

Orderly market entry, market stability and orderly market exit.

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Abstract

This paper forms our response to key elements identified within 'Ofgem's Statutory Consultation – Supplier Licensing Review: Ongoing requirements and exit arrangements'.

CNG (Group) Limited¹ welcomes the opportunity to participate in this consultation and acknowledges the need to address certain areas of disorder within the industry. CNG does not feel that this consultation goes far enough in acknowledging and understanding the broad divergences between the domestic and non-domestic sectors. We feel that, if implemented in its current guise, a number of the proposals within this consultation will ultimately lead to non-domestic participants having no option but to divert disproportionate levels of resource to address issues which are not prominent within the non-domestic sector. The provision of Customer Supply Continuity Plans (CSCPs), evidencing our compliance with the Financial Responsibility Principle, notifying Ofgem of system changes, accommodating external audits and a number of increases in oversight of internal governance arrangements could individually or cumulatively overwhelm smaller suppliers and divert limited resources from delivering against real customer needs and expectations.

Outside of extraordinary circumstances linked to the global COVID-19 pandemic, the non-domestic sector has seen minimal levels of disorder in comparison with that of the domestic market. The numerous instances of disorderly market exit within the domestic market have consequently had an adverse reputational impact on the industry as a whole, whilst leading to an increase in unforeseen costs upon mutualisation that are ultimately borne by the consumer.

We believe that keeping the consumer at the centre of the sector's efforts to deliver competitive pricing and excellent customer service requires us all to acknowledge that 'one size does not always fit all', and that recognising, understanding and adjusting to the nuances of each market sub-sector best serves the consumer and all market participants.

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1. Orderly Market Entry

Ofgem's mandate to enable competition and innovation in order to drive down prices and deliver new products and services for consumers has enabled an increase in supplier participants within the energy industry. In July 2017, in an open letter titled: *Future supply market arrangements – response to our call for evidence*, Ofgem proposed to develop and implement fundamental reform at pace, with focus on three priority areas: (1) improving customer access to data, (2) reducing code complexity, and (3) assisting innovators to enter the market and test propositions.

Whilst the influx of 'challenger brands' may have provided more innovation, choice and competition for consumers, previous barriers to entry may have been lowered to a degree that has resulted in some suppliers entering the market with inadequate capital and insufficient knowledge to survive in a challenging and complex industry. This has ultimately resulted in turbulence, and led to increased instances of market exit, particularly in the last 2 years, where over 25% of those exiting the industry have done so in a disorderly manner (energyscanner, 2020), leaving hundreds of thousands of customers with varying degrees of disruption.

1.1 Cost Mutualisation Protections

We agree that action is needed to reduce the risk of ongoing mutualisation of costs borne out of supplier failure. The proposed 'Financial Responsibility Principle' suggests that suppliers are expected to share an appropriate level of risk and that Ofgem expects suppliers to be able to provide on request, plans and supporting evidence e.g. cash flows projections, budgets, guarantees or proof of investments.

We would need to understand in more detail how this level of appropriate risk will be measured, particularly as a supplier's customer portfolio grows or shrinks in line with demand. New entrants to the market may not have the required revenues in their early months and

years of operation to bear an appropriate amount of risk, so would they be required to evidence an enhanced level of funding in comparison to an established supplier?

In terms of credit balances, we would recommend more focus on accurate billing, and that tackling an overall reduction in credit balances would be more beneficial than suppliers tying up cash in trusts or escrow. This would enable suppliers to utilise that funding to continue to enhance infrastructure, to continue to compete and grow.

With regards to mutualisation of Supplier of Last Resort (SoLR) costs, you could argue that the SoLR (who is ultimately benefiting from an enhanced portfolio) could bear some of these costs, with a view to recovering these through increased revenue streams.

We would also like to highlight that whilst Ofgem is seeking to reduce the impact of mutualisation of disorderly supplier exit costs, they are currently consulting on an enabler for networks to mutualise all bad debt via suppliers. We find initiatives like this out of step with the goals and spirit of this Standard Licence Conditions (SLC) review. Why should networks be protected from risk whilst suppliers are expected to take on more risk?

1.2 Operational Capability Principle

We agree that any business should operate within its own capabilities and acknowledge the importance of effective operational and financial risk management. Application of any such principle should be proportionate, acknowledging supplier size and circumstances. Whilst attempting to raise standards by monitoring and measuring poor performers, could the regulator do more to nurture and support newer less experienced entrants to the industry, thus ensuring that they have appropriate levels of resource and knowledge to secure a stable foothold in the market? In the financial services sector, the Financial Conduct Authority (FCA), via the New Bank Start Up Unit, provides potential entrants with information and

guidance and the fundamentals of market entry, from pre-application right through to achieving market maturity.

Whilst there may be a definitive requirement for an increased level of financial stability within the domestic market, we feel that segments must be assessed in different ways. Non-domestic suppliers have a greater exposure to non-recoverable bad debt as businesses are more likely to bankrupt in comparison with domestic consumers. Instances of demand destruction are also more likely in the non-domestic sector as suppliers are further exposed to fluctuations and volatility of consumption.

We support proposals that when making changes to practices, processes or systems suppliers should notify Ofgem and look to ensure they have appropriate risk and data management systems and processes in place to manage customer types and volumes.

We would consider it best practice when undertaking such developments to instigate various risk reduction measures such as: rollback plans, incremental transition to new systems, the use of simulations and pilots in test environments, or even the parallel running of new and existing systems. However, such practices again need to be proportionate to the level of risk and this will vary between suppliers. The challenge to maintain or enhance operational capabilities, to the consumer's ultimate benefit, whilst also needing to incorporate external changes resulting from regulatory requirements with a limited pool of resources, gives little respite – especially within the COVID-19 context – and could perversely lead to increased risk to services.

Since February 2020, CNG has registered a total of 296 contacts relating to regulatory change from a range of code bodies which we are required to work with. This is a significant challenge for a business of CNG's size, but for smaller businesses, just tracking and impact assessing this scale of activity, even before attempting to respond effectively, could be overwhelming.

We recommend that the requirement to notify Ofgem on system changes is limited to major transformations where there is a significant risk of customer impact. This would reduce the burden on suppliers and the

likelihood that Ofgem itself is inundated with notifications to review, thus rendering them nugatory. That expected mitigation measures be proportionate to customer volumes, supplier resources, and the potential risk impact in each case.

2. Market Stability

It is clear that more stability is required within the market for suppliers and consumers alike.

The industry as a whole, in trying to implement simple goals to enhance customer outcomes, has been led to endless regulatory reform, with disproportionate levels of complexity and effort being spent on the minutia rather than on delivering a simple and effective offering to consumers.

Suppliers are currently working through a number of technical and labour intensive initiatives (Smart Metering, Faster Switching etc.) whilst also being held accountable for delivering on government policy, decarbonation strategy, and increasing non-commodity costs, along with the additional ongoing complexities relating to COVID-19.

Suppliers are therefore unable to allocate the necessary level of focus and resource to providing the basics to consumers. Conversely, Ofgem have applied pressure in other areas, placing complex obligations on suppliers, which ultimately drives up consumer costs whilst also impacting service levels.

KPMG Nunwood research indicated that utilities remain one of the lowest performing sectors for customer experience excellence (CEE) and that utilities' CEE performance actually declined 5% during 2017, remaining 6% below UK average across a range of industries (KPMG Nunwood, 2017).

2.1 Ongoing 'Fit and Proper' Requirement

Whilst understanding the employment history of key decision makers should play a part in the licencing process, we feel that Ofgem should take a more active role in the application procedure. Ofgem could have a more open dialogue with new entrants to understand past issues/challenges.

An individual may be brought into a business to turn around operations, which may then be impacted by other external factors, e.g. COVID-19, and the business may subsequently go under. This business failure cannot be the sole factor in determining whether an individual is fit and proper to play a key role within the industry.

When considering cause and effect, the attribution of accountability may be complex, and this would need to be acknowledged and reflected in any proposed regulation.

What evidence has Ofgem collated to show that such a requirement would be effective in the industry? How will this help reduce the potential for customer harm?

We recommend that the 'fit and proper' requirement is assessed on broader evidence than business failure, is not applied retrospectively, and that individuals have a right to reply through open dialogue in the case of potential intervention.

2.2 Principle to be open and cooperative with the regulator.

We believe that all industry participants have a duty to be open and cooperative with the regulator, this being ultimately beneficial to all participants.

We believe it to be fundamental that if suppliers are required to be open and cooperative, that Ofgem must be proactive in engaging with issues as and when they are made aware, and take prompt action to prevent the situation from escalating.

2.3 Customer Supply Continuity Plans

We support the desire to minimise disruption to consumers when suppliers fail, and CSCPs may have a role to play in supporting this objective; but data is only useful if it is accurate, engagement is timely, and ultimately if intervention is swift.

If the intention is for sufficiently regular data to be provided as to be effective in all cases of supplier failure then the systems challenge for smaller suppliers may be onerous. If the intention is for ad hoc demands to be made where there is growing concern, how will

Ofgem procure this information if a supplier is in or nearing failure?

What will be the repercussions of a supplier not providing this information in such circumstances?

2.4 Independent Audits

The proposed amendments concerning independent external audits appear reasonable, if used in a fair and targeted manner. We believe that suppliers should be given the opportunity to evidence their own operational checks and balances prior to external intervention, and where a robust system of internal audits can provide evidence this should in many cases mitigate the need for Ofgem to deploy this power.

Costs and operational impacts of audit activity should be justified, proportionate and not unduly burdensome, though where operational issues have been acute or persistent we agree that it is in the supplier's own interest to engage positively with an external party for their own benefit and the benefit of their customers.

When the nature of the external audit is to scrutinise financial aspects, where businesses have current financial audit requirements (i.e. statutory audits), there is the risk of duplication, and this should be avoided wherever possible. Any external audits mandated should be as specific and narrow in scope as possible.

We recommend that where a business can demonstrate robust internal audit capabilities, these are given the opportunity to investigate areas of concern in advance of mandating an external audit, and where the subject of concern is financial, that statutory audit results or the outputs of existing RFIs are relied upon wherever possible.

3. Orderly Market Exit

We must surely all agree that the promotion of orderly market exits when these are required should be a priority for all participants. Does Ofgem feel it has done enough in the past to reduce the level of customer disruption in the event of supplier failure, and do the proposed steps in this review encourage orderly market exit?

There have been instances where Ofgem has been slow to react when customer volumes are small, deeming customer harm as low impacting. It is our assertion that no customer should be disadvantaged based on their choice of supplier. Customer harm is customer harm regardless of the impact to the supplier.

We recommend that in the case of impending supplier market exit, all efforts are made to treat suppliers equally – protecting all customers consistently.

3.1 SoLR Portfolio Splitting

The potential option to enable the portfolio of a failing supplier to be split and assigned to multiple SoLRs, which could be realised in the context of the Central Switching Service, is a principle that we support.

This could potentially enable more effective division and allocation of accounts e.g. the non-domestic customer book of a domestic/non-domestic supplier to a specialist non-domestic SoLR, or the simple division of a large portfolio so as to diversify any risks.

Conclusion

Overall, CNG is supportive of the intention of regulatory intervention. We believe that the lowering of entry barriers has resulted in a number of suppliers entering the market with insufficient knowledge and capital to survive in a complex regulated environment with low margins and high volatility. However, we want to draw attention to the significant differences between the domestic and non-domestic markets and the need to adjust requirements to the nuances of each market sub-sector to best serve the consumer and all market participants.

In addition to those recommendations made above, we specifically recommend:

1. That the consideration of portfolio splitting be the default for all large or mixed domestic/non-domestic portfolios entering a SoLR arrangement.

2. That the frequency and mechanism for collecting Customer Supply Continuity Plans be considered carefully to balance the systems and resource impact on suppliers against the necessity for accurate and timely reporting lest the plans be of little practical value in the case of supplier failure.
3. Whilst not specifically included within the scope of this consultation, that the proposed enabler for networks to mutualise all bad debt via suppliers be reconsidered, and that costs be spread more fairly across all market participants, including networks.
4. That Ofgem engages with suppliers to understand the breadth of requirements and changes that are currently being placed upon them, and how they impact their particular customers, so as to be more cognisant of the cumulative burden and competing priorities.

We encourage Ofgem to consult directly with non-domestic participants of all sizes to ensure that, rather than providing effective reform and enhancing customer outcomes, the proposed changes do not create new issues for business suppliers and consumers alike.

References

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