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Ofgem

By Email

29th July 2016

Dear Sirs

Consultation: Proposed approach to dealing with supplier insolvency and its consequences for consumers.

We write in response to the above consultation and welcome the opportunity to provide comment.

Q1) Do you agree with the approach to SOLR and energy administration set out in our revised guidance?

Q2) Do you agree with our preferred approach (option 1 – no further action, i.e. case by case use of SoLR powers to protect consumer credit balances).

We do not agree with either (i) the approach to SOLR as set out in the revised guidance or (ii) Ofgem's preferred approach as outlined in the consultation document.

It is our view that the consultation and the proposed revised guidance contain a misinterpretation of Ofgem's ability to use the SOLR process to protect consumers from financial loss. As a result of this, the consultation puts forward an option which is not available for use as its 'minded to' position.

In addition we consider the proposed solution (putting aside Ofgem's ability to effect it under existing legislation), is entirely inappropriate as it will only encourage an expansion in the use of 'Advanced Payment Models' by new entrants and hence further extend the number of consumers whose credit balances are at risk.

In our response, below we have provided our views on the following:

1. the basis for our belief that the proposed revised guidance contains a misinterpretation of Ofgem's ability to use the SOLR process to protect consumers from financial loss;
2. why we feel Ofgem's proposed solution would encourage expansion in the use of 'Advanced Payment Models' and extend the value and number of consumer credit balances at risk;
3. our view on the alternative options offered in the consultation.

1) Misinterpretation of Ofgem’s ability to use the SOLR process

The consultation states, “Our existing SOLR powers can be used to give some protection to consumers’ credit balances in the event of a supplier’s failure”. We do not consider that this is the case.

A customer who is transferred to a new supplier following a Supplier of Last Resort order is supplied by the new supplier under a deemed contract. There is no legal relationship between the old supply contract and the new deemed contract, and there is no legal basis under which a transfer of debt from the old supplier to the new supplier could take place automatically or be directed by Ofgem. Any payments made by the new supplier to the customer in relation to debt, would be *ex-gratia* payments. As they are not linked to the costs incurred by the new supplier in supplying electricity / gas to the consumer they could not, under SLC 9.4, be recoverable via a levy on network charges (as proposed in the consultation document).

Consequently, we consider that under Ofgem’s existing SoLR powers it could not approve a claim under the industry levy to cover *ex-gratia* payments made by the new supplier to the transferred customer.

2) Risk of expansion in the use of ‘Advanced Payment Models’ and how this would extend the value and number of consumer credit balances at risk

Impact on Consumers

The last few years have seen a rise in the number of independent domestic suppliers using what we would refer to as an ‘Advanced Payment Model’ (‘APM’) to finance growth. Under this model, the new supplier takes advanced payments from new customers and/or encourages its customers to not withdraw credit balances. In one case, a supplier offers interest payments on lodged credit balances as if it were a bank.

Using the Advanced Payment Model, a new or growing independent supplier can quickly take on many thousands of customers by offering a low (and loss making) tariff on a switching website. The funds received from consumers can be used to fund the supplier’s losses and allow it to expand despite its poor financial standing.

The concerning issue with this model is that consumers are providing funding for a very risky venture yet they are not informed enough to understand the risk they are taking with their funds and they are not rewarded for taking this risk on.

Other forms of finance are not available to the Advanced Payment Model supplier, or are prohibitively expensive, because the risks being undertaken by the finance provider to support the growth are huge. The only people who would fund such a model would have to be ignorant of the risks or not sophisticated enough to understand them – in this case, customers. Here we consider

that by allowing this model to continue, and in fact ‘institutionalising’ it by building legislation around it, Ofgem’s proposed solution fails to protect consumers.

The Advance Payment Model (‘APM’) produces the wrong incentives for the supplier and the industry as a whole. If an APM supplier runs into difficulties its sole source of funding is to take on more APM customers. To do that it must have the cheapest (and inevitably loss making) customers that will produce cash. But this only produces more difficulties, at which point the supplier again needs more money. A normal business in difficulties at this point would slow growth and make sure it sold its products at a profit in order to return to a sustainable position. No such break applies in this case. Instead a vicious circle of loss making growth ensues. The APM supplier has an inverse incentive to continue growing and continue placing more and more consumer deposits at risk.

Impact on the Industry

We also do not consider that Ofgem’s proposed solution (putting aside its ability to effect it under existing legislation) would meet with the requirement to promote competition in a way which is fair and non-discriminatory.

If some suppliers are reliant on customer credit balances as a source of working capital, and if that is required to be underpinned by the availability of levy funding to repay those balances if the supplier fails, then those suppliers cannot be paying the true risk value of that capital. On the contrary, it must be their competitors who are bearing the risk of failure, because they will be required to make good the balances if the supplier becomes insolvent. The levy is borne first by the remaining suppliers left in the market, and while some of it may be passed on to consumers, it is inevitable that not all of it can or will be.

Subject to the overriding objective of consumer protection, Ofgem is required to promote competition where it is appropriate to do so. However, if it is to do so consistently with the requirements of law, that competition must proceed on a basis which is both fair and non-discriminatory. If some suppliers were able to use consumers’ cash as a source of cheap working capital only because other suppliers were ultimately standing behind the risk, that would, in our opinion, fail to meet these requirements.

There are instances that can be pointed to in other sectors where the industry provides some form of mutualisation. But these schemes are always accompanied by some form of limiting factor.

Ofgem references the Financial Services Compensation Scheme under which compensation for deposit losses are funded by a levy provided by the deposit takers. But to be part of the scheme an organisation must first meet certain financial standing tests before it can take deposits.

What Ofgem proposes in the consultation is an FSCS-type scheme funded by suppliers, but with no checks or balances on the viability of a proposed entrant to the scheme or on the growth of the new entrant. As well as promoting loss making expansion which places consumer deposits at risk, this proposal also places risk on other industry mutualisation schemes. By encouraging the growth of non creditworthy suppliers, Ofgem increases the likelihood and scale of losses mutualised under the

Renewable Obligation, the DCUSA and CUSC. This could in turn lead to the failure of other suppliers, and continued contagion.

3) Alternative options offered in the consultation

On the basis that we consider the 'minded to' position both legally challenging to implement and (in our view) inappropriate, we do not find that there has been a full enough review of the alternative options. On this basis, it is our view that a second consultation process should be implemented to better review the alternative options.

We consider that this second consultation should focus on seeking way to:

- Put in place an effective mechanism to limit suppliers' ability to take advanced payments from consumers and/or limit the supplier's ability to use those funds to support risky, financially unviable growth strategies;
- Find ways to make consumers aware that their funds may currently be at risk.

In summary, we do not agree with either (i) the approach to SOLR as set out in the revised guidance or (ii) Ofgem's preferred approach as outlined in the consultation document.

If you would like to discuss this further please feel free to contact me.

Yours faithfully,

Gemma Newsham
Regulations Director