London Office
4th Floor,
1 Tudor Street,
London EC4Y 0AH
Tel: +44 (0)141 614 7501

Vlada Petuchaite and James Proudfoot
Licensing Frameworks
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

3 December 2019

Dear Vlada and James,

Supplier Licensing Review: Ongoing requirements and exit arrangements

Thank you for the opportunity to respond to this consultation. We have been supportive from the outset of Ofgem's review, which is extremely timely in light of the large number of insolvencies over the last two years. These insolvencies cause detriment not only to the customers of the failed suppliers but also the customers of other suppliers who bear the costs of refunding credit balances and other debt mutualisation, which have run to hundreds of £ millions.

In this context, we welcome Ofgem's latest review proposals, which should go some way to mitigating this consumer detriment. Nevertheless, we believe Ofgem's proposals could be further enhanced to the benefit of consumers, whilst not unduly impacting the market, by strengthening the protection of funds at risk of mutualisation following supplier insolvency. In addition, we agree it is important to improve Ofgem's ability to intervene where a supplier shows signs of poor performance or financial challenges and where there are clear gaps in Ofgem's current powers.

At the same time, we wonder if Ofgem could be doing more to use its existing powers to take strong early action where suppliers are not meeting their obligations or acting appropriately. Indeed, there are a number of proposals in this consultation where it is not entirely clear why Ofgem believes it needs additional powers over and above those it already has, including the overarching Standards of Conduct, and we would encourage Ofgem to avoid duplication where possible.

Our answers to the consultation questions are in Annex 1. Where Ofgem has not asked questions relating to a specific proposal, we have provided comments at the start of the relevant section of Annex 1.

<u>Cost mutualisation</u>

Reducing the impact of mutualising insolvent suppliers' debts should be a key focus for this stage of the supplier licensing review, recognising the significant impact that supplier failure has had on consumers in recent periods. We support the proposals to require suppliers to protect both customer credit balances and government scheme liabilities, but

we believe the proportion protected should be 100% rather than 50%. Unless 100% is protected, there will still be a significant moral hazard, where suppliers are tempted to behave irresponsibly in relation to the unprotected 50%. We recognise concerns that such protections may reduce available working capital for some suppliers, but we believe those operating their businesses sustainably and responsibly should be able to operate under increased protections. We do however recognise that suppliers may need time to adjust, and a phased implementation, moving from 50% to 100% protection, may be appropriate. We believe the requirements should extend to the Renewables Obligation, Feed in Tariff, Warm House Discount and Capacity Market schemes, with the option for Ofgem to add additional schemes at a later date where evidence supports the need to do so.

Supporting Ofgem in taking action against irresponsible suppliers

Ofgem should also focus on ensuring it has sufficient tools to take action early where it identifies that a supplier may be acting irresponsibly, whether through being unprepared to support a growing customer base, operating with significant financial risk or otherwise not servicing its customers appropriately. As noted above, it is important that Ofgem avoids duplication with other licence conditions and uses existing powers where it can.

We are supportive of Ofgem's proposal to introduce new milestone assessments for small suppliers who are growing rapidly or showing signs of financial instability. In particular:

- While it makes sense to link the assessments to existing customer number thresholds, it should be clear to suppliers that the assessment is for a wider review of the preparedness to service increased customer numbers across all obligations rather than only the new obligation linked to that threshold.
- We agree that the checks should be consistent with those undertaken at market entry and this should ensure that a responsible supplier can pass through the checks with little resource impact.
- For the assessment linked to financial instability, we agree with Ofgem that it should not apply a fixed set of financial criteria and have provided comments on additional criteria that Ofgem should include within its assessments in annex 1

We also support the proposed power for Ofgem to require a supplier to undertake an independent audit where there are significant concerns about its financial resilience or customer service arrangements. However, the drafting of the proposed licence conditions appears significantly broader than this, and could enable Ofgem to require an audit to test supplier compliance with an obligation where no such concerns exist. While we accept this is not Ofgem's intention, we believe the licence drafting should be tightened so that the circumstances in which Ofgem can use this power are limited to the situations set out in the consultation.

Living Will

We disagree with Ofgem's proposal to require all suppliers to maintain a living will and publish certain aspects ('Option 3') and think that if Ofgem decides to proceed with living wills, a risk-based requirement ('Option 2') would be more proportionate.

Whilst we understand that it is difficult to estimate the costs until the contents of the living will are better defined, we believe the costs (in terms of staff time and professional fees) could be very significant for larger suppliers, absorbing large amounts of senior management time, for little consumer benefit. Larger suppliers will have significantly

greater complexity in their arrangements, more onerous internal governance, and in any event, if there is to be a disorderly exit, it is likely to be via the special administration regime rather than the SoLR process.

We think the idea of public disclosure may be borrowed from the PRA proposals for financial firms, where issues of consumer trust are of far greater consequence. In the case of energy supply it will add significant cost for minimal consumer benefit.

Accordingly, we believe Ofgem should focus on Option 2, but should give further consideration to its contents and its likely effectiveness (eg bearing in mind that a supplier in the process of failing may not keep it up to date), and whether there are alternative ways to facilitate the SoLR process (such as improving access for SoLRs to data from industry parties such as Elexon).

Draft licence conditions

We note that Ofgem has not yet provided draft licence conditions for a number of the proposals in the consultation document. We would ask that Ofgem circulates draft licence conditions in advance of the statutory consultation, either in a formal policy consultation, or informally. It is important that stakeholders get the opportunity to review and comment on draft licence conditions ahead of the statutory consultation stage, where there is limited scope to make changes.

If you have any comments or queries on any aspect of this response please don't hesitate to contact me.

Yours sincerely,

Richard Sweet
Head of Regulatory Policy

Annex 1

SUPPLIER LICENSING REVIEW: ONGOING REQUIREMENTS AND EXIT ARRANGEMENTS – SCOTTISHPOWER RESPONSE

Section 1: Introduction

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?

We think Ofgem's package of proposals includes a number of measures which will help reduce the impact of failed suppliers on the wider GB consumer base. Ofgem is right to focus on actions to reduce the impact of mutualising the debts of failed suppliers, which we agree should be the priority of this programme of work. We also agree with the focus on proposals that ensure suppliers are required to demonstrate forward thinking and preparedness for growth, and enable Ofgem to take action where evidence suggests this is not the case and consumers may suffer detriment as a result. In this area, we are supportive of the new proposals for milestone assessments, and the right for Ofgem to ask suppliers to undertake independent audits.

We do however think that Ofgem should be using its existing powers now to take strong early action where suppliers are not treating customers appropriately and not meeting their obligations. Within this consultation there are a number of proposals where it is not clear why Ofgem believes it needs additional powers to take appropriate action where suppliers and not acting appropriately, over and above those powers it already has, including the overarching Standards of Conduct.

We would highlight in particular here the proposals for demonstrating sufficient operational capability and being open and co-operative with the regulator. While we are not necessarily opposed to those new obligations given that a responsible supplier should already be doing this, we believe it is important that within this consultation process, Ofgem provides the evidence demonstrating the gaps in the existing framework that these proposals would close. Ofgem has taken a number of steps in recent years to streamline and simplify the supply licence conditions including removing duplication, and we would be concerned if this programme of work were to reintroduce duplication.

As noted above, we think this review should focus on ensuring existing suppliers act responsibly, treating their consumers appropriately at all times and having appropriate financial risk management to mitigate cost mutualisation if they were to fail. As we have noted in previous consultation responses, if the new entrant application process is improved (as has been done), and Ofgem's ongoing monitoring of existing suppliers is robust and targeted, there should be less need to make significant changes to the supplier exit process. We are not therefore convinced that Ofgem's proposals for the exit process are proportionate to the risks that would remain after the proposed changes to the new entrant process and ongoing risk based monitoring.

In particular, we have a number of concerns regarding the proposed "living will", where we believe it is disproportionate to apply it to all suppliers and to require aspects to be published. We believe Ofgem should focus on its 'Option 2' and give further consideration to the likely contents and effectiveness of the living will, and whether there may be alternative ways to facilitate the SoLR process (such as improving access for SoLRs to data from industry parties such as Elexon).

Question 2. Do you agree with the outputs of our impact assessment?

We broadly agree with the outputs of the IA, but we disagree with Ofgem's assessment in respect of the living will proposal. We believe that a risk-based requirement ('Option 2') would strike the best balance between costs and benefits to the consumer. The proposal to require all suppliers to maintain a living will and publish certain aspects ('Option 3') would involve incremental costs that are disproportionate to the incremental consumer benefit.

Whilst we understand that it is difficult to estimate the costs until the contents of the living will are better defined, we believe the costs (in terms of staff time and professional fees) could be very significant for larger suppliers, absorbing large amounts of senior management time, for little consumer benefit. Larger suppliers will have significantly greater complexity in their arrangements, more onerous internal governance, and in any event, if there is to be a disorderly exit, it is likely to be via the special administration regime rather than the SoLR process. We think the idea of public disclosure may be borrowed from the PRA proposals for financial firms, where issues of consumer trust are of far greater consequence. In the case of energy supply it will add significant cost for minimal consumer benefit.

We also have some detailed comments on the assumptions used for cost mutualisation protections (see Question 4 below). In particular, we think the IA may have underestimated the incremental benefit of moving from 50% to 100% protection.

Question 3. What further quantitative data can industry provide to inform the costs and benefits of the impact assessment, particularly for cost mutualisation protections?

We would expect smaller suppliers to be in a position to provide Ofgem with some evidence of the costs of obtaining mutualisation protections. However, we would caution that in the absence of an established market for third party protection services (insurance, bank guarantees etc), initial fee estimates may be unreliable and significantly higher than the costs that would eventually be negotiated once a firm obligation was in place.

Question 4. Do you agree with the assumptions used to calculate the costs and benefits in our impact assessment? Please provide evidence to support further refinement.

With regard to cost mutualisation protections, we have the following detailed comments regarding the assumptions:

1. **Avoided SoLR events:** We would expect one of the more significant benefits of the cost mutualisation protections to be improved management and financial discipline within suppliers, resulting in fewer SoLR events overall. By omitting this potential benefit, we think Ofgem may be understating the case.

2. **Correlation between number of SoLR events and insurance premiums:** The sensitivity analysis in Tables 3.3a and 3.3b appears somewhat implausible, as it assumes that insurance premiums (or protection fees) are unaffected by the degree of market risk (for which the number of SoLR events is a good proxy). We think it would be more realistic to assume some correlation between insurance costs and market risk. This would have the effect of reducing the range of net benefit values.

3. **Protection fees**: Ofgem says it has used an indicative fee rate of 0.5% of the protected amount per annum, which it assumes is applied to 50% of credit account balances, and it assumes zero cost for the remainder. Whilst this may be a reasonable assumption overall, we would note that fees will be dependent on the perceived credit risk of the supplier in question, and some smaller suppliers may need to pay rather more than 0.5% for insurance - or alternatively adopt alternative measures such as putting money in escrow.

4. **Non-linearity with respect to percentage of amounts protected:** It is unclear how the numbers in Table 3.1a have been derived, but it appears Ofgem has assumed that a requirement to protect 50% of credit balances will result in 50% of credit balance-related SoLR costs being avoided. This would only be the case, on average, if credit balances were entirely wiped out via insolvency events. If, on the contrary, insolvencies only wipe out a proportion of credit balances, the benefits would be non-linear. Ie, protecting 100% would deliver more than twice the benefit of protecting 50%. (And the same for government obligations).

Section 2: Promoting better risk management

ScottishPower comments on Ofgem's proposal for a new principles-based requirement for suppliers to ensure they have sufficient operational capability.

We agree with Ofgem's proposed requirement to require suppliers to ensure they have the capability, process and systems in place to effectively serve all their customers and comply with, and to be able comply with, their regulatory obligations. However we would welcome further evidence from Ofgem regarding the need for this new principle over and above the existing licence conditions including the overarching Standards of Conduct.

As we noted in our response to Ofgem's May working paper however, as long as Ofgem takes a risk-based approach in monitoring compliance with such an obligation, targeting financially higher risk companies and those exhibiting systemic poor performance, we believe these requirements are proportionate as they require no more than a responsible company management should have in place already. Within the consultation document, this does appear to be the focus of when Ofgem would make use of this new requirement. We think it is important that Ofgem focuses its use of this new power in cases where it believes it cannot take action under the current regulatory framework (either at all, or sufficiently early). Otherwise we can see a risk that this new power is broadened out to apply to areas where there is no need for Ofgem to have additional powers, in effect creating duplication.

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.

General Approach and Level of Protection Required

Our understanding from Ofgem's consultation document, recent bilateral engagement and the workshop on 26 November, is that Ofgem is proposing to introduce licence obligations requiring all suppliers to put in place protections for:

- a minimum of 50% of their customers' credit balances; and
- a proportion of their government scheme liabilities.

We support the proposals to require suppliers to protect both customer credit balances and government scheme liabilities, but we believe the proportion protected should be 100% rather than 50%. Unless 100% is protected, there will still be a significant moral hazard, where suppliers are tempted to behave irresponsibly for the unprotected 50%. We recognise concerns that such protections may reduce available working capital for some suppliers, but we believe those operating their businesses sustainably and responsibly should be able to operate under increased protections.

We do however recognise that suppliers may need time to adjust, and a phased implementation, moving from 50% to 100% protection, may be appropriate. We believe the requirements should extend to the Renewables Obligation, Feed in Tariff, Warm House Discount and Capacity Market schemes, with the option for Ofgem to add additional schemes at a later date where evidence supports the need to do so

Options for providing protection

Ofgem is proposing suppliers choose from a menu of protection options including an option for suppliers to propose their own protection method to Ofgem. We agree with this approach, which should allow all suppliers to implement protections that are not unduly costly based on their own circumstances. For example, if suppliers find the cost of obtaining insurance too high, they could instead opt to put funds into an escrow account.

Ofgem suggests that the menu of options would include parent company guarantees, third party guarantees, insurance schemes, principles-based cost mutualisation protections, and a requirement to set aside funds in an escrow account. For the most part, these sound sensible, however we are not convinced at this point that Ofgem should allow a "principles-based" protection unless it falls into the category noted above, where suppliers must seek approval from Ofgem for an alternative method.

As noted in our response to the May working paper, we believe the allowed menu options, for both credit balances and government scheme liabilities, should be:

- maintenance of an investment grade credit rating (directly or by a parent via a parent company guarantee);
- a letter of credit or similar security against the liability from an entity with an appropriate credit rating;
- an insurance policy or equivalent covering the liability from an insurer with an appropriate credit rating;
- paying funds against the liability (or ROC certificates) into an escrow account; and
- an alternative approach proposed to and discussed with Ofgem.

In the case of government scheme liabilities, a simple alternative would be to reduce the liability by making interim payments to the scheme, where this is allowed.

Where a supplier proposes their own protection method to Ofgem, a clear process and timescale for agreeing this should be set out in the licence conditions to ensure both parties are sufficiently clear on how long the process will take. Suppliers selecting this option should be required to present sufficient detail regarding their proposed method of protection to allow Ofgem to verify that the proposed protection method is appropriately robust and transparent.

Government Scheme Liabilities

As noted above, we believe all suppliers should be required to guarantee payment of their government scheme liabilities in full (or reduce their liabilities by making interim payments). We recognise the funds held to pay such liabilities may be used by some suppliers as a source of working capital but we believe well managed suppliers should be able to manage working capital without recourse to such funds. We believe the obligation should cover the following schemes (which should be specified in the relevant licence condition or by way of an Ofgem direction):

- Renewables Obligation (RO);
- Feed in Tariff (FiT);
- Warm Home Discount (WHD); and
- Capacity Market (CM) payment.

Ofgem should have the power to add new schemes by way of a direction. This would "future proof" the licence condition for unforeseen situations such as that which arose due to the suspension of the capacity market.

Credit balances

As noted above, we believe suppliers should be required to protect 100% of their customers' credit balances to eliminate temptation to take unsustainable risks with unprotected credit balances in the knowledge such liabilities will be mutualised were they to become insolvent. A responsible supplier would ensure it is always able to honour its credit balances (in any circumstance where they became due to be returned, eg on request, or on exit from the market) and therefore a requirement to protect 100% of credit balances would not be disproportionate. We do however recognise that suppliers may need some time to adjust, and a phased implementation, moving from 50% to 100% protection, may be appropriate.

Should Ofgem require a level of protection of credit balances below 100%, there may be an argument to consider additional actions where a supplier is not meeting a satisfactory level of performance in billing accuracy. We understand this has been a particular issue in recent supplier insolvencies, where, as a result of poor billing accuracy, the failed supplier was holding more of their customers' credit than was justified by their actual meter readings. In this context Ofgem may want to consider an additional "uplift" to the proportion of protected credit balances to be imposed on such suppliers (for example 85% rather than the 50% proposed by Ofgem at present).

Licence conditions

We would suggest that credit balances and government scheme liabilities are protected via separate licence conditions, as the options for protection and associated assurance measures may not be identical. The licence conditions should specify the government schemes to be covered (see above), the menu of permitted protection options, and the evidence that must be provided to allow Ofgem to verify that protections are in place. This might include copies of insurance policies or bank guarantees, signed declarations from suppliers, or Ofgem having the right to ask that an independent third party validates that protections are in place where a supplier deemed to be high risk.

Where the supplier chooses to propose its own form of protection, the process for obtaining Ofgem's consent should be set out clearly in the licence condition or in associated guidance. We would expect suppliers to include in their proposals what evidence they will provide and how Ofgem can check from time to time that the protections are in force.

Use of protected amounts on supplier failure

Ofgem asks for view on the mechanism for returning protected credit balances to customers. We believe from a customer experience it would best for this to be paid through the appointed supplier of last resort (SoLR), as involvement of another third party is likely to add to customer confusion or mistrust if they are not aware their supplier has become insolvent. Furthermore, it not obvious that the insolvency administrator would necessarily pay protected credit balances back to customers and not to other creditors. We believe the best solution is to draft the licence condition so as to require that the protection put in place on credit balances eg third party guarantee, escrow account etc is set up so that only the appointed SoLR or a party nominated by Ofgem could liquidate the protection and access the funds.

Similarly, Ofgem may also need to consider how the protections or guarantees for government scheme liabilities could be accessed or exercised to ensure the associated funds were paid into the relevant scheme to avoid their mutualisation. One way to do this may be to draft the licence conditions in a way that enables only the relevant scheme administrator to liquidate the form of protection, for example Ofgem E-serve in the case of the RO and FiT.

Implementation

Finally, with regards to implementation we recommend Ofgem is guided by smaller suppliers and providers of such protections eg insurance providers as to what would be the quickest and most feasible timescales to putting such protections in place. Where a phased implementation approach is adopted as we have suggested it should be, Ofgem should ensure adequate protections are in place as quickly as possible without imposing disproportionate burdens on suppliers.

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?

Milestone assessment triggers

We agree with Ofgem's proposal to introduce new milestone assessments for growing small suppliers and to limit these assessments to domestic suppliers in the first instance. As noted in our response to Ofgem's January 2019 consultation, recent insolvencies have tended to occur in the first two to three years of trading rather than the initial 12 months, and as Ofgem notes in this consultation, during the year where they were at peak size. We think that Ofgem's proposals to introduce new milestone assessments before suppliers are allowed to grow past particular customer number thresholds is sensible and will mitigate the risk that suppliers implement growth strategies without a robust plan in place to service those increased customer numbers.

While we think the thresholds proposed by Ofgem are sensible, aligning them to existing thresholds where suppliers are currently exposed to additional obligations could create a risk that suppliers think they are only being assessed for preparedness for those new obligations rather than a wider review of the preparedness to service increased customer numbers across all obligations. In addition, given the wider aims for the assessments, we think Ofgem needs to be careful not to explicitly link the trigger to the new obligations. This is particularly important with the imminent changes to the small supplier thresholds for some obligations and the potential for further changes. We do not believe that Ofgem should

adjust a milestone assessment trigger where a change is made to a small supplier threshold as this could cause confusion for new suppliers, and potentially lead to the call for a removal of a milestone assessment where a small supplier threshold is removed.

As we note later in this section we agree that the checks should be consistent with the checks undertaken at market entry and this should ensure that a responsible supplier can pass through the checks with little resource impact. It is not clear to us the effort involved from an Ofgem perspective to operate checks at four different customer number triggers is justified, and Ofgem may want to revisit the thresholds at a later date based on experience of operating the milestone assessments.

We also agree with the proposal to apply these new assessments where a supplier shows signs of financial difficulty. We think these additional checks will be important to identify risks to consumers prior to a customer number threshold being breached. We agree with Ofgem that it should not apply a fixed set of financial criteria that would trigger an assessment. Ofgem has set out a number of areas within the consultation that it would consider as indicating financial instability for suppliers, namely:

- outstanding payments to industry parties;
- outstanding statutory demands;
- unusual or sharp price or direct debit changes.

We agree that the above criteria should be included, but note that Ofgem is not proposing implementing any new financial reporting requirements for suppliers which may have been a useful source of indicators of financial instability. In the absence of this we would also suggest Ofgem should consider the following areas:

- new short term fund raising where a supplier has a Charge registered against it at Companies House;
- inorganic growth for example via acquisition of significant new customer base (for example, increase of greater than 15%);
- indications from industry parties of insufficient collateral being posted to cover future obligations.

We note Ofgem is not proposing to proceed with milestone assessments where a supplier deviates from the business plan and growth strategy submitted at entry. While we continue to believe this is a trigger that could potentially indicate that a supplier is growing in an uncontrolled manner, we agree that it could be challenging to operationalise and believe that the proposed milestone checks based on customer numbers and indicators of financial difficulty should be sufficient.

<u>Milestone assessment checks</u>

Ofgem is proposing that the assessment it undertakes at each milestone trigger is similar to that completed for new entrants to assess operational capability and growth plans. We think the criteria Ofgem uses in these checks remain appropriate for these new milestone checks, namely that the supplier:

- has the appropriate resources to support the increased customer numbers;
- understands their regulatory obligations and has appropriate plans in place to meet these.

As we have noted above, we believe taking this approach will ensure that these checks will not be onerous for growing recent entrants to the market as they will have been familiar with the requirements through the entry process.

Actions by Ofgem where a supplier fails a milestone assessment

We agree that it is appropriate that a supplier should not be allowed to grow beyond a customer number threshold before it passes the required milestone assessment and that the responsibility to notify Ofgem should lie with the supplier. We also think it is appropriate that Ofgem places restrictions on supplier actions where a supplier fails a milestone check undertaken due to financial concerns. We do not think that there should be a fixed set of actions that Ofgem could take in this case, but agree that it could include placing limits on the supplier's ability to alter existing payment collection patterns including asking for additional one off payments from customers. We also think it should include limiting a supplier gaining new customers.

Section 3: More responsible governance and increased accountability

ScottishPower comments on Ofgem's proposal for a new principles-based requirement for suppliers to be open and co-operative with Ofgem.

We note Ofgem's comment that most suppliers are already engaging with it in an open and co-operative manner, and that rules currently exist that support constructive engagement with the regulator regarding potential or actual consumer detriment, and that Ofgem's Enforcement Guidelines take account of the existence or lack of as factors in any enforcement activity. However, we recognise Ofgem's justification in proposing this new requirement is that, in some cases, suppliers have not always displayed such behaviours.

We have some concerns however regarding the proposed drafting of the licence conditions within annex 1 of the consultation, namely:

- In paragraph 1.1 we wonder whether "constructive" would be a more appropriate adjective than "cooperative" to describe the behaviour required of suppliers. "Constructive" implies working together towards a common goal (consumer protection), which feels absent with "cooperative".

- Paragraph 1.2 requires that "The licensee must disclose to the Authority appropriately anything relating to the licensee of which the Authority would reasonably expect notice" While we note the intent within the consultation document that this requirement would be implemented on a proportionate basis, we do not think that this is reflected in the licence drafting, which requires a supplier to make a subjective assessment of what Ofgem would expect notice of.

Question 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, you believe suppliers should assess in conducting checks?

Yes, we agree with Ofgem's proposal to implement an ongoing fit and proper requirement. We also agree that it should be suppliers rather than Ofgem who undertake this assessment, however that Ofgem can request this information from suppliers.

The factors that Ofgem believes suppliers should use to assess fit and proper status are set out in the draft licence conditions in Annex 1 of the consultation document which also cover which individuals and roles would fall under the requirement to be fit and proper.

We have a number of comments on the draft licence conditions, specifically around ensuring that the requirements are implemented in a proportionate and balanced matter, capturing only the key senior managers within licensees, and taking account of matters where significant impact on consumers or the market have resulted from the actions of an individual.

Definition of "relevant matters"

We generally agree with the matters set out in paragraph 1.4 regarding the "relevant matters" which suppliers must have regard to in assessing fit and proper status and agree that this list should not be limited to only those points.

We do however have some concerns regarding the proposal set out in paragraph (e) which suggests that suppliers should have regard to any compliance activity an individual has been involved in as well as any enforcement activity when assessing fit and proper status. We think that Ofgem should limit this only to enforcement activity. Our reasoning is that Ofgem undertakes regular proactive compliance activity (ie where there is not an indication of non-compliance) as well as reactive activity, and in any event, where there is significant detriment to consumers or the market, Ofgem would most likely move the engagement from the compliance to enforcement stage. We therefore think it would be more proportionate to limit this to only enforcement engagement.

Definition of "Significant Managerial Responsibility or Influence"

We think there is a risk that the definition of "Significant Managerial Responsibility or Influence" could be interpreted as including a very broad range of employees and that different suppliers could take significantly different interpretations of this We therefore think it may be appropriate for Ofgem to provide more detailed guidance alongside this definition to ensure consistent application of the licence condition.

Definition of "periodic" assessment

While we agree with Ofgem's proposal not to set out a defined timescale for the periodic assessment, we wonder whether there may be merit in suggesting the typical interval that Ofgem would expect between assessments.

Section 4: Increased market oversight

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?

We disagree with Ofgem's proposal to require all suppliers to maintain a living will and publish certain aspects ('Option 3') and think that if Ofgem decides to proceed with living wills a risk-based requirement ('Option 2') would be more proportionate.

Whilst we understand that it is difficult to estimate the costs until the contents of the living will are better defined, we believe the costs (in terms of staff time and professional fees) could be very significant for larger suppliers, absorbing large amounts of senior management time, for little consumer benefit. Larger suppliers will have significantly greater complexity in their

arrangements, more onerous internal governance. The probability of most suppliers becoming insolvent in a manner that would jeopardise the supplier of last resort process and impact consumers is very low, and in the case of large suppliers, the exit likely to be managed by via the special administration regime rather than the SoLR process.

Accordingly, we believe Ofgem should focus on Option 2, but should give further consideration to its contents and its likely effectiveness. In our response to the May working paper, we suggested that a living will would be most effective as part of the risk-based reporting framework with Ofgem requiring living wills of suppliers where it has evidence that a supplier has been acting irresponsibly and unsustainably and therefore there is a reasonable risk the SoLR process could be compromised if the supplier became insolvent.

However, on further consideration of the proposals, and speaking to our operational team who managed our own process of acting as Supplier of Last Resort for Extra Energy customers, we are not convinced that the living will proposal will deliver the benefits Ofgem suggests it will. In particular, we would note that:

- Where a supplier is at risk of failing, the maintenance of a living will is likely to have dropped down the priority list for that supplier and therefore there will be a significant risk that the living will is out of date and does not result in a more orderly failure than if the will had not existed.

- Ofgem suggest in the consultation document and impact assessment that the living will would set out arrangements that would ensure continuity of services by key service providers. We are not convinced that it is practicable for suppliers to negotiate in advance with key suppliers how their services would continue to be provided, and believe this may be best left to the insolvency administrator or SoLR to negotiate when the time arises.

Ofgem should also consider whether there are alternative options that may be more effective, such as working with third party industry organisations regarding better access to industry data to complement and help validate data from the failed supplier. For example, the Data Communications Company, Xoserve and Elexon could potentially play a bigger role in supporting appointed SoLRs in sourcing accurate data for the customers of the failed supplier. We believe that this approach may be more effective and proportionate in supporting an orderly exit for suppliers than requiring some or all suppliers to produce and maintain a living will.

If Ofgem is to proceed with this requirement we would note that the proposed timescales for implementation of one to two months would not be sufficient without placing significant constraints on suppliers. While we think the maintenance of a living will should be relatively light touch from a resource perspective, but to produce the initial living will in the proposed timescales would require key operational resource to be taken from our business as usual processes and this would place significant operational constraints on us. We believe an implementation period of around six months would be more realistic, and would note that during this period, if a supplier were to fail, there would likely be part of a living will in place that would support a more orderly exit from the market.

We also note that Ofgem intends requiring suppliers to publish their living will with the aim of improving market confidence. We think the idea of public disclosure may be borrowed from the PRA proposals for financial firms, where issues of consumer trust are of far greater consequence. In the case of energy supply it will add significant cost for minimal consumer benefit. We would suggest as an alternative that Ofgem should have the powers to request

that suppliers provide their living will to Ofgem, with Ofgem then able to take action against the supplier if it believes that the living will is not sufficient. That should give sufficient confidence to the market, particularly if it sees Ofgem taking action where suppliers are not meeting their obligations in this area.

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

We agree with Ofgem's proposals to introduce a new requirement to enable it to compel suppliers to undertake an independent audit of financial accounts and customer service systems and processes, and that the audit would be undertaken by an external auditor.

We note within the main consultation document that Ofgem intends that the requirement would be implemented in a proportionate manner and would only be used where there were significant concerns about a supplier's financial resilience or customer service arrangements. We agree with this, but note that the drafting of the proposed licence conditions appears significantly broader than this and could introduce the potential for Ofgem to require audits simply to test supplier compliance of an obligation even were no concerns around the supplier actions exist.

While we accept that it is not Ofgem's intention to do this, we believe the licence drafting should be refined to ensure that the circumstances that Ofgem could trigger this new power are limited to those situations set out in the consultation document.

Section 5: Exit arrangements

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

Requirement to include debt recovery actions in supplier terms and conditions

We are supportive of this proposal assuming that the changes are not considered to be a negative variation to supplier terms and conditions given it is simply formalising within the customer contract existing activities which will apply to customers in particular circumstances. Assuming this is the case, then there should be little impact to suppliers in implementing this as customer terms and conditions will be updated on a phased basis with no obligation to proactively notify customers.

We would however note that where an administrator of a failed supplier is intent on following poor practice in its debt recovery, we are not convinced that it will take any notice of the terms and conditions within the customer's contract. However if the changes would result in any administrator taking a more appropriate approach to debt recovery then we are supportive of the proposed changes.

Requirement for SoLRs to honour commitments made in their SoLR submission

We note that Ofgem has included licence drafting in annex 1 relating to an obligation to require suppliers appointed as SoLRs to take all reasonable steps to honour any commitment made during the SoLR selection process including but not limited to having appropriate resources for and planning for customer on-boarding, maintaining or improving customer service standards and communication plans for immediate deployment on acquisition of the SoLR customers.

We note however that Ofgem has not provided any detail within the consultation document of the views of stakeholders on this point within its engagement since the initial proposals were published in the May working paper, or any reasoning on why it considers this licence conditions to be required.

In our response to Ofgem's May working paper, we raised some concerns with the proposals to introduce additional obligations on appointed SoLRs over and above the existing obligations notably Standards of Conduct. We noted that, as recognised by Ofgem, consumer experience is significantly impacted by the quality of customer information from the failed supplier and the quality of this information is often unknown until the SoLR has been appointed and starts to engage with the administrator. We highlighted that requiring additional undertakings and/or enforcing SoLR bid commitments is likely to dissuade many suppliers coming forward to be considered as a SoLR given that the SoLR performance is heavily dependent on the quality of customer information received and this is typically unknown when applications are sought to become the SoLR. We accept that the 'all reasonable steps' wording may partially allay such concerns, but we believe Ofgem should continue to give consideration to these concerns.

Question 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 options? Are there any potential difficulties you can foresee?

Yes, we believe there is merit in considering further the potential actions in relation to portfolio splitting or trade sales.

In relation to portfolio splitting, while we think there are potential benefits of splitting a failed supplier's portfolio across two or more suppliers, these benefits will need to be weighed against the potential consumer impact (for example in relation to risks of poor data quality or confusion over which supplier they have transferred to), and the costs of any required industry changes to support such a process.

ScottishPower
December 2019