

Licensing Frameworks
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

2 December 2019

Dear Colleague,

Supplier Licensing Review: Ongoing requirements and exit arrangements

ESB Energy welcomes the opportunity to respond to your consultation¹ on energy supplier licensing arrangements for ongoing suppliers and suppliers exiting the market. Your proposals mark a good starting point for discussion, but your proposed package needs a great deal of refinement in order for it to be effective, proportionate and well targeted. We've provided feedback below on the issues we consider most material.

Question 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.

The cost of supplier failure should be borne by investors, not consumers. Your proposal is a step in the right direction although we'd encourage you to go further and secure all credit balances and government scheme costs.

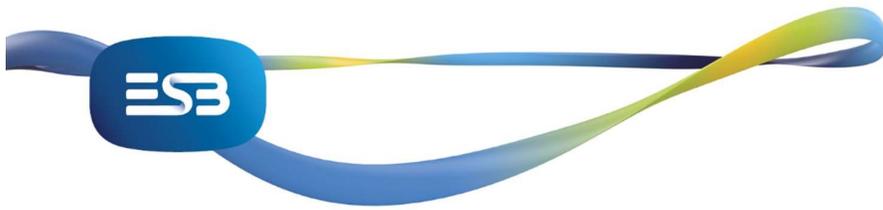
You state that requiring a larger proportion of credit balances to be protected would discourage innovative and untested new business models from entering the market, but this implies that you're supportive of consumers providing unsecured funding for businesses that are so risky, no financial institution will support them at a reasonable cost. It would be useful if you would clarify your position on this.

You suggest in your Impact Assessment that suppliers could decide to not collect credit balances due to the cost of securing the full credit balance and this could lead to higher bills for consumers in the winter. We do not think this viewpoint stands up logically. As you state in paragraph 2.13 of your consultation, suppliers that can demonstrate financial responsibility are likely to face little or no cost in securing credit balances. Therefore, there's little or no cost in allowing credit balances to build up over the summer so that customer bills remain steady and costs associated with managing customer debt are avoided. As for suppliers that aren't financially responsible, the single greatest risk to these businesses is running out of cash and consequently having to file for bankruptcy. The more cash a supplier has on hand, the further away they are from bankruptcy. The incentive on these businesses to continue to collect credit balances, even if there's a cost associated with securing it will be overwhelming.

You state that suppliers, especially irresponsible suppliers, will face costs associated with complying with securing credit balances and government scheme liabilities. The more credit balances that need to be secured, the greater the cost. These costs could trigger supplier failures among financially irresponsible suppliers. Your current proposal is to allow 3-6 months to implement this requirement. We suggest that a longer implementation period could remedy this issue. Suppliers could be given 3-6 months to secure 50% of their credit balances and a further 12-18 months to secure the remainder, perhaps in increments. This will allow suppliers that are financially irresponsible time to get their house in order where possible or otherwise exit the market in an orderly fashion through a trade sale.

Your Impact Assessment suggests that securing all credit balances and government scheme liabilities will cost a lot more or bring a lot more benefits to consumers depending on whether there's 1 or 4 Supplier of Last Resort (SoLR) events in a given year. We recognise the difficulties in developing impact assessments especially when there are so many interacting factors to consider. However, we would point out that securing more credit balances and government scheme liabilities will encourage more financially responsible behaviour which should reduce the number of SoLR events in the market. Unless we've misunderstood your assessment, on table 3.3b suggests the choice of approach from the Baseline to Option 3 will not change the outcome in terms of the number of SoLR events avoided. It only quantifies the benefits for the SoLR events that happen.

¹ <https://www.ofgem.gov.uk/publications-and-updates/supplier-licensing-review-ongoing-requirements-and-exit-arrangements>



If Option 3 (which secures both credit balances and Renewables Obligation RO liabilities) were to reduce the number of SoLR events in a 10 year period from 40 to 10, that would deliver benefits of £372m to consumers.

We strongly support the prescriptive menu approach to allowing suppliers to secure credit balances. It allows suppliers with different business models to choose an approach that best suits their needs while also ensuring that the money will be available to cover consumers credit balances should a supplier fail.

Finally, specifically with regards to the mutualisation of RO liabilities, the current situation cannot continue. Ideally, the government would overhaul the collection of RO payments to minimise the issue of excessive mutualisation but, given current political uncertainties, it may prudent to put in place a contingency should they fail to do so. We have already advocated securing all credit balances over a period of time long enough that the market has time to adjust and the possibility of the policy triggering a SoLR event is minimised. As a further step, you could require that RO liabilities are secured at a later date still with the understanding that you would suspend and subsequently remove the obligation on suppliers should the government put a suitable alternative in place. It is important that in developing proposals around securing RO and other government scheme liabilities that you do not distort the schemes themselves. For example, discouraging suppliers from purchasing RO Certificates throughout each scheme year.

Operational capability

You propose to put in place a licence condition requiring that suppliers demonstrate that they have the capability, processes and systems in place to effectively serve their customers. You state that this should not place any additional burden on suppliers as they should already be doing this - the goal is to provide further clarity on existing requirements. Indeed, when suppliers have not done this in the past you have opened enforcement or compliance cases to address these issues.

Your stated reason for introducing this obligation is to make it explicit to suppliers that they must have the appropriate systems and processes in place to meet the Customer Objective of the Standards of Conduct. For this to hold true there would have to be an operational supplier that takes the time and care to scrutinise and understand the entire 486-page supply licence but does not understand that they need to have adequate systems in place to treat their customers fairly. This seems unlikely to the extent that it's questionable whether this proposal has any benefit at all.

In terms of cost, one could take the viewpoint that adding in a further licence condition wouldn't cause undue burden on suppliers. However, each further licence condition makes the supply licence a little more unwieldy, less accessible and consequently, less effective. The effect of these additions can compound very quickly – between 2011 and 2017 the supply licence increased more than fourfold from 127 pages to 524 pages long. Ofgem's Future Retail Market Regulation work reversed this trend for a short time but it at the current rate of growth, the supply licence will be the longest it's ever been in a short matter of time.

Given the lack of clear benefit, we suggest that you don't move forward with this proposal.

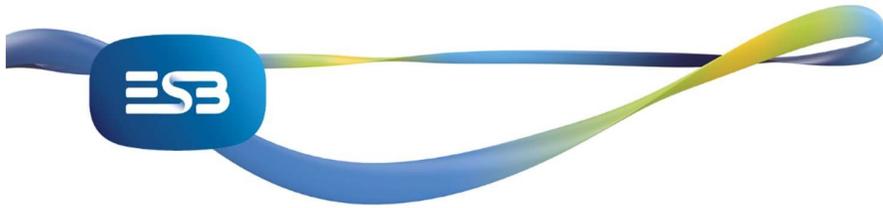
Question 6. Do you agree with our proposal to introduce new milestone assessments for suppliers? Do you think the milestones we have proposed and the factors we intend to assess are the right ones? Are there additional factors we should consider to help us to identify where suppliers' may be in financial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

Your explanation of the issue is very clear and concise. Many suppliers have grown at higher than average rates, their systems and processes have not been able to account for this growth and end consumers have suffered the consequences through poor customer service, often followed by supplier failure.

However, your proposal for dealing with this problem is poorly targeted and needs to be substantially reworked. It relies on static milestones, past which a supplier cannot grow unless given permission by Ofgem. In order to get permission, the supplier must pass an Ofgem assessment demonstrating that they're prepared for further growth. The proposal will allow Ofgem to assess high growth, high risk suppliers but it will also require Ofgem to assess suppliers whose growth is lower than average and suppliers with average growth and a 5-star Citizens Advice rating².

We are assuming that these assessments will be more than cursory, therefore, some degree of specialised skill will be needed to conduct them. Ofgem staff will need to be able to account for how different supplier

² Citizens Advice collect and publish data on the customer service performance of suppliers with more than 25k meter points.



business models could lead to radically different system and process requirements. For example, they would need to be able to vet the customer service requirements for a supplier that specialises in serving elderly customers via the telephone versus a supplier that only interacts with their customers via an app and chatbot.

The way that the proposal is currently structured means Ofgem will have to reactively allocate specialised resources when a submission comes in from a supplier. Given the number of suppliers in the market and the number of thresholds proposed, it's not unreasonable to foresee 10 or more submissions arriving in from suppliers in a short period of time. This raises the risk that suppliers will be barred from allowing consumers to switch to them and save, not because they pose a risk to the market but because Ofgem has a backlog of assessments to get through. This problem would be exacerbated for sensible suppliers that have invested staff and systems in anticipation of growing and now cannot pay for that investment because of administrative issues at the regulator.

Something similar has already happened in electricity wholesale markets. The Capacity Market (CM) was suspended and the Market Making Obligation (MMO) began to unravel at the same time. Only a single team within Ofgem had the expertise to deal with both problems and the CM work was sensibly prioritised. However, the MMO has now been suspended without a replacement and consumers will likely face higher costs as a result. Issues with the CM and MMO both arising at the same time was a question of bad luck and not easily foreseeable. However, your proposals with these assessments appear to be designed to create a backlog scenario which is as likely to hurt responsible suppliers as it is to prevent irresponsible suppliers from growing.

Your proposals need to be better targeted. They need to allow you to work proactively based on intelligence rather than reactively based on arbitrary static thresholds. We would suggest that you monitor suppliers that have high growth and low Citizens Advice ratings. These suppliers can then be required to provide an assessment using your existing powers under Standard Licence Condition 5. Where you are concerned that these suppliers are growing in an uncontrolled manner, you can agree a remedial plan with them and if necessary, place a Provisional Order on them to stop or slow their growth until the situation is addressed. No additional licence conditions are required. Suppliers with strong customer service and reasonable growth rates would not be subjected to unduly burdensome regulation.

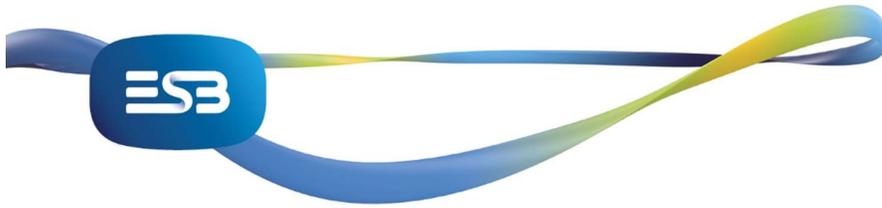
Principle to be open and co-operative with the regulator

The points we raised with regards to operational capability also apply to this proposal. You summarise the issue very clearly – while most failing suppliers are co-operative and facilitative through the SoLR process some are not. This creates unnecessary disruption for consumers and the market. You propose a principle of being open and co-operative with the regulator as a solution. Then you acknowledge the fatal flaw with this proposal “in times of supplier financial difficulties they may not prioritise compliance with such a requirement”. The likelihood is that the suppliers that were going to be co-operative anyway will continue to be co-operative while those who weren't will continue not to be.

You signal a hope that the insertion of another licence condition into the 486-page supply licence will trigger a cultural shift among poor performing suppliers. This hope seems extremely tenuous. The first paragraph of the supply licence already requires that suppliers treat their customers fairly, including during SoLR events. If a proportion of suppliers are already failing to pay due heed to that obligation, then there's no reason to believe that an obligation with a similar effect positioned elsewhere in the supply licence will prompt a profound shift in that supplier's culture.

Question 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?

A living will may be a useful requirement but only in terms of facilitating the technical and procedural elements of the SoLR process. Your aspirations appear to go beyond this, attempting to bind the supplier to behave in a certain manner as they fail. We consider it likely that this will not be effective due to a lack of effective enforcement options available to you should a failing supplier renege on a promise made in a living will. We consider each of your content suggestions in turn:



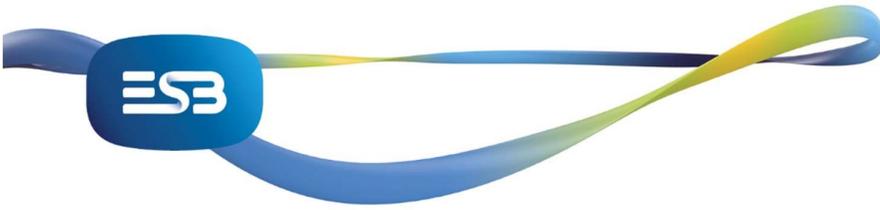
Ofgem Suggestion	ESB Energy Comment
An assessment of any barriers the supplier may face to an orderly market exit.	We don't understand this requirement. No supplier intends to go bankrupt and every supplier would rather exit via a trade sale if that were possible. SoLR events are caused by suppliers making irreversible mistakes that result in them running out of cash. We'd appreciate a fuller explanation of the value of this requirement.
Plans to mitigate the risk of excessive mutualisation of debts (including obligations under government environmental schemes such as the RO).	You acknowledge in paragraph 2.18 of your consultation that commitments such as these are unlikely to be effective once a supplier begins to fail. This issue should be dealt with as part of your cost mutualisation proposals.
Arrangements that would ensure continuity of services by key service providers.	This is a sensible suggestion. Provisions can be put in place in advance in order to ensure continuity. On the other hand, if the failing supplier isn't paying their service provider, they might be reluctant to provide their services free of charge.
Sensible plans for the sale of assets (such as those tradable under the ECO scheme for licenced suppliers).	We'd need more detail to understand this more fully but on the face of it, this requirement has the same problem as the requirement to mitigate mutualisation risks.
Plans for engaging with Ofgem and industry central bodies during the wind down process.	Suppliers will need to know what is expected of them at the time of drafting the living will. Improved guidance from Ofgem would be needed in order for these requirements to be effective.
A methodology for the efficient handover of information to the relevant party.	

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

You propose to compel suppliers to have an independent audit carried out where you have significant grounds for concern about their financial resilience or ability to meet the needs of their customers. You intend to deploy this power sparingly, mindful that overusing this requirement would place an undue regulatory burden on suppliers. You envisage it being used where you have serious concerns about a supplier's financial resilience, where the supplier is being obstructive or where you lack the expertise to identify and resolve financial and customer service issues. Your Impact Assessment states that you intend to only conduct audits "where the estimated costs of the audit review are proportionate to the risks being mitigated". On that basis, the audit is judged to provide a net benefit.

However, your suggested licence drafting provides you with the power that can be used far beyond your stated intent. Future Ofgem staff could compel suppliers to carry out an audit of any form they dictate on any supplier they so choose, unless that supplier can demonstrate that it is unreasonable. We cannot support your proposal in its current form for this reason. Checks and balances need to be placed into the supply licence to ensure this power is only used as intended.

We hope you've found this feedback helpful. We're more than happy to engage and provide assistance on the further developing your package of proposals in the next phase of your work. Please don't hesitate to get in touch.



Yours Sincerely,

Paul Fuller
Regulation Manager

