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By email: licensing@ofgem.gov.uk

Dear Vlada and James,

RE: Supplier Licensing Review: Ongoing requirements and exit arrangements

Under the current licensing arrangements, a supplier can take excessive risks and fail, resulting in the mutualisation of costs across all other suppliers, and ultimately all energy customers. This is a major distortion to the energy supply market as the costs of excessive risk taking by the management of a supply company should be borne by the company itself, not the generality of customers.

The most important goal of Ofgem's supplier licensing review should be to address the distortions that allow suppliers to fail and mutualise costs across the industry. If Ofgem addresses these distortions it will protect customers from the avoidable cost mutualisation that customers are currently exposed to when a supplier fails.

A moral hazard exists in the market today whereby suppliers can use an uninformed line of credit, using customers' money, to take excessive risks such as pricing at an unsustainably low level. Moral hazard leads to adverse selection where suppliers engaging in riskier practices have an advantage over suppliers with more responsible risk management. Ofgem correctly recognises that the "market failures" of moral hazard and adverse selection exist in the retail energy market and cause detriment to consumers and competition[1].

Requiring suppliers that have not failed, and ultimately customers, to pick up the costs of failed suppliers through mutualisation leads to the following outcomes:

- Suppliers can use customer and industry money to take excessive risks such as pricing at unsustainably low levels.

[1] Ofgem impact assessment: https://www.ofgem.gov.uk/system/files/docs/2019/10/191021_-_draft_impact_assessment_final_new_updated.pdf paragraphs 1.7 and 1.8

- This leads to more supplier failures that leads to an erosion of trust in consumers of energy suppliers.
- Competition is impacted as suppliers are driven to compete with artificially low prices – with the potential that this contagion could drive other suppliers to fail.

Of Ofgem's proposals only one will be effective at reducing cost mutualisation: the introduction of a licence condition for suppliers to prevent mutualisation of credit balances and Government policy costs in the event of a supplier failure.

The Ofgem proposal for suppliers to "protect a minimum of 50% of their customer credit balances and a proportion of government scheme costs in the event of their failure" does not go far enough.

Only by requiring suppliers to cover 100% of credit balances and Government policy costs will the risk of harm to consumers and competition be adequately addressed. Hereafter we refer to this proposal as the "100% requirement".

Backed up by Ofgem's proactive use of its existing powers, supplier certification requirements, milestone assessments and the ability to require relevant suppliers to carry out internal audits, the 100% requirement will address the market failures of moral hazard and adverse selection.

The 100% requirement will therefore address the consumer detriment that would be caused by a subsequent supplier failure. All Ofgem's other proposals will either be ineffective at preventing the mutualisation of costs or ineffective unless they are working alongside the 100% requirement.

We have expanded our views on mutualisation further within Appendix 1 of our response. We have also countered some of the arguments against a licence condition to prevent mutualisation of costs.

Many of Ofgem's proposals are unnecessary as they are likely to be ineffective at addressing the market failures of moral hazard and adverse selection which lead to the mutualisation of costs. We have set out our detailed views on Ofgem's specific proposals in Appendix 2 of our response.

In the table below we set out a summary of Ofgem's proposals and state whether they will be effective in either preventing the market failures of moral hazard and adverse selection that result in the mutualisation of costs when a supplier fails, and / or improving outcomes once a supplier has failed:

Ofgem proposal	Will it protect customers from paying avoidable mutualised costs of failed suppliers?	Will it improve customer outcomes when a supplier fails?
A licence condition to protect 50% of credit balances and a proportion of Government policy costs	Partly. It would be more effective if it covered 100% of credit balances and Government policy costs.	No

A principle to demonstrate suppliers have effective operational capability	No and covered by existing regulation.	No and covered by existing regulation.
Milestone assessments at certain thresholds	No.	Partly, as less customers may be impacted if a supplier does fail.
Fit and proper requirement	No, will be ineffective.	No, will be ineffective.
Principle to be open and cooperative with the regulator	No and covered by existing regulation.	No and covered by existing regulation.
A requirement to produce a living will.	No, will be ineffective.	Potentially, if regularly maintained.
Independent audits	Potentially, but only when used in conjunction with the 100% requirement.	Potentially, but only when used in conjunction with the 100% requirement.
Requiring administrators to adhere to licence conditions when it comes to debt collection	No	No, unlikely that this can be enforced upon administrators
Portfolio splitting	No	Possibly but costs and risks may outweigh benefits.
Ofgem Trade sales	No	No

We have commissioned a pair of reports, by NERA and Cornwall Insight, on recent supplier failures and both are attached to our response.

If you have any questions, please contact Tabish Khan in the first instance on 07789 575 665 or Tabish.khan@centrica.com.

Yours sincerely

Tim Dewhurst
Head of Regulatory Affairs
Centrica

Appendix 1: Protecting customers from the cost mutualisation of failed suppliers

In this appendix we set out the rationale for intervention, the measures required to remedy the market failures that currently exist in the domestic supply market, and counter some of the arguments that have been put forward against the 100% requirement.

Summary

The key issue of the supplier licensing review is addressing the market failures of moral hazard and adverse selection, and protecting customers from paying avoidable mutualised costs of failed suppliers which took excessive risks. Therefore, in this appendix we have set out our views on protecting against mutualisation separately to our responses to Ofgem's specific questions.

We proposed[2] a licence condition to address the market failures of moral hazard and adverse selection by protecting against mutualisation of costs. We are heartened to see that a similar proposal has been proposed by Ofgem. However, the Ofgem proposal for suppliers to "protect a minimum of 50% of their customer credit balances and a proportion of government scheme costs in the event of their failure" does not go far enough.

Ofgem would best meet its principal objective to protect the interests of current and future customers and proportionality duty by:

- Requiring suppliers to guarantee 100% of monies they owe to customers (i.e. credit balances) and 100% of monies they owe in respect of relevant Government policy costs (e.g. Renewables Obligation). Allowing suppliers to do so in the way that they choose, provided that the method they choose is effective.
- Ensuring that suppliers meet the requirement set out in the above bullet by declaring to Ofgem on an annual basis how they are meeting the requirement, with sign-off from an independent auditor. If Ofgem is not satisfied with the assurances that a supplier provides, it should be able to ask further questions and in extreme cases compel a supplier to get a "second opinion" from a different auditor.

These measures, including milestone assessments, are the least onerous way to achieve the legitimate aim of addressing the market failures of moral hazard and adverse selection that Ofgem sets out in its draft impact assessment[3]. No further measures are required, and any further measures would be disproportionate and run counter to Ofgem's principal objective.

The situation in today's retail energy market

In most competitive markets, where customers act as creditors to a firm ("debtor firm") by paying in advance, that credit is not reimbursed by other customers of other firms if the debtor firm fails. This arrangement:

- Incentivises customers to take steps to ensure that their money is safe, for example by examining the reputation of the debtor firm.
- Incentivises firms to build a reputation for being reliable and trustworthy.

[2] Centrica response: https://www.ofgem.gov.uk/system/files/docs/2019/04/centrica_response.pdf
[3] Ibid, paragraphs 1.7 and 1.8

- Incentivises innovation in protection for customers who pay up-front. For example, third-party intermediaries such as shopping platforms (e.g. E-Bay or Amazon) imposing standards by controlling which firms may operate on their platform.

In most competitive markets, it is not generally felt that customers being exposed to credit risk when they pay in advance unduly inhibits competition or innovation or is otherwise inappropriate.

Ofgem's previous actions indicate that it believes that the domestic energy supply market is different, and consumer creditors of debtor firms need protection that they do not get in other competitive markets.

If a domestic energy customer pays for energy in advance and builds up a "credit balance", that credit balance is protected if the debtor firm fails. Ofgem requires that the credit balances are reimbursed by the Supplier of Last Resort (SoLR). The cost of reimbursing the credit balances is borne by the SoLR, or the SoLR can claim up to all the costs via a levy that is socialised across all domestic customers via network charges.

Ofgem's prior intervention to require SoLRs to reimburse credit balances clearly protects the customers of debtor firms that fail: this is a clear benefit. But at what cost?

The costs of Ofgem's prior intervention are that:

- It reduces or removes the incentive for customers to take steps to ensure that their money is safe
- It reduces or removes the incentive for suppliers to build a reputation for being reliable and trustworthy in the sense of being financially sustainable
- It reduces or removes incentives for innovation in protection of customers who pay up-front

Because of these incentive effects, suppliers have been able to use customer credit balances as an uninformed line of credit to allow them to offer very low prices to attract customers by taking excessive risks.

Moral hazard

Ofgem's impact assessment recognises that the current market creates a moral hazard. The mutualisation of credit balances and Government policy costs means "suppliers could engage in risky practices, knowing that they will not bear the costs of all debts accrued in the event of their failure"[4]. Requiring suppliers to only cover a proportion of credit balances and Government policy costs will only address a proportion of the moral hazard.

With only a proportion of credit balances and Government policy costs covered by all suppliers a degree of market distortion will remain as suppliers will still have access to a free line of credit, albeit slightly diminished.

Ofgem's requirement to protect 50% of credit balances and a portion of Government policy costs would not address this market distortion. Only the 100% requirement would fully address this market distortion and fully address the moral hazard issue.

[4] Ofgem Impact assessment – paragraph 1.7

Adverse selection

Ofgem's consultation recognises that adverse selection exists in the market: "The growth of small suppliers has increased price competition, with some of the lowest tariff offers available from small and medium suppliers"[5]. In a recent Radio 4 interview Ofgem's Executive Director for Consumers and Markets, Mary Starks, recognised that "some of the companies that have gone under have gone under because they have been pricing at an unsustainable level"[6].

The lack of the 100% requirement has given some suppliers an uninformed line of credit they may use to take excessive risks, such as pricing unsustainably low.

In a market where some suppliers use customer credit balances as an uninformed line of credit to allow them to offer very low prices to attract customers, what are other suppliers to do? As Ofgem rightly recognises[7], there is an issue of adverse selection where responsible suppliers are either:

- unable to compete on price and are therefore deterred from competing at all; or
- are forced to find ways of competing on price, which could be by replicating the suppliers offering unsustainably low prices using an uninformed line of credit or otherwise reducing other sources of costs such as customer service.

Why the moral hazard and adverse selection cannot be left unaddressed

Ofgem might argue that there are benefits of protecting creditor customers by protecting customer credit balances owed by failed debtor suppliers. It might argue that this intervention has led to lower prices than would otherwise have been the case.

Whilst Ofgem's past interventions might have led to lower prices for some customers, these lower prices are enabled by a regulatory distortion rather than genuine competition and innovation and come at the expense of genuine competition and innovation.

The lower prices also only benefit a subset of customers. We understand that the subset of customers who benefit from these lower prices are on average richer than customers who do not benefit[8], so the status quo has regressive distributional effects. And the benefits are only temporary because the risky behaviour that the moral hazard encourages is not sustainable in the long term; suppliers will either fail owing money to customers or they will stop taking the same risks.

The current issues of moral hazard and adverse selection that exist in the domestic energy retail market fail to protect current and future consumers by undermining effective competition. Ofgem in part has unintentionally caused these issues of moral hazard and adverse selection, and its principal objective to protect consumers dictates that is has a duty to remedy them.

[5] Ofgem consultation – paragraph 1.2: https://www.ofgem.gov.uk/system/files/docs/2019/10/slr_policy_consultation_new_updated.pdf
[6] Radio 4, 22 October 2019.
[7] Ofgem impact assessment, paragraph 1.8
[8] Centrica publication: https://www.centrica.com/stories/2017/levelling-the-playing-field/

Promoting better risk management

Ofgem states in its consultation that "Requiring suppliers to put in place arrangements to cover all of their customer credit balances and scheme liabilities in the event of their failure is likely to have the greatest direct benefits in lowering the likelihood and impact of cost mutualisation"[9].

We agree and have set out the benefits of the 100% requirement throughout our response.

Yet Ofgem's proposals only seek to cover half of customer credit balances and a proportion of Government scheme costs. Covering all credit balances and Government scheme costs would prevent the main customer detriment caused by supplier failure – the mutualisation of costs.

Most of Ofgem's other proposals are addressing the issues that arise because the 100% requirement isn't in place.

All consumers pick up the costs of mutualisation when a supplier fails – essentially subsidising the excessive risk taking of failed suppliers

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Ofgem notes that some suppliers will use credit balances as working capital as part of their business model. This is only a sustainable business model if the supplier can cover these amounts should it fail. If a supplier cannot get insurance or ringfence their outstanding credit balances and Government policy costs, then this suggests its business is unsustainable.

We consider that implementing the 100% requirement is the most effective way for Ofgem to fulfil its principal objective to "protect the interests of existing and future electricity and gas consumers", and we have set out Ofgem's duties and their effect in the section below.

Ofgem's principal objective and proportionality duty

Neither Ofgem's consultation nor its draft impact assessment contain a proper assessment of whether, and if so how, its proposals meet Ofgem's principal objective and proportionality duty better than alternative proposals. We encourage Ofgem to remedy this deficiency in the next phase of consultation, which we presume will be a statutory consultation.

Ofgem's principal objective is to protect the interests of existing and future consumers. Ofgem is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition.

Ofgem also has a duty to act proportionately. This means that any given intervention should:

(a) be effective in achieving its legitimate aim;
(b) be no more onerous than needed to achieve its aim;
(c) be the least onerous if there is a choice between several effective measures; and
(d) not produce disadvantages which are disproportionate to the aim.

These principles pertaining to the proportionality duty were established in the Fedesa case, Case C-331/88, The Queen v Minister of Agriculture, Fisheries and Food and Secretary of State for Health, ex parte: Fedesa and others [1990] ECR I-4023, paragraph 13.

[9] Ofgem consultation – paragraph 2.13.

Ofgem needs to address the market failures to meet its statutory duties

In its draft impact assessment, Ofgem recognises that the issues of moral hazard and adverse selection exist and describes them as "market failures"[10]. Ofgem then goes on to say that "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"[11].

Ofgem's position that it is not aiming to fix the "market failures" it has identified is inconsistent with:

- Ofgem's principal objective.
- The purpose of economic regulation. The purpose of economic regulation is to correct market failures to enable effective competition to protect consumers to the extent that competition is possible (i.e. not in natural monopolies).
- Ofgem's proposal to oblige suppliers to guarantee 50% of credit balances and a proportion of Government policy costs that will partially fix the "market failures" it has identified.
- The stakeholder feedback that "prevention is better than cure" that Ofgem cites[12] as having influenced its proposals.

Ofgem's principal objective dictates that it does "fix" the "market failures"[13] that it has identified. Ofgem's principal objective also dictates that it goes no further than fixing the "market failures" identified, because if there are no other market failures then, by definition, effective competition can address the other issues. And as addressing the identified market failures is the only legitimate aim, it would not be proportionate to intervene in a way that is more onerous than achieving that aim.

Mutualisation of Ombudsman costs

The mutualisation of costs following a supplier failure is not limited to customer credit balances and Government schemes. A proposal has been put forward by the Ombudsman Services: Energy (OS: E) to require suppliers to mutualise the unpaid charges of failed suppliers, which year to date in 2019 is £1.6m. Suppliers are expected to pay a pro-rated amount in January 2020.

This comes at a late stage in 2019, when much of our forecasting and financial provisions have already been set. And it follows debt accrued due to supplier failure, despite the warning signs of:

- unpaid case fees (which OS:E will have been aware of),
- a spike in complaints prior to failure, and
- other signs that Ofgem itself may have spotted e.g. issuing of Provisional Orders to address customer service failures.

There is no requirement today, and no proposal as part of Ofgem's Supplier Licensing Review to ensure that suppliers adhere to their obligations around Alternative Dispute Resolution. OS: E is a non-profit organisation, so cannot be expected to fund suppliers' debts. Other suppliers

[10] Ofgem impact assessment - paragraph 1.9
[11] Ibid
[12] Ofgem consultation - paragraph 1.10
[13] It would be more accurate to call these "regulatory failures", but we use Ofgem's terminology for the sake of clarity

should also not be expected to continue to fund these suppliers' failures, particularly costs which end up being added to customer bills.

We urge Ofgem to ensure that the unpaid Ombudsman costs are also considered within the supplier licensing review and our proposed 100% requirement.

Smaller supplier concerns

Some small suppliers have expressed concerns that requiring suppliers to protect all credit balances and Government policy costs in the event of failure may place a financial burden on smaller suppliers who may struggle to cover these costs and prevent new entrants from entering the energy supply market.

However, an inability to cover these costs suggests that a supplier's business is unsustainable and that they may be contributing to adverse selection by not fully reflecting the true costs of running their business in the tariffs they offer to customers.

Ofgem should look to other competitive markets where suppliers are required to securitise any customer money that they are holding, and competition is still able to thrive. Two examples of note are:

- Singapore[14]: "Retailers must also safeguard all security deposits collected from household consumers and return them to these household consumers should a retailer exit the market."
- Texas[15]: "shall keep customer deposits and residential advance payments in an escrow account or segregated cash account, or provide an irrevocable stand-by letter of credit payable to the commission in an amount sufficient to cover 100% of the [suppliers] outstanding customer deposits and residential advance payments held at the close of each month.

A market where suppliers must prevent the mutualisation of costs should they fail will remain an attractive market to any new entrant that acts responsibly and does not take excessive risks with their customers' money.

Ofgem recognises that "Suppliers that can demonstrate financial responsibility are likely to face smaller, or possibly no, additional costs to implement the protection required".

We concur and consider our 100% requirement will result in only responsible suppliers entering and growing in the energy supply market. Focussing their efforts on genuine competition and innovation rather than taking advantage of a regulatory distortion. With customers not footing the bill should a supplier fail. It is in the interests of both consumers and competition to implement the 100% requirement.

We note that there have been two opinion pieces recently trying to make a case against Ofgem's proposals to protect credit balances and Government scheme costs:

- Juliet Davenport, Good Energy – writing in Utility Week[16].

[14] Speech by Dr Tan Wu Meng: https://www.mti.gov.sg/Newsroom/Speeches/2019/03/Speech-by-Dr-Tan-Wu-Meng-SPS-for-Ministry-for-Trade-and-Industry-During-the-COS-Debate-under-Head-V
[15] See section F2: http://www.puc.texas.gov/agency/rulesnlaws/subrules/electric/25.107/25.107.pdf
[16] Utility Week: https://utilityweek.co.uk/ofgem-rule-changes-risk-penalising-ethical-suppliers/

- ‘All Hallow’s Eve in the retail market’, Cornwall Insight’s Energy Spectrum[17].

Below we set out their key concerns in italics and put forward the arguments to counteract their views:

Good Energy: why has energy attracted so many ‘entrepreneurs’ that do not have such a baseline level of business ethics or understanding of governance?

Energy has attracted poor business practices due to the lack of the 100% requirement. This lack of requirement encourages risk taking by giving suppliers an uninformed line of credit they may use to offer unsustainably low tariffs. We have expanded on this point at the beginning of this appendix, and throughout our response.

Good Energy: The danger in Ofgem’s new proposals is that they could hurt well-run businesses. Requiring them to put cash down up front to cover the cost of customer balances and environmental schemes is excessive and could impact liquidity within businesses which need it to do good.

Good Energy is arguing that suppliers should be able to use customer credit balances as working capital, essentially treating customers’ money as if it were their own – when it is not.

Understandably customer credit balances are part of a supplier’s wider cashflow and we are not necessarily suggesting all credit balance funds should be ringfenced. However, a supplier should be able to demonstrate that it can cover 100% of the costs of its credit balances and Government policy costs should it fail.

If suppliers can take risks with customers’ money, then this can result in moral hazard and adverse selection, which Ofgem has accepted are market failures. We have set out the detriment of these market distortions at the beginning of this appendix.

Good Energy: There is huge variety in business models among suppliers of different sizes. Obligating them all to keep a pot of money on hold could have unintended consequences, such as stifling growth and innovation. It will also favour the big six, and consequentially reduce competition.

Responsible suppliers who compete on price should welcome the protection of credit balances and Government policy costs as it ensures a level playing field for those suppliers.

Suppliers such as Good Energy do not compete on price at the lower end of the market and they are exempt from the Default Tariff Cap. Suppliers like Good Energy have not been impacted by the moral hazard and adverse selection that exists in the market today to the same extent as other suppliers.

Good Energy: Ofgem is right to stamp out incompetence, but making other companies pay for someone else’s failure is not how the market should operate.

In today’s market, responsible suppliers and their customers are required to pay for the failure of other suppliers who have used their customers’ money to take excessive risks.

To date over £150 million of costs have been mutualised and much of this could have been avoided if the 100% requirement was in place.

[17] Cornwall Insight: https://www.cornwall-insight.com/uploads/191104_es_689.pdf

Contrary to Good Energy's views, the requirement to protect credit balances will ensure companies take any risks on their own account rather than using an uninformed line of credit that is mutualised across all suppliers.

Good Energy: The right route needs to start with the right questions: why weren't the non-executive directors protecting cash flow? And why weren't administrators called in earlier? These businesses clearly were not acting 'fit and properly'; what are the existing laws that were not enforced and should have been?

Ofgem's tougher new entry requirements should address some of the risks of poorly run suppliers entering the market.

However, tougher new entry requirements will not address the risks from existing suppliers that are poorly run nor will it protect the market and consumers from suppliers who start responsibly and then choose to take excessive risks.

Once a supplier is already failing Ofgem's ability to address issues are limited and it often becomes a matter of when, rather than if, a supplier will fail. For this reason, prevention will be effective whereas cure will not: our 100% requirement is the solution.

Good Energy: In a functioning market, the news of one failed supplier is normal and a sign of healthy competition. 16 in 24 months is a sign of something else altogether. New policy in this area should protect that competition and not punish the good guys.

We consider the glut of supplier failures to be a sign that the energy supplier market has been too permissive of business models that take risks with money that belongs to their customers. It is a sign that that suppliers with flawed business plans have been able to enter the energy supply market without putting in place protection for credit balances and Government policy costs.

Cornwall Insight: We suspect a new market to ensure customer credit balances will take a while to settle down and while it does it will be the least well capitalised companies that pay most, if they can get cover at all. A proposal for such a significant change to the terms of trade needs to be much better justified than one rule of thumb figure.

Ofgem's 'rule of thumb' figure is not the justification for the 100% requirement, or Ofgem's proposed 50% requirement. The moral hazard and adverse selection that leads to the mutualisation of costs is the distortion that requires fixing. Our response sets out key arguments for why the 100% requirement is justified.

While less well capitalised companies may find it more expensive to find cover, this would reflect market forces recognising these suppliers are riskier to protect. This is not a barrier to entry or growth, it is a recognition of a supplier's risk of failure.

Cornwall Insight: We think there is a risk from these proposals of making it more expensive and tougher for the smallest suppliers to do business, when their exits are not those that have to date caused the most detriment. The impact assessment is based on averaged costs of SoLRs and needs to be refined to consider better the cost per customer by size of failed supplier.

Smaller suppliers offering unsustainably cheap deals can cause as much detriment as larger suppliers because they force larger suppliers to compete at the same unsustainably low level and create risk of failure. See our sections on moral hazard and adverse selection for further detail.

Given that suppliers who have ceased trading recently included those who had priced at the bottom of the market, smaller suppliers can have significant impacts on the market in terms of pricing, beyond the mutualisation of costs.

Appendix 2: Consultation questions

In this appendix we answer the questions posed by Ofgem in the supplier licensing review consultation.

Overarching question

1. Do you think the proposed package of reforms will help to reduce the likelihood of disorderly market exits, and the disruption caused for consumers and the wider market when suppliers fail? Are there other actions you consider we should take to help achieve these aims?

The key issue of the supplier licensing review is addressing the market failures of moral hazard and adverse selection and protecting customers from paying avoidable mutualised costs of failed suppliers which took excessive risks. We have explored these topics in much greater detail in Appendix 1.

Implementing the 100% requirement is the most effective means of meeting the aims of the supplier licensing review. Ofgem's other proposals are either ineffective or can only be effective when implemented in conjunction with the 100% requirement.

There are several common themes that emerge with respect to many of Ofgem's proposals so we have summarised them in this answer:

Will the proposal be effective without the 100% requirement?

All Ofgem's other proposals will be ineffective at meeting the aims of the supplier licensing review if the 100% requirement isn't in place. Some like the milestone assessments and internal audit could be effective if implemented alongside the 100% requirement but would be ineffective on their own.

This is because only the 100% requirement can address the moral hazard that results in excessive risk taking by suppliers. In turn resulting in the mutualisation of costs that customers ultimately must bear.

Is this proposal duplicative of Ofgem's existing powers?

Proposals including the 'open and cooperative' and 'operational capability' requirements can be managed by more proactive enforcement by Ofgem. Ofgem admits that in many cases suppliers are already operating in line with their proposed principle. Suggesting a principle that applies across all suppliers is disproportionate and a more targeted requirement, potentially via internal audits, would be more effective.

Implementation of duplicative licence conditions will result in responsible suppliers bearing an additional cost to ensure compliance with a new licence condition. While suppliers that take excessive risks are unlikely to change behaviour.

The proposals we consider duplicative of Ofgem's existing powers are listed below:

- Operational capability principle,
- Open and cooperative, and
- Fit and proper persons requirement.

Is the proposal consistent with Ofgem's duties?

Except for the 100% requirement, no proposal fully prevents the market failures that result from the moral hazard and adverse selection present in the market. This means they are not in line with Ofgem's legitimate aim or consistent with Ofgem's principal objective.

As noted above other proposals duplicate existing regulation and therefore are not consistent with Ofgem's proportionality duty.

Many proposals would not work as prevention. As a supplier meeting that proposal may still use customer credit balances and Government policy monies owed to take excessive risks.

Many proposals would not work as cure. As a supplier meeting that proposal that has used customer credit balances and Government policy monies owed to take excessive risks has few if any levers to pull to rectify the situation.

The proposals that would not work as a prevention or a cure are listed immediately below:

- Operational capability principle,
- Open and cooperative,
- Fit and proper persons requirement, and
- Maintaining a "living will"

Does the draft licence condition meet the intent of the policy proposals?

We note that there is no drafting for the mutualisation licence condition, 50% requirement. and there is a licence condition that is not referenced in the main document.

Other proposed licence conditions are drafted too broadly so that they may apply to situations outside the scope of the supplier licensing review. We have significant concerns on the loose drafting of the licence conditions and they should be made specific to the market failures they are seeking to address.

We do not repeat all these overarching views in response to each proposal but our answers to each proposal below should be read with these overarching views in mind.

Questions for the impact assessment

2. Do you agree with the outputs of our impact assessment?
3. What further quantitative data can industry provide to inform the costs and benefits of the impact assessment, particularly for cost mutualisation protections?
4. Do you agree with the assumptions used to calculate the costs and benefits in our impact assessment? If not, please provide evidence to support further refinement.

It is not clear why Ofgem has adopted option 1 to require suppliers to protect 50% of credit balances and a portion of Government policy costs. Given the greatest potential net benefit is in option 3, which would require suppliers to protect all credit balances and Government policy costs.

We have concerns that Ofgem's net benefit figures are derived by a direct subtraction of costs from benefits as if both costs are comparable on a one to one basis.

Any costs incurred by suppliers in requiring them to protect credit balances and Government policy costs will be targeted directly at suppliers based on their risk portfolio. While the benefits will sit with the generality of customers who will not be required to pick up the costs of mutualisation should a supplier fail.

The 100% requirement would ensure that no customer or other supplier is cross subsidising the poor business practices of another supplier. This distributional benefit should be factored into Ofgem's impact assessment.

There is a regressive element to the distributional impacts. Customers with failed suppliers that price at the bottom of the market tend to be active switchers and on average wealthier than the average customer. As all customers pick up the costs of mutualisation there is likely to be redistribution from those customers less able to pay, to those that are more able to. This distributional impact should also be factored into Ofgem's impact assessment.

Our proposed 100% requirement will remove the market failures of moral hazard and adverse selection that cause suppliers to take excessive risks and fail. Ofgem should quantify the costs of these market failures and include the benefits of more responsible supplier behaviour, in the impact assessment.

We agree with the moral hazard and adverse selection points raised by Ofgem in its impact assessment. It is these market failures that must be addressed by the supplier licensing review and we consider that the only means to address these distortions is our proposed 100% requirement.

Promoting better risk management

5. Do you agree with our proposed option to cost mutualisation protections? Are there other methods of implementing this proposed option? Please provide an explanation and, if possible, any evidence, to support your position.

Our key views on cost mutualisation protections are set out in Appendix 1. In this answer below we focus purely on implementation and enforcement of the licence condition to prevent mutualisation of costs.

We note that Ofgem has not put forward a draft licence condition to require cost mutualisation protections. We put forward a proposed licence condition for the 100% requirement in our previous response[18], and would suggest that as a starter for drafting a proposed licence condition.

We share Ofgem's concern when it comes to implementing and enforcing a licence condition for suppliers to protect credit balances and scheme liabilities should they fail: "However, the threat of action for a breach of such a principle, in isolation, may be less effective when a supplier starts to fail and needs access to monies to fund its ongoing operation".

To be effective, Ofgem would need to be able to monitor and enforce this new requirement. The most proportionate way of doing this would be by suppliers declaring to Ofgem on an annual basis how they are meeting the requirement, with sign-off from an independent auditor. If Ofgem is not satisfied with the assurances that a supplier provides, it should be able to ask further questions and in extreme cases compel a supplier to get a "second opinion" from a different auditor.

[18] Centrica response: https://www.ofgem.gov.uk/system/files/docs/2019/04/centrica_response.pdf

Ofgem will need to be swift in enforcing any breach of a licence condition by a failing supplier, i.e. if a supplier removes money from a ringfenced account or lets a financial instrument lapse that was protecting customers' credit balances. It is important that any licensee in breach of this licence condition cannot quickly accumulate debts that it isn't able to honour should it fail. Suppliers should be expected to report any breach of this licence condition to Ofgem, in line with Ofgem's enforcement guidelines[19].

We note that Extra Energy was under investigation for over two years before it failed and yet no actions were taken by Ofgem. Ofgem will need to be able to identify a licence breach quickly and act upon it to limit the impact on the wider market.

Our proposed 100% requirement would be more effective at addressing market failures than Ofgem's current proposal to protect 50% of credit balances and a proportion of Government policy costs.

Operational capability

We do not support this proposal.

We understand Ofgem's drive to introduce a principle for suppliers to "demonstrate that they have, the capability, processes and systems in place to enable them to effectively serve all their customers and comply with their regulatory obligations".

We echo the concerns that Ofgem has noted in its consultation: "Some stakeholders questioned whether this requirement would duplicate existing conditions – in particular they pointed to the Standards of Conduct and suggested that suppliers should already be ensuring they have the necessary arrangements in place to meet their obligations."

Ofgem further notes that "Many, if not most, suppliers are already operating in line with the spirit of our envisaged operational principle. As such, this new requirement would be targeted at poor performing suppliers".

This suggests that a new licence condition is not needed, rather stricter enforcement of existing licence conditions would be more effective. The Standards of Conduct enable Ofgem to act against any supplier which does not have adequate capability, processes and systems in place. Ofgem's guide to the standards of conduct is clear in covering the areas that Ofgem's proposed operational capability would seek to address.

In terms of assessing proportionality, Ofgem has also not explained how this proposal would be different to:

- The Standards of Conduct, specifically c.iii which requires that suppliers "*otherwise ensure that customer service arrangements and processes are complete, thorough, fit for purpose and transparent*".
- The requirement to comply with the regulatory obligations that are already in place to which the new requirement refers. In other words, how would failing to comply with the new proposal be seen differently by Ofgem to failing to comply with existing regulatory obligations? If there is no difference, how can there be merit in the new proposed requirement?

[19] Ofgem enforcement guidelines – paragraph 3.5: https://www.ofgem.gov.uk/system/files/docs/2017/10/enforcement_guidelines_october_2017.pdf

Furthermore, there is not net benefit for this principle in Ofgem's impact assessment and therefore the case has not been made for introducing this principle.

6. Do you agree with our proposal to introduce new milestone assessments for suppliers? Do you think the milestones we have proposed and the factors we intend to assess are the right ones? Are there additional factors we should consider to help us to identify where suppliers' may be in financial difficulty?

We are supportive of milestone assessments as a measure to prevent unsustainable growth, particularly for those suppliers who are pricing at the bottom of the market and may be responsible for the market failures we referenced in Appendix 1 of our response.

We note that Ofgem's impact assessment[20] shows that suppliers that fail tend to grow rapidly and the milestone assessments should be able to pick up on these suppliers specifically and their unsustainable growth.

In the past we have seen suppliers grow quickly before failing and a milestone assessment should partly address this risk.

However, milestone assessments are not an alternative to our proposed 100% requirement. Rather milestone assessments should function alongside the 100% requirement to prevent market failures.

Should a supplier fail a milestone assessment Ofgem should act swiftly to prevent said supplier from gaining new customers.

We would further propose that Ofgem should have the powers to allow a supplier a qualified pass of a milestone assessment if the supplier meets the criteria set by Ofgem, but Ofgem has concerns around the potential for consumer harm. This qualifying power would allow Ofgem to continuously monitor an 'at risk' supplier outside of the milestone assessments.

We support Ofgem's proposals to carry out assessments on suppliers that deviate from their entry plans or show signs of financial difficulty.

We are comfortable with the thresholds Ofgem has selected given how they tie in with existing supplier obligations.

More responsible governance and increased accountability

7. Do you agree with our proposal to introduce an ongoing fit and proper requirement? Are there additional factors, other than the ones we have outlined, that you believe suppliers should assess in conducting checks?

We do not support this proposal.

We see some benefit of the fit and proper persons test at the point of market entry that Ofgem has already implemented. It may prevent individuals responsible for failed suppliers starting another supplier and potentially failing once again, with costs being mutualised across consumers.

[20] Figure 2.2 in Ofgem impact assessment: https://www.ofgem.gov.uk/system/files/docs/2019/10/191021_-_draft_impact_assessment_final_new_updated.pdf

However, for companies that are an ongoing concern this test will not prevent the moral hazard that can result in the mutualisation of costs. In both cases this cost would be addressed more effectively if our 100% requirement was implemented.

It is unclear what positions within a company would be impacted by a fit and proper person test and what consequences Ofgem would be able to enact, i.e. we do not believe Ofgem have the powers to require a company to fire an individual, nor should it.

We note that Ofgem has a definition in its proposed licence condition of an individual with "Significant Managerial Responsibility or Influence" but this is still broad, and we would struggle to identify who this applies to within our organisation.

Open and cooperative

We do not support this proposal.

In Ofgem's words: "Currently, most suppliers are already open and cooperative with Ofgem, and certain existing rules can help to prevent the most egregious offences – for instance, it is a statutory offence to provide false statements to the Gas and Electricity Markets Authority. In addition, our Enforcement Guidelines already encourage self-reporting of risks and issues to our compliance and enforcement teams."[21]

This suggests that a new licence condition is not needed, rather stricter enforcement of existing licence conditions would be more effective – i.e. through targeted reporting and enforcement on non-cooperative suppliers. There are strict reporting requirements on larger suppliers and yet we are not aware of these being mirrored for smaller and medium sized suppliers – who have been the sole cause of mutualisation of costs over the last three years.

Increased market oversight

8. Do you agree with our proposal to require suppliers to produce living wills? What do you think we should include as minimum criteria for living will content?

We do not support the proposal.

A requirement for a living will is likely to be particularly burdensome and would apply to all licensed suppliers. This is disproportionate given the problem lies with suppliers who haven't maintained good quality and up to date customer data. Rather than placing a blanket requirement on all suppliers, Ofgem would be better served through more targeted reporting of suppliers who are likely to fail and using these powers to request the equivalent of a living will from the 'at risk' suppliers.

Requesting customer data from suppliers in financial difficulty may lead to better quality data rather than waiting until the 'point of no return' when a supplier is almost certain to fail.

Ofgem's proposal is that a living will should include "Plans to mitigate the risk of excessive mutualisation of debts". This would be wholly unnecessary if Ofgem were to implement the 100% requirement.

[21] Ofgem consultation – paragraph 3.17.

9. Do you agree with our proposed scope for independent audits? Please provide rationale to support your view.

We are supportive of Ofgem's powers to conduct independent audits only if it used in conjunction with our proposed 100% requirement.

The proposed new power is needed but should only be available to Ofgem on a very narrow basis, which is to check that suppliers are meeting the 100% requirement.

We have significant concerns around the wording of the licence condition that is generic and would apply to all suppliers, not just those in distress, if they were called upon to conduct an independent audit.

Ofgem's policy is designed specifically to "ensure appropriate protections are in place against financial instability and poor customer service" as has been seen in the recent spate of supplier failures. Therefore, any proposed licence condition should also specifically apply to such circumstances.

As currently written the licence condition could apply to any supplier activity – this is wholly disproportionate, we have not seen a business case for such a broad licence condition and we consider it to be an unjustified extension of Ofgem's powers.

Ofgem's proposal states: "We would seek to use this requirement in a proportionate way. We would use it only where we had significant concerns about a supplier's financial resilience or customer service arrangements"[22].

If the licence condition is adopted, the targeted applicability should be reflected in the licence condition itself to ensure it is only targeted with the specific policy intent of the supplier licensing review.

Exit arrangements

10. Do you agree with the near terms steps we propose to take to improve consumers' experience of supplier failures? Are there other steps you think we should be taking?

We do not believe Ofgem's proposal to place a requirement on suppliers "to include references in their contract terms and conditions that activities relating to debt recovery will be executed as outlined in relevant licence conditions" will be effective as it will not be enforceable.

We agree with Ofgem that there have been some poor behaviours from administrators, particularly relating to aggressive debt collection. It is also correct for Ofgem to recognise has no direct powers over administrators.

While Ofgem's letter to insolvency practitioners[23] was well intentioned we doubt it will be effective given administrators have been appointed to manage the affairs, business and property of a supplier and to do so as quickly and efficiently as is reasonably practicable.

[22] Ofgem consultation – page 38.
[23] Ofgem letter: https://www.ofgem.gov.uk/system/files/docs/2019/11/open_letter_to_insolvency_practitioners_appointed_to_failed_energy_supply_companies_.pdf

Therefore, administrators could argue that by either chasing debt or selling it to a debt collection agency, who may chase the debt aggressively, that administrators are honouring the terms of their appointment and acting within the legislative framework that they operate in.

Given that Ofgem cannot regulate administrators we can understand Ofgem's desire to regulate administrators by proxy, by placing a requirement on suppliers "to include references in their contract terms and conditions that activities relating to debt recovery will be executed as outlined in relevant licence conditions".

However, we do not think this will be effective as we do not believe administrators will be bound by a contract that is tied to a supplier that is no longer operating.

11. Do you think there is merit in taking forward further actions in relation to portfolio splitting or trade sales? What are your views of the benefits of these steps? Are there any potential difficulties you can foresee?

We recognise there may be some competition benefits to portfolio splitting to ensure customers get the best possible tariff, especially for a split of the domestic and non-domestic portfolios.

However, the SoLR process is fast paced and complex when a portfolio remains intact. When a portfolio is split it carries a high risk of errors occurring in the splitting process.

If there is a way to split a portfolio that is cheap, quick and reliable then we are open to industry discussions to facilitate portfolio splitting. However, we are concerned that a portfolio split may lead to a greater rate of errors in the SoLR process and therefore result in greater consumer harm than the potential consumer benefit.

Trade sales

Much like Ofgem we have concerns on trade sales where suppliers 'cherry pick' customers from another supplier's portfolio and leave behind the 'unwanted' customers who may be those that are the most debt laden. The remnant of a supplier's portfolio then fails with its costs mutualised across the industry.

However, the directors of a supplier have a duty to act in the interests of shareholders and the sale of customers may be deemed an appropriate action if it can rescue the company or recover costs before it fails.

Therefore, we do not advocate Ofgem having the right to veto a trade sale as the decision to go ahead with a trade sale is a purely commercial decision.

Licence conditions

12. Do you think our draft supply licence conditions reflect policy intent?

No. We have significant concerns that Ofgem's draft supply licence conditions are too broad and provide Ofgem with powers that go beyond the intent of the supplier licensing review. Specifically, this refers to the following licence conditions:

- New operational capability principle,
- New principle to be open and cooperative with the regulator, and
- New requirement to conduct independent audits when requested by the Authority,

All three of the above have been drafted to apply across all supply licensable activities when the policy intent is for them to be applicable only to address the concerns raised in the supplier licensing review – i.e. regulating suppliers to raise standards around financial resilience and addressing the broader market impacts of a supplier failure.

As stated in our response we consider the operational capability principle unnecessary. Even so the requirement to: “have the capabilities to … comply with relevant legislative and regulatory obligations” is so broad as to cover all supplier activities. Given the policy intent is only focused on the supplier licensing review it should only refer to supplier activities that relate specifically to the market failures that we have observed in failed suppliers.

The open and cooperative requirement is also extremely broad, and again another licence condition we do not support. The requirement that “The licensee must disclose to the Authority appropriately anything relating to the licensee of which the Authority would reasonably expect notice” could feasibly cover every element of a supplier’s business and it is entirely disproportionate to what could be reasonably required of a supplier.

We support the independent audit requirement, but only to be used to verify our proposed 100% requirement. Ofgem’s drafting of the audit requirement to apply to ‘any functions’ is far too broad and should be amended to apply only to the aims of the supplier licensing review.

We propose that all the three above licence conditions are amended and made specific to the market failure that they are trying to address. In line with Ofgem’s proportionality duty.

We further note there is a licence condition on other improvements to the exit arrangements that is not discussed in the main consultation document. We assume this is an error and the licence condition should be removed from any future supplier licensing review publications, including the statutory consultation.