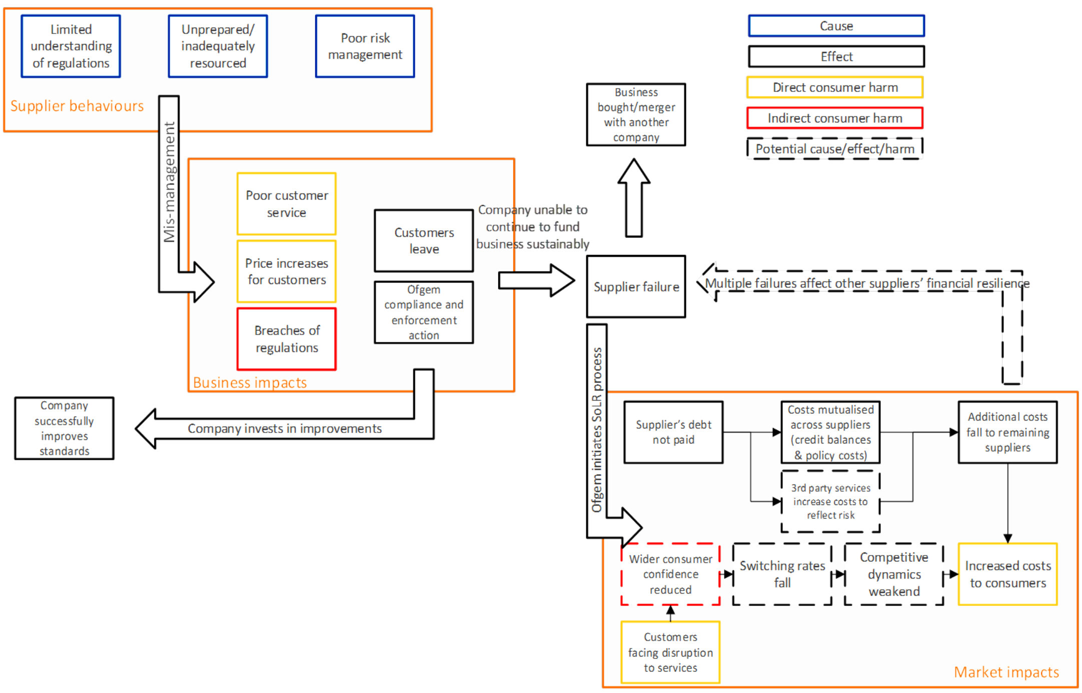
1.29. Businesses that provide services to suppliers could also suffer financial losses, potentially making them reticent to enter into contracts with all market participants if repeated failure were to occur. Similarly, reduced market confidence could negatively impact the availability of service provisions, if providers were to implementing tougher credit cover requirements as a means to protecting themselves from supplier failure. This could result in suppliers facing difficulties in securing contracts with other industry.

1.30. In addition to the above, the cumulative effect of cost mutualisation could put a strain on the market, causing further supplier failure, as multiple failures can impact the financial resilience of other suppliers. This could further drive down confidence in the market.

Summary of impacts

1.31. As the sector regulator, we have an obligation to promote effective competition and protect consumers from these potential risks. The figure below summarises current and theoretical impacts we believe supplier failure could have on consumers and the market without intervention.

Figure 1: Theories of harm



2. Approach to the draft impact assessment

Overarching approach to the draft impact assessment

Overarching principles of the IA

2.1. We have conducted the impact assessment in accordance with the Ofgem Impact Assessment Guidance[15,16] and the HM Treasury Green book.[17]

2.2. Ofgem's approach to impact assessments draws upon the principles that underpin the Government's Better Regulation agenda. These principles recommend that an impact assessment should:

- concisely summarise the impacts, including the qualitative and quantitative costs and benefits
- keep the process transparent
- be comparable to other assessments, without unnecessary detail or duplication
- be consistent so that impacts can be compared across proposals
- follow government best practice guidance.

2.3. In addition, the analysis of impacts included within an impact assessment should reflect the scale and materiality of the impacts (ie a proportionate approach should be adopted).

2.4. We have taken a proportionate approach to the assessment of individual impacts included within this impact assessment. Our analysis of the individual areas of costs and benefits (impacts) associated with the proposals is proportionate to the likely scale of those

[15] Ofgem, Impact Assessment Guidance, October 2016.
[16] We are conducting the impact assessment in accordance with the Ofgem Impact Assessment Guidance in so far as that guidance is relevant and consistent with the distinct legal framework envisaged by the draft default tariff cap legislation.
[17] HM Treasury, The Green Book: appraisal and evaluation in central government, March 2018.

costs and benefits. We have undertaken more detailed analysis where the specific area of impact is expected to be substantial.

Consideration of policy options and scope

2.5. We published our final decision on conditions for entering the market this June[18] and the new arrangements have come into effect on 5 July 2019. We set out some initial thinking on ongoing requirements on suppliers in our November consultation.19 We set out some further thoughts on this and potential exit arrangements in a paper in May[20] and held a stakeholder workshop in June.[21]

2.6. As noted in our summary of options table, we have considered different options for intervention for each policy area. We have grouped these into a minimum, medium and maximum intervention option, each placing increased costs upon industry. We have then outlined our preferred option and justify our choice by outlining the relevant costs and benefits we have considered.

2.7. This impact assessment treats each policy area separately for the purposes of examining the different options outlined in the policy consultation. We have considered each policy area separately in order to explore the different options within each policy area in detail and reflect the options we are consulting on in our accompanying policy consultation.

Assessment of options

2.8. Our assessment below assesses these options under the relevant policy area. We examine the impact on consumers, business impacts and wider market impacts. We have monetised these assessments where possible. Where not possible, we have used a logical assessment to determine which option would result in the greatest net benefit for consumers.

[18] Ofgem, Decision on new Applications Regulations and guidance document, June 2019.
[19] Ofgem, Supplier Licensing Review, November 2018.
[20] Ofgem, Update on the way forward for 'ongoing requirements' and 'exit arrangements' phases of the Supplier Licensing Review, May 2019.
[21] Ofgem, Supplier Licensing Review workshop summary notes and slides – 21 June 2019, July 2019.

Determining the baseline for the assessment of impacts

2.9. Our impact assessment assesses the relative impact of a set of policy options considered against a baseline scenario where we do not implement any of the policy options set out here.

2.10. We make assumptions about this baseline scenario in order to measure the impact of the policy options considered relative to what would happen if we made no further changes as part of the SLR. Due to the complexity of the retail energy market, we need to make a number of simplifying assumptions in order to estimate the parameters of the baseline scenario. We base our assumptions on recent trends and current view of the market.

2.11. We set out our metrics below under the relevant SLR principle. As mentioned in our consultation, the SLR principles represent the outcomes we expect to see as part of the SLR. The below provides evidence of the baseline scenario and demonstrates that our SLR principles are not currently being met. This subsequently results in consumers experiencing a poor quality of service and bearing undue costs. We have not included our principle to ensure our licensing regime facilitates effective competition and enables innovation in the below assessment, as an assessment of effective competition and innovation in the market are difficult to quantify. In subsequent chapters, we identify how each of our proposals satisfy our SLR principles and justify their introduction.

2.12. In our approach to the below assessment we compare suppliers who have previously failed with the average performance of suppliers in the market. This is to demonstrate that some suppliers' behaviour is so poor; intervention is required beyond the rules and regulations that currently exist within the supply licence.

Suppliers adopt effective risk management, are adequately prepared and resourced for growth, and bear an appropriate share of their risk

2.13. Ultimately the consequences of poor risk management are felt by consumers and can take the form of poor quality of service or increased prices as a result of supplier failure.

2.14. This section demonstrates that some suppliers do not deploy effective risk management strategies, and in some cases are not adequately prepared or resourced for growth. We look at how excessively risky business strategies – for example in relation to hedging or growth – can contribute to a suppliers failure, and compare quality of service metrics of failed suppliers who grew quickly against the average.

An excessively risky approach to hedging could contribute to supplier failure

2.15. Our analysis shows that if there were no further policy changes under the SLR, we would continue to see suppliers taking an excessively risky approach to running their business, which can contribute to failure. Due to the difficulty in estimating the extent and costs of poor risk management by suppliers, we use their approach to hedging as a proxy.

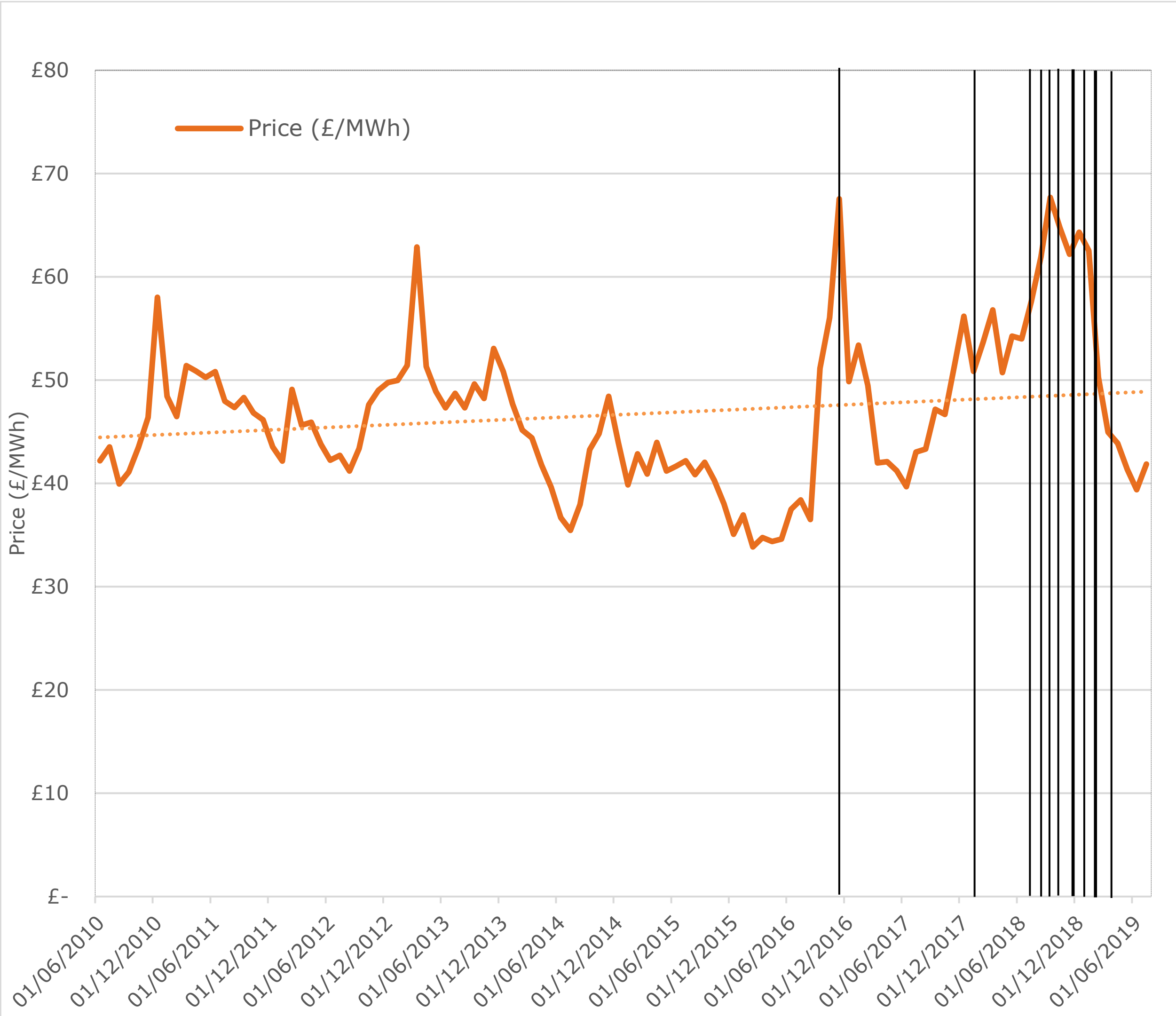
2.16. We have observed some correlation between wholesale price spikes and suppliers in a weak financial position failing. We reason that this could be due to weak hedging as a result of cash flow issues, financial unpreparedness or miscalculated consumptions needs due to rapid customer growth. There is no one 'right' type of hedging strategy, or that a particular hedging strategy necessarily leads to supplier failure. Rather, we have observed that – possibly due to the market failures discussed in the previous chapters – some suppliers take an excessively risky approach to hedging.

2.17. We have developed this analysis by looking wholesale electricity prices each month between June 2010 and May 2019[22] (along with their trend lines) and the timing of various suppliers exiting the market via a SoLR.

2.18. In figure 2.1, we can see a relationship between spikes in wholesale prices (relative to trend) and suppliers failing (and exiting the market via a SoLR) since 2016 (see appendix 2 for the corresponding data table for figure 2.1). Although this might not be the sole reason contributing to supplier failure, it suggests that some suppliers may be incentivised to take an excessively risky hedging strategy, such that their costs increase significantly when wholesale prices increase greatly relative to trend. We also note that suppliers do not always fail there are spikes in wholesale prices relative to trend, as there are numerous reasons why a supplier can fail.

22 Ofgem, Wholesale market indicators, July 2019.

Figure 2.1: Wholesale electricity prices (MWh) between 2010-2019



Continuous rapid growth without adequate resourcing can contribute to failure

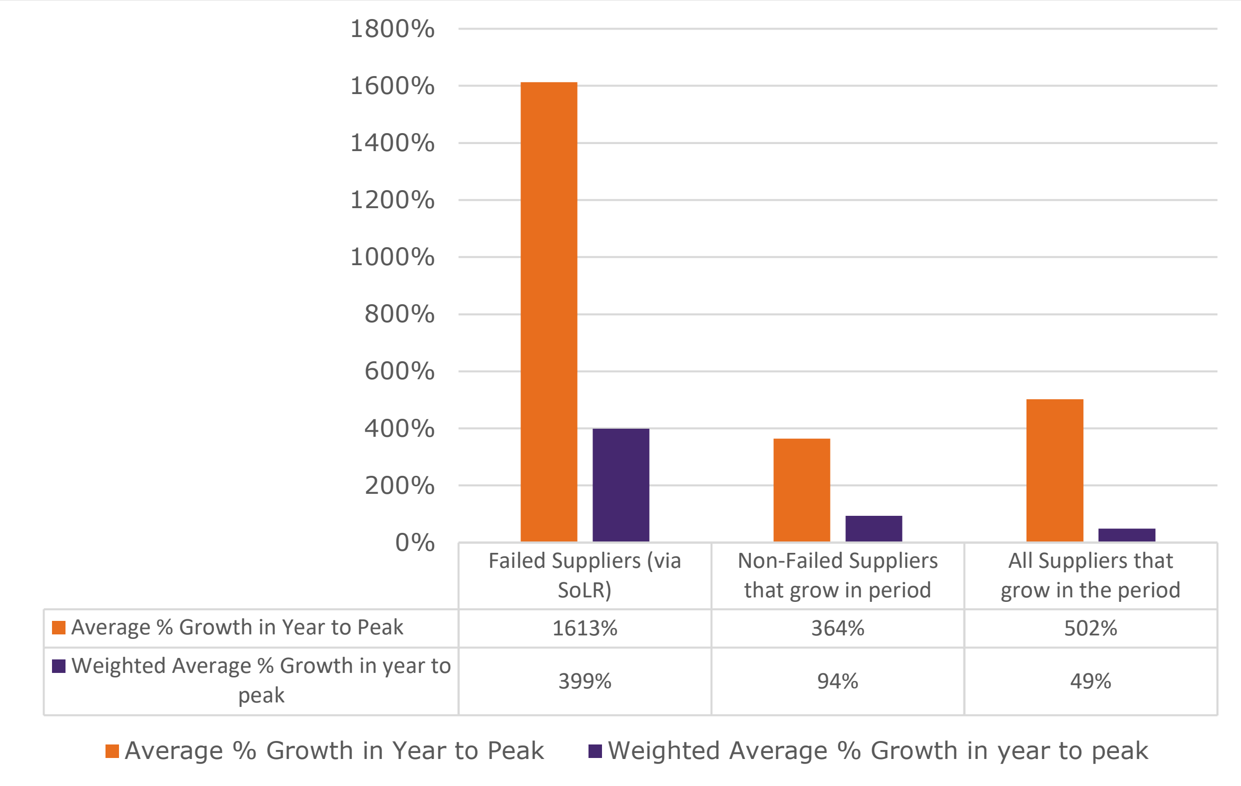
2.19. Our analysis shows that if there were no further policy changes under the SLR, there would continue to be the potential for some suppliers[23] that are active in the market to grow at high rates and be inadequately prepared for this, resulting in poor customer service. We demonstrate this by looking at the relationship between growth rates and quality of service provided by some of the suppliers that have failed since 2016.

[23] Including those getting a licence after our new entry arrangements were put in place in July 2019.

2.20. We have observed that companies that have experienced high growth rates often have poor customer service. This analysis took the average customer numbers across gas and electricity for each supplier and each quarter between January 2016 and June 2019.[24] We then calculated for each suppliers the growth in customer numbers in the year before its peak in customer numbers.[25] We also calculated the weighted average to factor in the number of customers the supplier had for the different supplier groups (failed and non-failed) to account for different sizes amongst the groups.

2.21. From the results in the graph we can see that suppliers that failed had growth rates in the year to their peak size which were four times higher than other suppliers. This demonstrates that suppliers with high growth rates across a short period of time have a higher rate of failure.

Figure 2.2: Growth in customer numbers in the year before peak (%)[26]



	Failed Suppliers (via SoLR)	Non-Failed Suppliers that grow in period	All Suppliers that grow in the period
Average % Growth in Year to Peak	1613%	364%	502%
Weighted Average % Growth in year to peak	399%	94%	49%

[24] We took monthly data on meter numbers from DNOs and Xoserve and assumed one meter was assigned to one consumer. We then averaged the monthly data to get quarterly data.
[25] Where we did not have enough data prior to the peak we annualised for the months/quarters where data was available. We also did not include suppliers that saw declines in customer numbers (including the six largest suppliers).
[26] Years observed were between 2013-2019.

2.22. As demonstrated by the above analysis, some suppliers are not currently adopting effective risk management strategies or adequately prepared and resourced for growth as evidenced by their failure. As such, we believe that the outcome outlined by our SLR principle is not being met.

Ensure Suppliers maintain the capacity and capability to deliver a quality service to their customers, and foster an open and constructive dialogue with Ofgem.

2.23. Energy is an essential service and as such, there are certain minimum standards that suppliers must meet. Suppliers need the operational capacity and capability to meet these standards, and must also cooperate with Ofgem in order to ensure they can be regulated effectively.

2.24. In this section, we demonstrate that some suppliers are currently unable to deliver a quality service to their customers. We examine Ofgem compliance and enforcement investigations of suppliers who subsequently failed, and how delays in the SoLR process due to a lack of open and cooperative behaviour from suppliers can lead to increased costs for industry.

Ofgem compliance and enforcement investigations of suppliers who subsequently failed

2.25. Our analysis shows that if there were no further policy changes under the SLR, then we would still see some suppliers experiencing high growth rates and the associated non-compliance issues, which often results in a poor quality of service to consumers.

2.26. We developed this analysis by taking Ofgem's published data on investigations for possible breach of licence conditions or other obligations as at 22 July 2019, and Ofgem data on suppliers and meter numbers between January 2016 and June 2019.

2.27. We then assessed for each case whether the supplier had failed as at 31 July 2019, the type of case, the date the case was opened along with categorisation of investigation as falling under following categories; Customer Service, Switching, Billing, Tariffs and Contracts, RO and FiT, and Other. We then calculated the number of all cases and those that involved suppliers that had failed via SoLR and all other suppliers i.e. non-failed suppliers.

2.28. There are limitations to measuring performance in this way. An open investigation does not mean a company has breached licence conditions or other obligations, but could be indicative of this.

2.29. We found that 48% of investigations on suppliers in the period involved suppliers that had failed by 31 July 2019. It is worth noting that suppliers that had failed only represented 10% of all suppliers in the market. This suggests that failing suppliers were nine times more likely to be under investigation by Ofgem, which could imply that failed suppliers were more likely to be in breach of their licence and other obligations.

Table 2.1: Number of Ofgem compliance and enforcement investigations on suppliers 2015-2019

Theme	Failed supplier	Non-failed supplier	All suppliers
Customer service	5	7	12
Switching	2	1	3
Billing, tariffs and contracts	5	7	12
RO and FiT	3	1	4
Other	1	2	3
Total	10	11	21
Total (%)	48%	52%	100%

Higher costs as a result of lack of open and cooperative behaviour

2.30. Our analysis shows that if there were no further policy changes under the SLR, then we will continue to see some failing suppliers not being open and cooperative with the regulator. This would continue to cause undue delays, in some cases, to us launching the SoLR process. The consequence of delays to launching the SoLR process is extended periods when the failing supplier is active and continuing to accrue further debts – which consumers and third parties then ultimately pay for. In the case of Elexon we note that the debts owed to them amount to £47,239 for every day that the SoLR launch is delayed (taking the medium scenario).

2.31. We developed this baseline by using Ofgem internal supplier failure case studies and Elexon data on unpaid trading charges by failed suppliers prior to market exit. We used the dates of the licence being revoked for failed suppliers. We then identified low, medium and high scenarios from the data by taking the 25th, 50th and 75th percentiles respectively.

2.32. The average debt accrued by failing company for Elexon trading charges are set out in the table. The table demonstrates that undue delays during the SoLR process can result in increased debts being accrued by suppliers. We use the medium scenario below to calculate the NPV for some of the wider benefits our reforms could have across industry.

Table 2.2: Average daily debt accrued with Elexon following a supplier failure

Scenario	Percentile	Average daily debt accrued (£)
Low	25	8,084
Medium	50	47,239
High	75	247,600

2.33. As demonstrated by the above analysis, some suppliers are not able to maintain the capacity and capability to deliver a quality service to their customers demonstrated by compliance and enforcement cases being undertaken by Ofgem, and lack of open and cooperative behaviour resulting in undue SoLR delays can result in costs across industry.

Maintain proportionate oversight of suppliers, and ensure that effective protections for consumers exist in the event of failure.

2.34. Effective oversight of the market is essential for Ofgem as it allows us to ensure that suppliers are complying with the relevant standards. Energy supply is a competitive market and we will not operate a 'zero failure' regime, but we need to ensure that arrangements are robust to protect consumers when failure occurs. Without proportionate oversight it is difficult for the regulator to take action and act in the best interests of consumers when suppliers are facing financial difficulty.

2.35. In this section, we will look specifically at the impacts that SoLR events have on consumers, by looking at the costs consumers continue to pay as a result of supplier failure.

Consumers continue to pay costs mutualised across industry as a result supplier failure

2.36. Our analysis shows that if there were no further policy changes under the SLR, then we will continue to see costs being mutualised across industry as a result of supplier exit and accompanying SoLR. We assume that these costs are ultimately passed onto consumers through higher tariffs.

2.37. We have calculated the average cost of a supplier failure and subsequent SoLR per GB consumer. To do this we consider three separate components that make up the average cost per GB consumer per supplier failure. These are:

- Last Resort Supply Payment (LRSP) cost per GB customer
- Renewables Obligation (RO) & Feed-In-Tariff (FiT) cost per GB consumer
- Cost of SoLR honouring credit balances (which is not claimed via the LRSP) per GB consumer

2.38. We used data from the twelve SoLRs that have occurred since November 2016 to July 2019.[27] Our estimates of LRSP cost per customer are based on the average LRSP of these twelve SoLR events, which is then averaged across all GB consumers. The LRSP cost estimate is based on claims agreed to 31 July 2019[28] and our estimate of what other SoLRs may claim based on information provided in their bids to be a SoLR.

2.39. Our estimates of RO & FiT cost per GB consumer are based on an average of all non-payment information Ofgem holds across the twelve failed suppliers (which exited via a SoLR event) which is then averaged across all GB consumers. The cost information comes from the mutualisation figures for 2017/18 and 2018/19 as of July 2019.

2.40. Our estimate of credit balance costs per customer is based on the average credit balance costs across these twelve SoLR cases. The average costs are made up of all balances that the on-boarding SoLRs paid to customers and did not claim for under the levy. This is then averaged across all GB consumers. This is based on information we have

[27] We look at SOLRs in this period as GB Energy was the first supplier that required a supplier of last resort process since Electricity 4 Business failed in October 2008.
[28] Co-operative Energy Levy claim (2017), Octopus Energy Levy claim (2018).

published as part of our work on deciding on levy claims and our estimates from information provided by SoLRs when they bid to take on that role.

2.41. We sum our estimates of the three components mentioned in 2.37 to provide an indication of ongoing SoLR costs per GB customer if we made no further policy changes, outlined in table 2.3. To calculate the total cost we assume total GB customers of 28.5m.[29] We have used a range of 1, 5, 10 and 15 SoLRs as hypothetical scenarios to demonstrate the range of these costs over multiple SoLR events.

Table 2.3: Estimated average SoLR cost per GB consumer (£)

Number of SoLRs			
1	**5**	**10**	**15**
£0.44	£2.19	£4.38	£6.56

Table 2.4: Estimated total SoLR cost across GB consumers

Number of SoLRs			
1	**5**	**10**	**15**
£12m	£62m	£124m	£187m

2.42. Our analysis shows that where there is no further policy changes under the SLR then there would continue to be a high turnover of suppliers in the market. We developed this analysis by looking at the number of suppliers with customers between January 2016 and June 2019 as reported to us by Xoserve and the electricity DNOs.

2.43. Our analysis notes that with no further policy action there would continue to be a high turnover of suppliers of around 10% failing in period of 3.5 years. We observe that this is high in relation to the number of suppliers who have failed over the last decade. This can make it difficult for investors to know which supplier business is sustainable to invest in

[29] We use the number of electricity meter points outlined in our 2019 State of the Market report (28,500,000) as a proxy for number of consumers. We assume the same number of consumers across the different SoLR scenarios.

and for innovators to know which suppliers will have longevity in which to take their innovations to the market.

3. Promoting more responsible risk management

3.1. The consequences of poor risk management are ultimately felt by consumers. We propose to address these risks to consumers by putting in place measures to reduce the need to mutualise costs in the event of supplier failure, require suppliers to ensure they have appropriate operational capability to effectively discharge their obligations, and introduce new checks at milestones and trigger points.

Cost mutualisation protections

3.2. As outlined further in our consultation, a number of government and regulatory policies have mutualisation mechanisms. In broad terms, mutualisation occurs where a supplier fails to pay a relevant debt.[30] The outstanding amount is split between the remaining suppliers, and is subsequently paid for by consumers through increased tariff prices. While this is an effective way to ensure that the relevant policies continue to operate as intended, it can distort the incentives on suppliers (in particular those experiencing financial difficulty) to manage these costs responsibly.

3.3. Our preferred option is option 1, to protect a minimum of 50% of credit balances.

Option 1	Option 2	Option 3
Protect a proportion of credit balances and scheme costs (50% of customer credit balances for the purpose of this assessment).	Require all credit balances to be protected	Require all credit balances to be protected, as well as protections in place for government schemes.

3.4. The overall benefits and costs of each policy option are described as an assessment against the expected outcomes and relevant Supplier Licensing Review principles. This assessment will be quantified where possible but will be substantially qualitative as the outcomes of this requirement are inherently difficult to quantify.

[30] Or in the case of credit balances, the appointed SoLR honours customer credit balances but then claims through the LRSP.

Monetised costs and benefits

Consumer impacts

Benefit - consumers experience lower costs imposed as a result of supplier failure

3.5. We anticipate financial benefits to consumers from implementing any of the options mentioned above. Our baseline analysis (table 2.3) estimated that for every supplier failure resulting in a SoLR, consumers are faced with a cost of £0.44 per consumer. This cost is comprised of three components:

- Last Resort Supply Payment (LRSP) cost per GB customer;
- Renewables Obligation (RO) & Feed-In-Tariff (FiT) cost per GB consumer;
- Cost of SoLR honouring credit balances (which is not claimed via the LRSP) per GB consumer.[31]

3.6. To evaluate the residual cost and benefit to consumers of each of the policy options considered, we applied protections to the relevant component of the baseline cost.

3.7. The table below outlines the direct savings of the options relative to the baseline. It is based on an estimated average cost to consumers of previous SoLR events. For option 1, we assume that 50% of credit balances held by industry are protected. We have also calculated the total cost to consumers in table 3.1b.[32]

Table 3.1a: Average balances protected per SoLR for each GB consumer

	1 SoLR	
	Residual Costs to Consumer(£)	Benefit to Consumers (£)
Baseline	0.44	-
Option 1	0.36	0.07
Option 2	0.29	0.15
Option 3	0.02	0.42

[31] We have not included credit balances absorbed by the SoLR in this estimation because this can be viewed as an 'acquisition fee' for the SoLR.
[32] We use the number of electricity meter points outlined in our 2019 State of the Market report (28,500,000) as a proxy for number of consumers.

Table 3.1b: Total balance protected per SoLR across all GB consumers

	1 SoLR	
	Residual Cost to Consumers (£)	Benefit to Consumers (£)
Baseline	12.4m	-
Option 1	10.3m	2.1m
Option 2	8.2m	4.2m
Option 3	0.6m	11.8m

3.8. The residual cost of mutualisation to consumers is reduced with each progressive option. The maximum benefit to consumers occurs when option 3 is implemented, where consumers bear only £592,801 of mutualised costs for every SoLR.

Cost - consumers bear the cost of implementing protections

3.9. For the purposes of our assessment, we assume that consumers will bear the cost of introducing these new protections through increased tariff prices. This allows us to net these costs against the benefits calculated in the previous section.

3.10. As part of our analysis, we have considered the cost of different methods of delivery in applying these protections. Further details of our considerations around potential protections available to industry can be found in Appendix 1. We consider the maximum cost associated with protecting the relevant costs in our policy options as being represented by an annual third-party guarantor fee, relative to the protected amount.

3.11. We have used a number of assumptions for calculating these costs:

- We have used an indicative fee rate of 0.5% of the protected amount per annum.[33]

- We have applied this figure to the credit account balances held by industry in October 2018.

[33] This figure was provided to Ofgem by a well-known high-street bank as an indication of what these costs could be.

- We assume that not all market participants will adopt this method of protection and so have applied this protection cost to only 50% of credit account balances as held by industry in October 2018. This is because we assume that some larger market participants (who hold a much higher proportion of credit balances) will be able to access other methods of protection such as a parental-guarantee or holding funds in escrow that are significantly cheaper.[34] We have attributed £0 of costs to the remaining 50% of credit account balances as held by industry in October 2018, however we would welcome views on what these costs would be as part of our consultation.

3.12. Table 3.2 below shows the costs that would ultimately be borne by consumers[35] per year based on credit account balances held by industry in October 2018.

Table 3.2 Cost to consumers of protections per year

Options	Cost to Consumers Per Year (£)
Baseline	Nil
Option 1	4m
Option 2	8m
Option 3	32m

<u>Net benefit for each proposal</u>

3.13. We have made a number of assumptions for calculating the net benefit of this proposal.

- We have calculated the costs over a 10 year period. We have applied a discount rate of 3.5% to both the costs and benefits.

- We have assumed a range of between 1 to 4 SoLRs per year over the next 10 years. This range is based on our observation of the number of SoLRs over the last few years, as well as factoring in our enhanced entry requirements.

[34] We made this assumption based on an internal review of the market to determine which suppliers could access a parental guarantee and the amount of credit balances they held.
[35] We assume that all policy costs are ultimately passed down to consumers from a supplier by way of higher bills.

- For Option 1, we have calculated the net benefit using 50% protection of credit balances.

- We have applied our cost figure to the credit account balances held by industry in October 2018. A limitation with this is that it does not factor in how this may change over 10 years due to changes in supplier business models, or how this figure could change as a result of each supplier exit and subsequent SoLR.

- We have assumed that the proportion of protected costs is also the proportion of costs that will not be passed onto consumers as a result of a SoLR event. This does not take into account the distributional impact of these reforms across different sized suppliers, or the fact that suppliers use different business models that rely more/less on credit balances as a source of working capital.

Table 3.3a: Total cost and net benefit for different number of SoLRs to each GB consumer

	10 SoLR		40 SoLR	
	Cost (£)	Net Benefit (£)	Cost (£)	Net Benefit (£)
Baseline	Nil	Nil	Nil	Nil
Option 1	1.21	-0.57	1.21	1.36
Option 2	2.42	-1.14	2.42	2.73
Option 3	9.70	-6.11	9.70	4.66

Table 3.3b: Total cost and net benefit for different number of SoLRs for all GB consumers

	10 SoLR		40 SoLR	
	Cost (£)	Net Benefit (£)	Cost (£)	Net Benefit (£)
Baseline	Nil	Nil	Nil	Nil
Option 1	34.5m	-16.1m	34.5m	38.8m
Option 2	69m	-32.4m	69m	77.7m
Option 3	276.5m	-174.2m	276.6m	132.7m

Hard to monetise impacts

Consumer impacts

<u>Cost - Consumers could experience greater price volatility because of the increased cost to suppliers of collecting credit balances</u>

3.14. Consumers could face a poorer quality of service associated with supplier's incentives not to collect credit balances due to additional regulator costs associated with this practice, particularly with options 2 and 3. Credit balances serve an important function in smoothing the cost of variable annual consumption. This prevents consumers from facing increased costs during high consumption winter and autumn periods. Incentives for suppliers to collect inadequately low credit balances from consumers could have negative impacts on consumers.

Business impacts

<u>Benefit - Suppliers will face lower mutualised costs following a disorderly market exit and SoLR</u>

3.15. If credit balances and government schemes are protected, suppliers will face lower mutualised costs following a disorderly market exit and SoLR. However, we assume that all costs of mutualisation are passed down from suppliers to consumers in the form of higher bills.

Benefit - The proposals above will impact the incentives currently on suppliers operating in the market

3.16. Incentives to operate less risky supplier business models may increase investor and consumer confidence in the market. Ensuring that protections are put in place to cover the costs of credit balances and government schemes shifts some of the risk currently paid for by industry (and ultimately consumers) to the supplier. Suppliers are directly responsible for these debts and so, to some extent, the problem of moral hazard (as discussed in our consideration of the problem) in the energy retail market is mitigated. Given the complexity of modelling incentives, we have not included these effects in our quantitative analysis of impacts. This broad direction and relative strengths of incentives is discussed to inform comparison of policy options.

Cost - Suppliers will face increased costs as a result of acquiring a credit protection mechanism

3.17. We expect that suppliers will face additional costs associated with implementing this policy proposal. We have outlined these potential costs in relation several protections likely to be adopted by suppliers in Appendix 1. We would welcome further quantitative evidence about what these costs could be as part of the consultation.

Cost - There are a number of distributional impacts that all options will have on suppliers

3.18. It is likely that there will be a differential in the cost borne by suppliers for providing protections. Larger suppliers with better credit ratings, more stable business plans, and those with wealthy parents will likely bear less costs associated with implementing protections. In addition, the additional regulatory costs of implementing and maintaining protections may increase the risk of supplier failure in some cases. This would lead to greater mutualisation costs for the market, and consumers, and would likely reduce both consumer and investor confidence in the retail market.

Wider impacts

Benefit - Market distortions will decrease which could increase overall confidence in the market and lower costs

3.19. As discussed in our consideration of the problem, the cost of operating can go up if there is a high risk of supplier failure resulting in contracting parties in the market increasing their prices because of their lack of confidence in the market. Introducing these protections could increase confidence in the market and subsequently decrease costs for all market participants.

Evaluation against assessment criteria

3.20. Option 1 is our preferred option as it is able to achieve the outcomes outlined in our SLR principles. In particular, option 1 would satisfy our principles that ensure suppliers adopt effective risk management and ensure that effective protections for consumers exist in the event of failure would be satisfied.

3.21. Our reasoning for this largely rests on the fact that there is net benefit to consumers through the implementation of this option, as the costs that are mutualised across industry as a result of each supplier failure are lower. This option also recognises that there is a distributional cost impact across suppliers, and so is in line with our SLR principle to ensure our licensing regime facilitates effective competition and enable innovation.

Implementation timescales and reporting

After engaging with stakeholders, we believe the most appropriate timescale for implementation of this policy is 3-6 months. Under each option, suppliers would be required to submit an annual assurance report.

Operational capability

3.22. We have not considered the operational principle as part of this Impact Assessment. This is because the principle clarifies Ofgem's existing expectations for how suppliers should behave. As such, there is a low practical burden on suppliers and we expect changes to be diminutive. In addition, the principle directly achieves the SLR principles that are outlined in the baseline, providing benefits to consumers.

Implementation timescales and reporting

We believe that the statutory notice period of 56 days is the most appropriate timescale for implementation of this policy. We do not for believe there would be an additional reporting requirement for the policy at this stage.

Milestone assessments/trigger points

3.23. As discussed in our consultation, we are proposing to introduce an operational principle that will require suppliers to have the capability to operate to the standards they are required to meet. This requirement can be assessed by Ofgem at particular milestones or due to certain trigger points. The potential for regulatory assessments at milestones or trigger points could become a strong incentive for suppliers to operate and grow in a responsible manner.

3.24. Milestone assessments could be required when suppliers reach a certain customer number threshold (option 1) or when they deviate from entry plans (option 2). We have also proposed a regulatory assessment when suppliers reach a defined financial status (option 3), which if the assessment is not passed, could result in Ofgem preventing the supplier from changing the pattern of their payments to take advance payments from customers (option 3a), or from completing a partial sale of their customer book (option 3b).

3.25. This policy area will encourage suppliers to foster an open dialogue with Ofgem and allow us to maintain proportionate oversight of suppliers. It will also help encourage suppliers to adopt effective risk management and be adequately prepared and resourced for growth, which will help them maintain the capacity and capability to deliver a quality service to their customers.

3.26. Our preferred option is option 1, to carry out milestone assessments when suppliers reach certain customer number thresholders (these are outlined further in the consultation). We also currently intend to progress with both options 3a and 3b outlined for trigger points, which would allow Ofgem to restrict suppliers from changing their collection pattern to take advance payments from customers and also prevent suppliers from partial customer book sales when they meet a defined financial status.

Milestone assessment options		Trigger point options	
Option 1	**Option 2**	**Option 3a**	**Option 3b**
Customer number thresholds	Deviation from entry plan (deviation from growth forecasts/withdrawal of expected funding)	Defined financial status (restriction on supplier changing to take payments in advance from customers)	Defined financial status (Ofgem oversight of, and power to prevent, partial customer book sales)

3.27. The overall benefits and costs of each policy option are described as an assessment against the expected outcomes and relevant SLR principle. This assessment will be quantified where possible but will be substantially qualitative as the outcomes of this requirement is inherently difficult to quantify. The costs and benefits of options 1 and 2 are considered together, and the costs and benefits of options 3 (a) and (b) are considered separately.

Hard to monetise impacts

Consumer impacts (Options 1 and 2)

<u>Benefit - Suppliers with fit-for-purpose operations should provide a more reliable quality of service</u>

3.28. Under options 1 and 2, suppliers who undergo an assessment will be required to demonstrate that they are adequately prepared for growth before they are able to grow further. This will include ensuring that suppliers have the operational capacity to support growth, showing how customer service is being and will be maintained, demonstrating how

IT systems are being integrated into their growth plans and show how they are prepared to meet their obligations in line with growth plans.

3.29. Since July 2016, Ofgem has opened 11 Compliance and Enforcement cases related to domestic customer service issues, against 9 suppliers. All of these suppliers passed the 50,000 customer threshold, and three of these passed the 50,000 customer threshold less than a year before their case was opened. Of the three cases, two were opened in relation to concern about customer service arrangements not being fit for purpose, and both suppliers failed less than a year later, in part due to high growth.

3.30. The new licensing rules require suppliers to provide information, including growth plans, for the first two years' trading operation. It should be noted that none of the above compliance cases occurred in the first two years of the suppliers' operations, and therefore none of these would have undergone a milestone assessment had option 2 been in place. However, under option 1, if there were milestone checks at 50,000 customers, some of these companies would have been checked shortly before a case was opened, growth may have been restricted had the suppliers not been able to demonstrate that they were adequately prepared for growth. Alternatively, they may have been incentivised to operate and grow in a responsible way and passed the assessment, with both scenarios potentially limiting consumer detriment.

3.31. If suppliers can demonstrate that they are prepared for growth and have fit for purpose operations, it follows that they should provide a more reliable quality service to their customers, resulting in less consumer detriment.

<u>Benefit – Better data quality in the event of failure, improving the SoLR experience for consumers</u>

3.32. Of the 14 supplier failures up to August 2019, six of them had passed the 50,000 customer threshold and would have therefore had to undertake a milestone assessment had Option 1 been in place. For a supplier to pass a milestone assessment, a supplier would have to demonstrate that their systems and operational processes are fit for purpose and therefore they are incentivised to ensure that this is the case. This means that if a supplier does fail having passed a milestone assessment, it is likely that the quality of data that is sent to the SoLR will be better, resulting in a better outcome for consumers.

Supplier Failure Case Studies

We have seen instances where the quality of a failing supplier's data has been so poor that it has caused delays in launching the SoLR. Better data quality would mean that the on-boarding process is quicker and smoother for consumers. Consumers would be able to switch away to a supplier of their choice quicker, potentially saving money. It may also enable them to access their credit balance quicker with fewer disputes over the credit balance amount, and engagement with the new supplier or administrator is likely to be less disruptive resulting in an overall better customer experience.

3.33. Better data quality may also make the SoLR more competitive and cheaper for consumers, as it will be more attractive for a potential SoLR, so they may be willing to absorb some of the SoLR costs rather than claim on the levy or offer a more favourable tariff to the failed supplier's customers. SoLRs are able to claim for costs reasonably incurred in becoming the SoLR, and in past SoLR events, SoLRs have claimed for data cleansing costs, which will ultimately be passed on to consumers.

<u>Benefit - Suppliers will be required to mitigate risks of non-compliance, which could reduce the number of compliance breaches or reduce the impact when they do occur</u>

3.34. Milestone assessments will test that suppliers have the capability, processes and systems in place to meet their regulatory obligations. Since 2016, there have been 16 Compliance and Enforcement cases opened against 10 different suppliers related customer service, billing, Renewables Obligation and FIT payments. This does not necessarily indicate findings of non-compliance in these cases.

Supplier Failure Case Studies

Of the 16 cases since 2016, in 5 cases (3 suppliers) the suppliers passed 50,000 customers less than a year before opening the case. All 10 suppliers who Ofgem opened a case against had passed the 50,000 customer threshold and all but two had also passed 150,000 customers. Of these 16 cases across 10 suppliers, 5 of these suppliers (responsible for 9 cases) have now failed.

3.35. We would expect milestone assessments to help reduce the number of compliance breaches and reduce the impact when they do occur, as suppliers will be incentivised to ensure that they are able to meet these obligations in order to pass the assessment.

Consumer impacts (Option 3a)

<u>Benefit - In the event of failure, customer credit balances would be limited, reducing costs mutualised across consumers</u>

3.36. Restricting a supplier's ability to change their payment collection pattern to take advance payments means that customers would not build up as large a credit balance as they otherwise would have done at the point the supplier fails. Although customer credit balances are protected in the event of supplier failure, it can take time for their credit balance to be allocated and for the customer to be able to access it. Under option 3a, the additional month's payment that they would have made when making an advance payment would be with the customer, rather than having to wait for their new supplier to allocate it to their account. Consumers experiences when going through a SoLR would therefore be improved.

<u>Benefit - Customers could be protected from being forced to make two payments in one month</u>

3.37. Restricting suppliers from changing the timing of their payment collections from collecting payments after consumption, to collecting advance payments when they are in financial difficulty, means that customers will be protected from being forced to make two payments in the space of one month, which could cause customers cash-flow issues.

Consumer impacts (Option 3b)

<u>Benefit - SoLR competitions may be more competitive, resulting in cheaper SoLRs</u>

3.38. In instances where a supplier in financial distress sells part of its customer book and subsequently fails and goes through the SoLR process, there is a risk of consumer detriment. For example, the gaining supplier purchasing from the supplier in financial distress is likely to purchase the most easy to serve customers, leaving the customers who have a higher cost to serve, or accounts with data inaccuracies behind to go through the SoLR process.

3.39. This can make a SoLR competition less competitive, with fewer, or no suppliers wanting to become SoLR. As such, they are more likely to offer less favourable tariffs to the failed supplier's customers, there is likely to be a higher administrative burden on the SoLR, and they are more likely to make substantial claims on the industry levy which will be passed on to all energy consumers.

<u>Benefit – Improved SoLR experience for consumers</u>

3.40. Where supplier failure is imminent, a partial trade sale can complicate and delay the SoLR process, allowing the company to accrue more debt. If a requirement is introduced for Ofgem to authorise any such trade sale, it would allow Ofgem to gather more accurate data and have a better understanding of the supplier's finances. This would then help Ofgem to better prepare for the SoLR competition, making it a smoother process for customers.

<u>Cost - Customers who would have been sold in a partial trade sale may go through SoLR process when they wouldn't otherwise have done</u>

3.41. It is difficult to assess the impact on customers who would have been sold as part of a trade sale but instead are transferred via the SoLR process. Depending on who the purchasing supplier would have been and who the appointed SoLR is, they may have received a different level of service, or the tariff that they would be put on to may be a different price (although in both cases they would be able to switch away without penalty.)

3.42. If a customer in debt is transferred to a new supplier via a trade sale, the debt would be passed on to the purchasing supplier, who is obliged to comply with customer protections included in the licence aimed at protecting vulnerable consumers. If the customer is transferred via a SoLR, the failed supplier's debt book becomes the responsibility of the administrator. If the administrator decides to collect the debt itself or transfer the debt to a debt collection agency, rather than enter into a commercial agreement with the appointed SoLR, then the consumer would not get the protections that it would have done had they been transferred as part of a trade sale.

Business impacts (All options)

<u>Cost - Administrative costs for suppliers for preparing for milestone/trigger point assessments</u>

3.43. Suppliers undergoing a milestone assessment will be required to provide Ofgem with information demonstrating that they have appropriate resources for growth and that they understand regulatory obligations. This will include providing growth projections with evidence of financial and operational capacity to support, showing how customer service is being/will be maintained, how IT systems are being integrated into growth plans, details on their compliance and enforcement track record, how they are prepared for new obligations (for option 1) and updated information on pricing strategy, projected volume of energy and purchasing strategy (for option 2).

Business impacts (Option 1 and 2)

Benefit - The cost of becoming a SoLR could be reduced if data quality and operational standards were better

3.44. As discussed above, we envisage that milestone assessments will help improve data quality and operational standards. Assuming that a failed supplier had passed a milestone assessment and that they would have had to make improvements in order to do so, this could reduce the cost of becoming a SoLR. Costs such as IT migration, data-cleansing and operational costs may be reduced for a SoLR and this could make it more attractive to a potential SoLR. If the SoLR decided to absorb the costs incurred rather than claim on the levy, it may be cheaper for them compared to if they had become SoLR and the failed supplier had not made improvements to their systems in order to pass the milestone assessment. This also assumes that a SoLR would have decided to absorb the same proportion of the SoLR cost irrespective of whether the failed supplier had passed the milestone assessment.

Business impacts (Option 3a)

Benefit - Reduced credit balances means in the event of failure, the SoLR won't need to absorb as large costs if they don't claim on the levy

3.45. As discussed above, if a supplier who is prevented from switching to collect advance payments fails, then the overall credit balance that customers will be due will be lower. If the supplier claims to recover credit balances on the levy, this will therefore be a consumer benefit compared to if this restriction had not been implemented. If the SoLR does absorb the full cost of credit balances, then assuming the SoLR absorbs the same proportion of credit balances that they would have done, there will be a benefit to the SoLR, as the cost of taking over the new customers would be cheaper.

Cost - Suppliers may have to source funds from elsewhere at a higher cost, which could lead to further financial difficulty / supplier failure

3.46. If a supplier is unable to change their collection pattern to make use of customer credit balances as a source of working capital, they may need to source credit from elsewhere, at an additional cost. This restriction would only be enforced when a supplier reaches a defined financial status. The supplier may have difficulty in sourcing these funds and this could therefore lead to further financial difficulty for the supplier and could ultimately contribute to supplier failure.

3.47. Overreliance on customer credit balances as a source of working capital can be unsustainable and we expect a supplier to bear an appropriate share of the risk, in order to reduce consumers' exposure to failure. This restriction would not impact suppliers who are already collecting advance payments from customers, but only where a supplier in financial difficulty intends to move to collecting advance payments as a way of sourcing extra funds, which could expose consumers to extra costs if they were to fail.

Business impacts (Option 3b)

<u>Benefit - SoLR likely to be more attractive to bidders</u>

3.48. Preventing the partial sale of a failing supplier's customer book is likely to make the SoLR process more competitive as the mix of customer accounts is likely to be more attractive to potential SoLRs. If no suitable bid is forthcoming, Ofgem would have to appoint a SoLR who it believed could carry out the role without significantly prejudicing its ability to supply its own customers and fulfil its contractual obligations for the supply of gas and electricity. This means that the appointed SoLR would likely be a larger supplier.

3.49. The appointed SoLR would benefit, as it would be less likely that Ofgem would have to appoint a supplier who did not want to become SoLR, and if it did, the mix of accounts would likely be more attractive.

<u>Cost - Cost to the prospective purchaser if they prevented from buying customer book</u>

3.50. A supplier would only engage in a commercial transaction with a supplier in financial difficulty to buy their customer book if they felt it was in their best interests to do so. Ofgem would not prevent the purchase of the complete customer book, but only a partial trade sale. If Ofgem prevent a supplier from completing the transaction, they would miss out on the lost revenue and potential profits that taking on these customers could bring.

Wider impacts (Options 1 and 2)

Benefit - Wider market efficiencies of suppliers with fit-for-purpose operations

3.51. If introducing milestone assessments incentivises suppliers to ensure they have fit for purpose operations resulting to better data quality, this could also lead to wider market efficiencies. For example, by improving industry data and making the switching process more efficient.

Wider impacts (Option 3b)

Cost - Wider impact of market distortions

3.52. Regulatory intervention causes market distortion and it is difficult to assess the impacts of this. We consider that commercial solutions such as trade sales are generally more desirable than regulatory intervention, and the SoLR process is meant to be a 'last resort' to protect the interests of consumers. However, there may be circumstances where regulatory intervention is needed, if the proposed transaction results in significant costs being imposed across the rest of the market.

Evaluation against assessment criteria

3.53. Option 1 and Options 3a and 3b are our preferred options as they are best able to achieve the outcomes outlined in our SLR principles. In particular, our principles that ensure suppliers maintain the capacity and capability to deliver a quality service for their customers and foster an open and constructive dialogue with Ofgem. In addition, Option 3 allows us to maintain proportionate oversight of suppliers, only applying to suppliers who are experiencing financial difficulty.

3.54. Our reasoning for this largely rests on the fact that there is net benefit to consumers through the implementation of these options. Option 1 allows Ofgem to adequately monitor suppliers who surpass thresholds and ensure they have the capacity and capability to deliver a quality service to their customers as they grow. Option 3a and 3b will give Ofgem additional tools to protect consumers but will only apply when a supplier is in financial distress and their actions could expose consumers to increased costs if they were to fail.

Implementation timescales and reporting

We do not anticipate that any implementation period outside of the statutory 56 days would be required to implement this proposal.

Under Option 1, suppliers would be required to notify Ofgem before they exceed the customer number threshold, leaving sufficient time for the assessment to take place.

Under Option 2, suppliers would be required to notify Ofgem when they deviated from their entry plan by a certain tolerance level.

Under Option 3a, suppliers would be required to notify Ofgem when they met the definition of financial difficulty.

Under Option 3b, there would be no additional reporting requirements specifically for this policy. We are proposing that suppliers would be required to notify Ofgem of 'Change of Control' events. A partial trade sale would be covered by this scenario.

4. More responsible governance and increased accountability

4.1. We propose to introduce two new requirements to mitigate the risks of poor supplier behaviour causing detriment to consumers or the energy market. The proposals are targeted at promoting more responsible governance and increased accountability among individuals with significant managerial responsibility or influence in supply companies. They comprise of an ongoing 'fit and proper' requirement and a principle to be open and cooperative with the regulator.

Ongoing fit and proper requirement

4.2. As part of our new enhanced entry requirements, prospective licensees, as well as senior managers, must now demonstrate that they are 'fit and proper' to hold a licence. However, there are no requirements specifying those already operating in the market in senior management or position of influence are, and continue to be fit and proper in their role. We observe that a fit and proper entry test does not guarantee future behaviour nor does it provide any assurance that all suppliers are taking necessary steps to maintain good governance practises within the organisation. This is a gap in the current regulations.

4.3. Our preferred option is option 1, to introduce an ongoing fit and proper licence requirement where suppliers must ensure they have the processes and systems in place to ensure the relevant persons are fit and proper. Suppliers must ensure they carry out assessment checks to determine whether a person is fit and proper.

Option 1	Option 2
An ongoing fit and proper licence requirement where suppliers must ensure they have the processes and systems in place to ensure relevant persons are 'fit and proper'. Suppliers must carry out assessment checks to determine whether relevant person is 'fit and proper'.	An ongoing fit and proper licence requirement where Ofgem make assessments to determine whether relevant persons are fit and proper.

4.4. The overall benefits and costs of each policy option are described as an assessment against the expected outcomes and relevant SLR principle. This assessment will be quantified where possible but will be substantially qualitative as the outcomes of this requirement are inherently difficult to quantify. Unless stated otherwise, the costs and benefits of both options are considered together.

4.5. It has not been possible to monetise any impacts to consumers or businesses that any of the above options would have.

Hard to monetise impacts

Consumer Impacts

Benefit - Consumers experience an improved quality of service

4.6. The introduction of this requirement could incentivise suppliers to improve their standards and overall conduct by ensuring individuals in senior or influential positions are able to manage the business's risks effectively. In doing so, they are more likely maintain the capacity and capability to deliver a quality service to their customers.

4.7. As noted in table 2.1, we have observed that failed suppliers are more likely to be under investigation by Ofgem, which could imply that failed suppliers were more likely to be in breach of their licence and other obligations. While compliance issues do not automatically equate to persons not being fit and proper, it does strengthen individual accountability by increasing incentives for suppliers to scrutinise the actions of those appointed in senior positions, particularly where there could be consumer detriment that could ultimately lead to compliance or enforcement action.

Benefit - Consumers experience better outcomes during the SoLR process

4.8. An ongoing fit and proper policy could incentivise suppliers to appoint individuals who would be more open and cooperative with Ofgem prior to imminent failure and during the SoLR process. We come to this view based on the fact that there could be a significant number of individuals who may have previously been involved in a SoLR looking to re-enter the market at a later stage. In this scenario, we expect a fit and proper requirement to mitigate the risks of individuals who have engaged in unacceptable conduct moving from one supply business to another.

Supplier Failure Case Studies
Our internal case studies on past supplier failure suggests that the behaviour of some suppliers in the lead up to failure may have contributed to undue delays before the launch of the SoLR process. Examples of this have included:

- Being evasive and uncooperative with the regulator during bilateral engagements
- Contravention of Requests for Information (eg inappropriate delays in providing information that where often incomplete or contained inaccuracies)
- Suppliers not being forthcoming with relevant information.

Business impacts

Cost - Increased costs for suppliers as a result of introducing this requirement

4.9. The majority of suppliers should already be carrying out adequate assessment checks to ensure those in senior management positions are fit and proper for their role, which means the cost of implementing this policy option would be negligible. For option 1, we anticipate a small proportion of suppliers may have to update their current processes and systems to ensure relevant persons are fit and proper. Given the different governance structures and process that exist within organisations, we are unable to estimate the transitional costs for this but would welcome further quantitative evidence of this as part of our consultation.

Wider impacts

Cost - Administrative burden on the supplier and the regulator

4.10. Option 2 would require the regulator to carry out assessment checks on whether all relevant persons were fit and proper. This would place a large administrative burden on the regulator in order to assess such a large number of individuals. It would also place a larger administrative burden on suppliers than option 1, as they would be required to continuously submit profiles for assessment.

Evaluation against assessment criteria

4.11. Option 1 would be our preferred option as it is able to achieve the outcomes outlined in our SLR principles. In particular, our principle to ensure Ofgem can maintain proportionate oversight of suppliers and for suppliers to foster an open and cooperative dialogue with Ofgem.

4.12. Our reasoning largely rests on the fact that requiring suppliers to ensure they have the processes and systems in place to ensure relevant persons are fit and proper will ensure that consumers will receive an improved quality of service and they would experience better outcomes as part of the SoLR process. This will ultimately result in lower costs to consumers. This option also takes into account the additional administrative burden on both suppliers and the regulator if the regulator was to determine whether relevant persons were fit and proper.

Implementation timescales and reporting

We believe that the statutory notice period of 56 days is the most appropriate timescale for implementation of this policy**.** There is no reporting requirement associated with this policy.

Principle to be open and cooperative with the regulator

4.13. We have not considered the open and cooperative principle as part of this Impact Assessment. This is because the principle clarifies Ofgem's existing expectations for how suppliers should behave. As such, there is a low practical burden on suppliers and we expect changes to be diminutive.

Implementation timescales and reporting

We believe that the statutory notice period of 56 days is the most appropriate timescale for implementation of this policy**.** We do not for believe there would be an additional reporting requirement for the policy at this stage, unless there is something that the supplier feels they need to report in line with the principle.

5. Increased market oversight

5.1. It is essential that we have effective oversight of the market to alert us to potential risks to consumers or competition, facilitate timely compliance action and enable earlier preparation for SoLR processes if necessary. To support this, we propose to introduce new rules to enable us to request independent audits, assess readiness for orderly exit through living wills, and ensure effective and proportionate reporting requirements are in place.

Living Wills

5.2. A requirement for a 'living will' would mean that suppliers would have to set out what would happen in the event of their failure, including any barriers to an 'orderly exit'. This could include risks of costs to consumers, disruption to services for their customers and how they would ensure compliance with any relevant licence conditions.

5.3. Our preferred option is option 3, which would require all suppliers to maintain a 'living will' and publish a public disclosure to promote confidence in the market.

Option 1	Option 2	Option 3
Require suppliers over a specific customer threshold to produce and maintain a living will.	Require some suppliers to maintain a living will using a risk-based approach established by Ofgem.	Require all suppliers to maintain a living will and publish a public disclosure to promote confidence in the market.

5.4. The overall benefits and costs of each policy option are described as an assessment against the expected outcomes and relevant SLR principle. This assessment will be quantified where possible but will be substantially qualitative as the outcomes of this requirement is inherently difficult to quantify. Unless stated otherwise, the costs and benefits of both options are considered together.

5.5. It has not been possible to monetise any impacts to both consumers and businesses that any of the above options would have. Though we have investigated costs of producing a living Will, costs are likely to vary between suppliers depending on the scale and complexity of the business and their current capabilities. As part of this consultation, we would welcome quantitative estimates of these costs.

Hard to monetise impacts

Consumer impacts

Benefit - Consumers will have an improved experience when going through the SoLR process

5.6. The requirement for suppliers to produce a living will allow both the regulator and the SoLR to more readily attain information from the failed supplier. As noted in table 2.2 of our baseline assessment, undue delays to the SoLR process can result in increased costs that may be imposed on consumers and industry. We expect this requirement would reduce such delays and help to reduce these costs.

Benefit - Consumers could benefit from increased competition in the market that we expect to arise as a result of improved market confidence

5.7. We expect the requirement for suppliers to produce a living will to have beneficial impact on confidence in sector. As such, this could result in improved transparency and consumer confidence as service providers are more willing to provide competitive deals to suppliers. This benefit is much more likely to manifest under option 3, which requires all suppliers to produce a living will and requires these to be publically available.

Business impacts

Benefit - Suppliers obligations to maintain a living will could result in increased investment

5.8. Incentives to plan for orderly wind down would benefit suppliers and their shareholders, as they are likely to preserve greater value following an orderly wind down as opposed to lesser value preserved following a disorderly wind down. For example, suppliers maintaining a living will could likely reduce the loss of assets associated with obligations under the Energy Company Obligation scheme that are otherwise lost should a failing supplier not sell these assets prior to the revocation of its supply licence.

5.9. In addition, suppliers may also benefit from greater engagement from market participants who may have increased confidence in the market as a result of robust plans for orderly wind down. Parties who engage in contracts with suppliers will have increased confidence of business continuity during and following periods of supplier stress or wind down. This benefit is much more likely to manifest under option 3, which requires all suppliers to make their living wills publically available.

Cost – Administrative costs associated with producing and updating a living will

5.10. Most of the costs associated with producing a living will be on a one-off operational basis. These costs will arise as a result of carrying out an assessment of the supplier's key risks to orderly wind down and outlining steps to achieve an orderly wind down. Additional costs may arise under policy option 3 associated with publishing a public facing version of the will. These costs will be lower under options 1 and 2 as not all suppliers will be required to produce a living will.

5.11. We anticipate the majority of supplier costs to be the staff costs of producing and maintaining a living will, including costs of specialists such as lawyers and financial experts and costs associated with the time taken by boards and committees to review and sign off these documents[36]. Smaller suppliers may outsource this task to specialist auditor or consultant that may come at a price premium.

Evaluation against assessment criteria

5.12. Option 3 is our preferred option as it is best able to achieve the outcomes outlined in our SLR principles. In particular, our principles that Ofgem should maintain proportionate oversight of suppliers, and that suppliers should foster an open and cooperative dialogue with Ofgem.

5.13. Our reasoning largely rests on the fact that option 3 requires all suppliers to publish their living will and therefore realises the benefits this could have in restoring confidence in the market. It also recognises that producing a Living Will would be a relatively low and one-off administrative burden for suppliers.

[36] Based on the costs considered by the Prudential Regulation Authority for firms producing living wills (https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp3118.pdf?la=en&hash=BD48DE730C2A69D35C690C69CFF201D0B382E6D3)

Implementation timescales and reporting

After engaging with stakeholders, we believe the most appropriate timescale for implementation of this policy is 1-2 months. We do not believe there would be an additional reporting requirement for the policy at this stage.

Independent audits

5.14. This policy proposes to introduce a requirement for suppliers to provide assurance to Ofgem through independent audit. This policy area will encourage suppliers to foster an open dialogue with Ofgem and allow us to maintain proportionate oversight of suppliers. It will also incentivise suppliers to have due regards to their obligations.

5.15. Our preferred option is option 1, to provide Ofgem with broad powers to require suppliers (where necessary) to undertake an independent audit review.

Option 1	Option 2
Ofgem to have broad powers to request supplier to undertake an independent audit review conducted by an established auditor. Suppliers will need to provide Ofgem with assurance they have the processes, systems and controls in place that allows them to meet their obligations under relevant licence condition.	Ofgem to conduct independent audit reviews of suppliers. Ofgem would assess whether suppliers have processes, systems and controls in place that allows them to meet their obligations under relevant licence condition.

5.16. The overall benefits and costs of each policy option are described as an assessment against the expected outcomes and relevant SLR principle. This assessment will be quantified where possible but will be substantially qualitative as some outcomes of this requirement is inherently difficult to quantify. Unless stated otherwise, the costs and benefits of both options are considered together.

5.17. It has not been possible to monetise any impacts to both consumers and businesses that any of the above options would have. Though we have investigated costs of undertaking an independent audit, these vary significantly depending on the size of the business and the outcomes the audit seeks to achieve. As part of this consultation, we would welcome quantitative estimates of these costs.

Hard to monetise impacts

Consumer Impacts

Benefit – Improved quality of service for consumers

5.18. If suppliers are aware that Ofgem could request an audit of the capabilities, processes and systems they have in place to adequately serve their customer base, they will be more likely to invest in such capabilities, process and systems. This will ultimately result in improved quality of service for consumers. In addition, investment in such business requirements could help prevent suppliers from getting into a position in which they fail, which could result in less mutualised costs being imposed on consumers as outlined in our baseline (table 2.3).

Benefit – Improved regulatory oversight

5.19. Ofgem's oversight of suppliers' business practises would increase as a result of this proposal. This increased oversight could allow the regulator to intervene earlier to mitigate or manage serious consumer detriment. For example, the outcome of an independent audit could show irresponsible management of credit balances or that a firm is unable to quantify its current financial position. This would result in a reduction in costs that are passed onto consumers if that supplier were subsequently to fail.

Supplier Failure Case Studies

Our internal case studies on past supplier failure have demonstrated that some suppliers can be evasive regarding their financial position. This limits Ofgem's oversight and can cause delays in launching the SoLR process, increasing costs for consumers.

Business impacts

Cost - Additional costs associated with undertaking audit reviews (Option 1)

5.20. If Ofgem were to request an independent audit, suppliers would have to bear the cost of this. However, as noted in the consultation, we intend to use this power proportionately (ie where the estimated costs of the audit review are proportionate to the risks being mitigated). By adopting an outcomes-based approach, Ofgem will retain a degree of flexibility around the application of this policy. Ofgem would seek to ensure proportionality by applying this policy without an unduly burdensome compliance cost that will deliver a net benefit for consumers.

5.21. Based on our experience of using external audits in the compliance context, Ofgem estimates that audit cost could vary significantly. However, we believe suppliers should have capacity to manage costs associated with undertaking audit assessments. This is evidenced by similar mandates[37] where suppliers are required to providing assurance that they have the process and compliance systems in place to meet certain requirements.

Cost - Additional costs associated with undertaking audit reviews (Option 2)

5.22. Under option 2, there are likely to be additional costs to the regulator as a result of carrying out independent audits on suppliers. In addition, as outlined in the consultation, Ofgem as less likely to have the necessary in-house expertise to do some of the technical and systems analysis that may be required.

Evaluation against assessment criteria

5.23. Option 1 is our preferred option and we believe that this option will adequately satisfy the outcomes described in the SLR principles. In particular, our principles that Ofgem should maintain proportionate oversight of suppliers, that suppliers should maintain the capacity and capability to deliver a quality service to their customers and that suppliers should foster an open and cooperative dialogue with Ofgem.

5.24. Our reasoning largely rests on the fact that option 1 will give Ofgem additional powers to investigate suppliers' business practises in order to enhance oversight, and also ensuring these are carried out by parties with the necessary expertise. As outlined in the consultation, we would take a proportionate approach to using this and therefore we envisage this will result in additional costs to suppliers only when necessary.

[37] Such as the Smart Meter Installation Code of Practise independent audit of compliance, or the Competent Independent Organisation (CIO) audit which ensures suppliers are compliant with the system, organisational and information security requirements outlined as part of the smart energy code.

Implementation timescales and reporting

We believe that the statutory notice period of 56 days is the most appropriate timescale for implementation of this policy**.** The outcome of the audit would need to be reported to Ofgem.

General monitoring and reporting

5.25. We already undertake risk based monitoring and compliance, and intend to continue doing so. As part of the SLR, we outlined in May 2019 that we were exploring whether there are benefits in formalised reporting or introducing new reporting requirements. In addition to the reporting described for the policy proposals outlined elsewhere in this impact assessment and policy consultation document, we are proposing that suppliers are required to notify Ofgem when there is a change of control.

5.26. The overall benefits and costs of this proposal is described as an assessment against the expected outcomes and relevant SLR principle. This assessment will be quantified where possible but will be substantially qualitative as the outcomes of this requirement is inherently difficult to quantify. It has not been possible to monetise any impacts to consumers or businesses that any of the above options would have.

Hard to monetise impacts

Consumer impacts

Benefit – Improved quality of service

5.27. Notifications of change of control help Ofgem to maintain a more proportionate oversight over suppliers. This will allow Ofgem to intervene earlier and provide a clearer idea of when suppliers are facing financial difficulty. This will ultimately lead to improved quality of service for consumers and potentially lower costs if a SoLR event is avoided.

Supplier Failure Case Studies

Our internal case studies on past supplier failure suggests some suppliers have entered the market and subsequently had a significant change of control, before entering a period of financial distress and subsequently failing.

Business impacts

<u>Cost - Administrative cost of notifying Ofgem when undertaking a predefined business activity</u>

5.28. There is likely to be an administrative cost to suppliers in providing Ofgem with information as a result of a change in business activity. However, as suppliers are already required to report on these activities to other bodies (such as Companies House) we believe the cost would be diminutive.

Evaluation against assessment criteria

This proposal would help Ofgem maintain proportionate oversight of suppliers as outlined in the SLR principles.

Implementation timescales and reporting

We believe that the statutory notice period of 56 days is the most appropriate timescale for implementation of this policy**.** We do not for believe there would be an additional reporting requirement for the policy at this stage.

6. Exit arrangements

6.1. In this chapter, we set out a proposal to minimise the disruption associated with supplier exit. We propose changes to certain customer contract terms to ensure administrators are subject to some of the same requirements as suppliers.

Customer interactions with administrators

6.2. The primary objectives of this policy area are to ensure that effective protections for consumers exist in the event of supplier failure and to ensure that Ofgem maintains proportionate oversight of suppliers, improving our ability to act where needed.

6.3. As noted in our problem under consideration chapter, the process that accompanies a supplier failure also pushes elements of the consumer journey outside the remit of regulation by Ofgem, namely the appointment of administrators to reclaim debts on behalf of the failed supplier. We propose to add a requirement to gas and electricity supply standard licence conditions to require suppliers to include references in their terms and conditions that activities relating to debt recovery will be executed as outlined in SLCs 27.5-27.8 (inclusive) and 28B.

6.4. The overall benefits and costs of each policy option are described as an assessment against the expected outcomes and relevant SLR principle. This assessment will be quantified where possible but will be substantially qualitative as the outcomes of this requirement is inherently difficult to quantify. Unless stated otherwise, the costs and benefits of both options are considered together.

6.5. It has not been possible to monetise any impacts to consumers or businesses that any of the above options would have.

Hard to monetise impacts

Consumer impacts

<u>Benefit - Improved quality of service during the SoLR process</u>

6.6. Consumers could experience an improved quality of service as the obligations placed on their energy supplier by the regulator are subsequently passed onto administrators through their terms and conditions.

Business impacts

Cost - Administrative costs of updating supplier' Terms and Conditions

6.7. There is likely to be an administrative cost for suppliers to update their terms and conditions, which will be a one-off diminutive cost.

Evaluation against assessment criteria

6.8. This proposal will help to ensure that that effective protections for consumers exist in the event of failure.

Implementation timescales and reporting

We believe that the statutory notice period of 56 days is the most appropriate timescale for implementation of this policy**.** We do not for believe there would be an additional reporting requirement for the policy at this stage.

Appendices

Appendix 1: Methods of delivery for protecting credit balances and government scheme costs

6.1. We have assessed the likely costs of implementing a range of potential protections for customer credit balances. Based on the assumption that suppliers ultimately pass additional regulatory costs onto consumers, our analysis suggests that the costs associated with these policy interventions will lead to greater costs to energy consumers. We also anticipate that costs could vary depending on the method of delivery chosen by each supplier.

6.2. Based on our analysis, research and stakeholder engagement we believe the following represent a non-exhaustive list of reasonable delivery options open to suppliers:

- Parent Company Guarantee (PCG);
- a third party guarantee; and
- a solicitor controlled escrow account.

6.3. Overall, we estimate that additional costs are likely to be low for those suppliers who choose to adopt a PCG or solicitor-controlled escrow account to protect their customer credit balances. While suppliers making use of a third party guarantee are more likely to face higher costs and, as a result, higher bills for consumers, with possible wider price implications for their consumers across the market.

Parent company guarantee costs

6.4. PCG's represent a cost effective way to implement protections for customer credit balances and/or obligations under government schemes, although we do acknowledge that this is not an option open to all suppliers in the market. We expect initial legal and administrative costs of negotiating this guarantee with the suppliers' group parent company. Costs are further mitigated if relevant expertise is held in-house. As such, it would seem to us that these costs would be relatively low, and mostly constrained to the design and implementation stages.

6.5. In the event that a supplier became insolvent and was unable to pay its debts (including unsecured debts to customers in the form of credit balances), the parent company would be responsible for settling these debts and so would bear these costs.

Third Party guarantee

6.6. Third party guarantees are likely to present the highest costs to suppliers and consumers when used to protect customer credit balances and obligations under government schemes. Our review of the terms and conditions of third party guarantee providers[38] suggest that an annual guarantor fee, relative to the protected amount, is likely to be charged for any guarantee. It is also likely that this fee will come at a premium should the guarantor feel the supplier is at greater risk of default.

6.7. In addition, in the case of third party guarantees, we estimate costs to cover supplier obligations under government schemes to be very high. We do, however, expect this figure to be lower should larger suppliers adopt an alternative, more cost effective mode of protecting their Renewables Obligation.

Solicitor controlled escrow account

6.8. With regards to solicitor-controlled escrow accounts, we anticipate a potential for further costs which we believe would be passed onto consumers. Solicitor-controlled escrow accounts could be a cost effective way of implementing effective protections on consumer credit balances. We assume that the likely costs faced by suppliers to consist mostly of solicitor costs associated with operating the account, which are unlikely to vary materially with account size. There would also be capital and liquidity costs associated with preventing suppliers from utilising these funds as working capital.

[38] Our review included a review of the terms of major UK high street banks.

Appendix 2: Data table for wholesale electricity prices (MWh) between 2010-2019

Date	Price (£/MWh)
01/06/2010	£42.18
01/12/2010	£58.03
01/06/2011	£50.82
01/12/2011	£43.54
01/06/2012	£42.24
01/12/2012	£49.76
01/06/2013	£47.31
01/12/2013	£50.81
01/06/2014	£36.67
01/12/2014	£43.96
01/06/2015	£41.66
01/12/2015	£35.07
01/06/2016	£37.51
01/12/2016	£49.87
01/06/2017	£39.68
01/12/2017	£56.18
01/06/2018	£54.00
01/12/2018	£64.32
01/06/2019	£39.40