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

By email to: licensing@ofgem.gov.uk

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Dear Vlada and James

Supplier Licensing Review: Ongoing requirements and exit arrangements

Shell Energy Retail Limited (**SERL**) welcomes the opportunity to respond to this consultation.

We strongly supported July's New Entrant package, and it is right Ofgem also introduces financial responsibility rules for existing suppliers.

At present GB's regulatory regime has a unique combination of factors which together create the moral hazard we see in the market today. These are (i) no solvency requirements (ii) the ability for retailers to take significant customer money upfront without in some way protecting it (iii) full protection of customer credit balances in case of insolvency, with customers effectively indemnified by the industry via Ofgem's safety net (whether by the SoLR itself, claims against the industry levy or both) and (iv) the mutualisation across industry of Government scheme costs.

Together the above allows an irresponsible supplier to fund their operations not through equity or bank financing - the norm across most markets we have evaluated, nor through have in place appropriate risk management policies, but rather through customer credit balances or by avoiding meeting their legal obligation towards Government schemes. These suppliers take more risks because they are gambling with other people's money.

This has a significant impact on competition. £160m of mutualisation costs occurred in 2018/9, around £90m of which were ROCs, £4m FiTs and £60m industry credit balances[1]. Responsible suppliers effectively lose twice. First, by losing customers to rivals who are pricing below cost because they are defaulting on their green taxes - we estimate such suppliers are enjoying a c. £130 per customer pricing advantage[2], plus another £50 advantage from being above the small supplier threshold for ECO, Warm Home Discount and the smart rollout obligations; and second by paying the cost of mutualisation as a result of these defaults.

As set out in our response to Q1, SERL therefore supports much of the package proposed but with two important caveats.

First, any package must target as a priority the non-payment of scheme costs, given this is both the clearest case of moral hazard and also the highest mutualised cost. From the start of the next ROC compliance year, Ofgem should put in place measures to ensure that suppliers must meet their Renewable Obligation as it accrues throughout the compliance year, as we set out in Q1 below.

Second, further consultation is needed regarding the proposed treatment of credit balances. We very much welcome proposals to limit excessive supplier practices. However, more detail is needed as to how Ofgem arrived at the 50% figure and what this might mean in practice - it is unclear how Ofgem

[1] *New RO buy-out price confirmed amid expectations of mutualisation for a second year,* Cornwall Insight**,** 27th February 2019

[2] £160m mutualisation cost / 1.2 m customers of the 2018/19 supplier failures

proposes to calculate customer balances i.e. including unbilled or not, how often this will be reviewed (seasonality), how Ofgem intends suppliers to report and how they will audit the reporting. Further, the 0.5% financing cost seems low. We would also welcome Ofgem considering the impact on different business models of moving to a different financing model; or whether alternative means to ensure solvency might be better required instead.

Alongside this Ofgem should consult on a "Living Will" which should aim not only to smooth the SoLR process but to prevent one happening in the first place. This regular document should demonstrate a supplier has sufficient risk management measures in place to avoid calling on the Last Resort Levy or any other form of mutualisation.

We therefore welcome this first policy consultation but believe a further consultation is now needed.

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?

Shell strongly supports Ofgem's policy intention with this package.

We agree that changes are needed to ensure suppliers are solvent and financially responsible in order to ensure a better customer experience; reduce the cost of mutualisation; and to stop mutualisation occurring in the first place by removing the most material aspects of "moral hazard" have facilitated irresponsible business models.

We therefore agree with Ofgem that wide-ranging changes are needed, and likewise support the bulk of proposals in this consultation, including:

- **Ensuring that scheme costs are paid - although we feel strongly the goal here must be ensuring that 100% of all scheme costs, as with any taxes, are paid in full, rather than protecting "a proportion" as currently worded in the consultation**. We note the bulk of mutualisation costs thus far have related to ROCs. Changing the payment terms from annually to monthly via legislation or, in lieu of that, ensuring that suppliers are regularly accruing towards their ROCs, would therefore be highly effective at reducing the likelihood and cost of mutualisation.

  From the start of the next ROC compliance year, Ofgem should put in place measures to ensure that suppliers are either setting aside cash or ROCS under some form of escrow arrangement or providing a bank or corporate guarantee as their Renewable Obligation accrued throughout the year. We would prefer that funds sit outside the organisation (e.g. via escrow arrangement or a bond) so it can be drawn down to address the specific liability should the company be put into administration, so avoiding the need to mutualise. Any changes should be brought in at the start of the ROC compliance year. We believe Ofgem must progress these changes even in the absence of Government legislation.

- **Establishing supplier customer growth milestones** at which point Ofgem should have the right to request an audit of systems and operations to ensure they are fit for purpose, which will discuss more below.

- **Targeted one-off assessments, and independent audits, where warning signs suggest a supplier may be in difficulty or behaving irresponsibility.** These could include a spike in complaints; unilateral change of customer payment terms, or where a supplier consistently offers tariffs below gross margin, which would imply they are not able to cover the cost of energy without recourse to their own funds (in which case that is their decision to make) or their customers' credit balances (in which case Ofgem should intervene).

- **Introducing an ongoing "Fit and proper" requirement for directors, which could also be extended to ensure suppliers maintain certain internal policies,** such as requiring suppliers to demonstrate that they have the appropriate controls/ expertise in place to manage the commodity price risk that comes with offering a fixed price tariff, perhaps as part of a "Living Will" as set out below.

- **Introducing a "Living Will"** to improve the transfer of customer data during a SoLR event but, most importantly, to demonstrate on a regular basis that each supplier has both sufficient solvency and the appropriate risk frameworks needed to avoid requiring the Last Resort Levy or other mutualisation.

- **Limit the excessive and irresponsible use of customer credit balances to fund working capital: However: greater clarity and further consultation is required regarding the level and cost of credit balances to be protected.** Based on our current understanding of Ofgem's proposals (based on its impact assessment) we consider that requiring suppliers to protect 50% of credit balances may be too high and our current preference is that Ofgem should introduce a more focussed intervention aimed at limiting excessive practices, such as limiting the amount of customer cash taken upfront.

We therefore strongly believe further policy consultation is needed.

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

The impact assessment states that there are two market failures that Ofgem is seeking to address.

We agree with the first market failure of moral hazard. We do not agree that adverse selection is a market failure: this is a regulatory failure as customers know that their credit balances will be protected in the event of supplier failure by Ofgem as part of its safety net. If this was left entirely to the market, customer credit balances would be at risk, as is the case in the Netherlands and Germany and customers would consider this in deciding which supplier to sign up to.

In terms of solutions, more detail is needed to interrogate these proposals.

In the next consultation we would welcome a fuller break-down of the assumptions used by Ofgem on both the credit balances under protection and the accompanying cost of finance.

Our main concern with Ofgem's impact assessment is that it is not clear how Ofgem would expect a supplier to calculate credit balances against which to set a level of protection.

Based on Ofgem's calculations, we understand that for its impact assessment Ofgem has assumed that the relevant level of credit balances is £56.14, and that 50% of this is £28.07. it is not clear how this was calculated or how it relates to the £130 figure on credit balances from Ofgem's 2016 calculations[3] or the 2018 RFI referenced at the recent supplier workshop in November. This suggests that Ofgem expects that suppliers would be required to hold a level of protection of £28.07 per customers over the entire year. This would be significantly higher than the level of protection required prior to 2001 which was set at about £4.90 per customer and would be disproportionate during periods when credit balances are low or negative.

It would also be helpful to understand in more detail how the £12,400,000 baseline for residual cost to consumers from the Supplier of Last Resource breaks down into credit balances and policy costs. Based on our understanding of the impact assessment we understand that 75% of these costs are made up of policy costs, but it is not clear which policy costs (i.e. is 50% of this made up of the RO or

[3] Energy industry makes progress in returning money after domestic customers change suppliers, Ofgem Press Release, December 2016, Link

otherwise?), and 25% of these costs are made up of customer credit balances. Further clarity on this breakdown would be beneficial to ensure that any intervention is effectively targeted and proportionate.

In addition:

- Can Ofgem provide details of the average annual and monthly credit balances held as per the October 2018 RFI referenced?

- Are these credit balances calculated gross or net of unbilled consumption?

- Are they based on peaks from the end of October or an average across the year? Indeed, it would be good to understand how Ofgem would calculate any ongoing obligation on suppliers to protect balances given the impact of seasonality, weather, growth and prudent measures to help manage bad debt risk; we expect live based on last month end would be the easiest option here, but would still be out of date

- It would also be useful to understand how Ofgem sees the amount of credit balances evolving in the future in a world of smart meters (where we could perhaps expect lower credit balances due to an end to estimated reads) but also of electric vehicles and electric heat (where balances could be significantly higher)

Likewise we would welcome more detail on the presumed cost of financing or insurance cover as the levels indicated do not seem to be commensurate with the level of risk that a finance provider or insurer would be exposed to. Indeed, we note recent SoLR submissions have implied a much higher cost of finance (in excess of 10%) to cover the cost of working capital finance and our own experience of obtaining bank guarantees in lieu of industry cash collateral suggests a much higher cost than 0.5%.

As per our answer in Q3, we suggest Ofgem hires an expert consultancy to evaluate fully the range of potential costs different business models could face: the goal should be for this policy to drive out - but only to drive out - fundamentally insolvent and irresponsible suppliers.

It is important to stress that a higher cost of financing does not mean all action should be ruled out - on the contrary, policy changes are needed to prevent the excessive and irresponsible use of customer credit balances. But we feel more detail is needed from Ofgem here, as if, for example, the average cost of financing for suppliers is 4% then the costs associated with the proposed policy would increase from £4 million per annum to £32 million.

We would also welcome Ofgem considering the impact of alternative proposals, such as:

- banning suppliers from taking more than one month's prepayment upfront without full protection;
- requiring suppliers to protect only excessive credit balances - a judgement over which we would welcome further consultation; and
- requiring suppliers to provide an Annual Certificate of Adequacy as part of a "Living Will" to check solvency.

As a final note, the Impact Assessment does not model competitive effects on today's market, which is loss-making across all supplier sizes and models. Poorly capitalised and managed suppliers may be driving down the price to unsustainable levels across the market, which could eventually cause solvent and responsible suppliers to exit, ultimately reducing competition and innovation for consumer and undermining consumer faith in the market.

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

Ofgem should hire an expert consultancy to model the cost of finance for suppliers of different sizes and business models.

4: Do you agree with the assumptions used to calculate the costs and benefits in our impact assessment?

We do not agree - please see our answer to Q2.

5. Do you agree with our proposed option to cost mutualisation protections? Are there other methods of implementing this proposed option?

We do not agree. Whilst supporting the intent of this proposal, as stated in Q1, we cannot support the proposal to protect 50% of credit balances until greater clarity is provided on the level of balances to be protected, the realistic cost of finance and impact of this proposal on industry.

We would welcome further clarity and consultation on this.

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 agree that milestone assessments at 50,000, 150,000 and 250,000 unique customer accounts seems appropriate, given at these points suppliers take on new obligations which require system and operational changes. However, we also note that an aggressive acquisition tariff could see a supplier rapidly push through these milestones: it would be good to understand whether Ofgem would expect suppliers to hold off on further acquisitions until each milestone has been passed, and the process for reporting (which could take some months).

We also support further assessments as suppliers scale between 500,000 and 800,000 customer accounts, given at this point system upgrades are often required; and suppliers are likely to take on new challenges from Homemove through to more significant bad debt.

We also further agree that targeted, risk-based reporting should be triggered where suppliers are:

- consistently selling below cost and where there is inadequate capitalisation, putting customer credit balances at risk;
- are late publishing their accounts or have extended their accounting period or changed their accounting period to give themselves extra time to file, or have otherwise clear examples of aggressive accounting;
- see a material deterioration in customer service;
- are not refunding customers' credit balances or have unilaterally amended payment terms; and
- have seen rapid growth.

Should any of the above occur, Ofgem could ask for an updated Business Plan which should demonstrate the supplier has the appropriate controls/ expertise in place to improve their customer service and, when offering below cost tariffs, to hedge their fixed price tariffs. In the latter case Ofgem should also request a liquidity / funding cash flow forecast.

If suppliers are unable to satisfy Ofgem or, for significant and material concerns, an independent auditor that their business represents a going concern, there must then be risk-based consequences.

For example: if a business has low levels of equity, is unhedged and is offering below cost tariffs, Ofgem must be ready to ban those tariffs if the retailer does not have the cash reserves to fund these.

In the case a business cannot pay its green levies, Ofgem must be prepared to rapidly revoke a licence: the longer a failing business continues to trade, the higher the eventual cost of their insolvency. and the worse the impact on their customers and customers of other suppliers.

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?

We support an ongoing "fit and proper" requirement to cover directors, which should dovetail with the disqualification regime for directors and new entrant requirements introduced by Ofgem in July.

We also agree with Ofgem that suppliers should self-certify and be ready to provide regular evidence to Ofgem as they do so.

We would welcome Ofgem also consulting on whether the "fit and proper" requirements should be extended from directors to policies, i.e. ensuring suppliers have in place certain risk management policies. We think that of particular importance will be Ofgem being able to understand whether suppliers have in place the appropriate controls/ expertise in place to manage the commodity price risk that comes with offering a fixed price tariff, perhaps as part of a "Living Will".

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 support the concept of a "Living Will", although we note details remain unclear for how Ofgem sees this working in practice, or what exactly Ofgem expects it to contain.

We agree a standalone document of the kind proposed by Ofgem could enhance the customer experience of a SoLR by supporting a cleaner migration of customer details, credit balances and the debt book to the gaining supplier. Items the "Living Will" could usefully contain would include a supplier's external systems provider, key contacts (internally and externally, e.g. at their Shipper), key staff, and their Priority Service Register where this is possible within the constraints of GDPR.

However, our priority for any "Living Will" is not simply to smooth the process of a SoLR but prevent one happening in the first place. We would welcome Ofgem consultation on an obligation on suppliers to demonstrate they have sufficient risk management measures in place to avoid calling on the Last Resort Levy, which should include disclosing regularly some sort of solvency or liquidity metric. We would urge Ofgem to consult early and fully on options here.

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

We agree that in certain instances, independent verification of a suppliers financing and operational systems has merit, please see our answer to Q6 which goes into further detail.

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?

We support Ofgem's proposal that suppliers should insert into their customer contracts clauses that commit an Administrator to behave in a certain way with regard to debt recovery. The use of explicit contract terms could help override company law/insolvency obligations in order to give a better customer experience.

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?

Trade Sales

We strongly agree that the regulatory regime should not allow transactions where there is a high likelihood that other suppliers and ultimately their customers will need to bear the costs 'left behind' by the gaining supplier as per the recent Solarplicity / Toto Deal. We also have grave concerns about the type of pre-pack SoLR deal we have seen where the purchase of a company's physical assets, personnel etc has been explicitly tied to winning the customer book in a SoLR, i.e. gaining the entire company and customer book but avoiding all the financial liabilities. Ofgem should explicitly ban any approaches which seek to divorce assets from liabilities tied to the SoLR process.

Portfolio Splitting

Yes, there is merit in exploring ways to split portfolios that go through a SoLR event, as this would likely increase the number of bids, thereby likely reducing the need to call on the Levy and therefore costs for consumers, and enhance the customer experience, by allowing specialist retailers to take on different customer groups.

Ofgem will need to carefully consider whether and how portfolios would be split including consumer type (Domestic, Microbusiness, SME, Industrial & Commercial) or meter type (credit, prepayment, smart, export). We propose any portfolio splitting is limited to a split between Domestic and Non-Domestic only, given the risk of customer confusion if a domestic book was split between multiple retailers. An exception could perhaps be needed for a large SoLR (which would anyone go through the Special Administration regime).

In order to allow portfolio splitting, we anticipate changes to Ofgem's direction-making power would be needed, as well as changes to the industry identification processes, and to the bid process, with potentially more time to consider joint bids, or a system for separate bids to be compared.

Finally, we note any changes here could impact the role of the administrator in negotiating with more than one supplier, which may mean that for very small customer bases, the costs could outweigh the benefits. The ability to split rather than the requirement to do so could perhaps enable Ofgem to consider these issues prior to indicating via the RFI if a portfolio split can be proposed or is being contemplated as part of the SoLR process.

We look forward to working with you on these proposals and in particular, to having the chance to consider in more details the further detail on the options explored in the consultation. In the meantime, if you have any questions or would like to discuss any of the above, please do let us know.

Yours sincerely

[not signed]

Natasha Hobday
Policy and Regulation Director

APPENDIX

Examples from previous or other regulatory regimes

An initial desktop analysis suggests GB's regulatory regime has a unique combination of regulations which together create the moral hazard we see in the market today. These are (i) no solvency requirements (ii) the ability for retailers to take significant customer money upfront without in some way protecting it (iii) full protection of customer credit balances in case of insolvency, with customers effectively indemnified by the industry via Ofgem's safety net (whether by the SoLR itself, claims against the industry levy or both) and (iv) the mutualisation across industry of Government scheme costs.

Together this allows an irresponsible supplier to fund their operations not through equity or bank financing - the norm across most markets we have evaluated - but through customer credit balances without having appropriate risk management policies in place.

Below we set out by way of example alternative arrangements, which fall into the following buckets: (i) solvency (ii) protecting credit balances (iii) banning risky tariffs unless there is clear evidence these are financially backed (iv) risk-based insurance pools (v) buyer-beware.

A. Solvency Requirements
Great Britain

Until 2001, suppliers were *"required by licence to take out and maintain security cover in order to provide adequate payment in the event that a SoLR is appointed to take over their customers."*[4]

Types of Cover allowed included:

- a bond from an insurance company;
- a standby letter of credit from a City of London branch of a bank;
- a cash deposit; or
- a bond from the licensee's ultimate holding company (providing it has credit
- rating of not less than AA- (Standard and Poor's long term) or AA1 (Moody's
- long term)).

The cover was set by the Regulator based on an annual analysis of:

- what a SoLR could charge customers under its deemed contract; and
- the likely market conditions (i.e. if spot prices would be higher than any deemed contract could allow without hardship)

The level of protection that suppliers were required to provide at that time was equivalent to £4.90 per customer.

The SoLR levy would then only be used *"if the value of the bond is not sufficient to cover any or all of the otherwise unrecoverable costs of the SoLR"*.[5]

Ofgem noted that no supplier's security cover had ever been used and argued it was therefore an excessive cost on the industry - despite costing industry just £1m in the year 2000, or £1.6m in inflation-adjusted prices.

[4] Supplier of Last Resort - Guidance on current arrangements, Ofgem, March 2011, Link
[5] Supplier of Last Resort - Guidance on current arrangements, Ofgem, March 2011, Link

Ofgem therefore removed this requirement in 2001, because *"the need for a SoLR seems quite low.."*[6]

In the UK, proof of solvency is still required by industries with similar insurance schemes, such as the ATOL package holiday protection scheme[7] or the Financial Services Compensation Scheme[8] . .

USA

12 of the 14 states surveyed require ongoing proof of financial solvency[9] - usually a bond or Letter of Credit. This includes Texas, seen as one of the most competitive energy markets in the world (with 109 suppliers as of September 2016, and 92% of consumers having switched at least once)

Australia

Australia's National Energy Retail Law[10] requires applicants to prove they have "*the capacity and resources to enter the energy retail market"* and evaluates operational capability; financial resources and the suitability of key staff. In addition, once a licence is awarded, the Australian Energy Market Operator (AEMO) also *"undertakes ongoing prudential assessments of energy retailers to ensure they have sufficient financial capacity to operate in the energy wholesale markets."*

B. Credit Balance Protection

Texas

In Texas, in addition to solvency requirements, Retail Energy Providers (REPs) must fully protect 100% of both customer deposits and residential advance payments

REPS are required to 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 Public Utilities Commission of Texas (PUCT), covering 100% of both customer deposits and residential advance payments held at the close of each month.

Should the REP fail, customers will be repaid their deposit and advance payment monies within seven days from the escrow account.

Where an irrevocable stand-by letter of credit is used, it must permit the commission's executive director or the designee to draw it down

We note that Texas is seen as one of the most competitive retail power markets in the world, with 109 suppliers as of September 2016, and 92% of consumers having switched at least once.

Singapore

Retailers must also safeguard all security deposits collected from household consumers and return them to these household consumers should a retailer exit the market.[11]

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6 Consideration of responses to the consultation document: Supplier of Last Resort – security cover and levies, September 2001, Ofgem, Link

7 Civil Aviation Authority Website: ATOL Protection, Link

8 Financial Services Compensation Scheme Funding Handbook, Link

9 Summary of Financial Assurance Requirements by State, State of New York Public Services Commission, April 2018, Link

10 Retailer Authorisation Guidance 2014, Australian Energy Regulator, Link

11 Speech by Senior Parliamentary Secretary for Ministry for Trade and Industry and Foreign Affairs, March 2019, Link

C. Tariff Checks or Hedging Requirements
Singapore

In addition to protecting credit balances, retailers in Singapore's Open Electricity Market are required to consistently hedge at least 50% of their wholesale electricity price risk[12]

In addition, retailers need the explicit agreement of the regulator to take payment in advance: "*A Licensee shall not, without the prior written consent of the Authority, offer to sell to a residential consumer, or enter into with a residential consumer, any contract which involves prepayment by a consumer for the supply of unconsumed electricity service"*[13]

Netherlands

Retailers required to submit tariffs to the regulator (the ACM) for approval 4 weeks before launch date to check they are "reasonable", although, to our knowledge, this has mostly been used to evaluate excess prices rather than to check hedging.

D. Risk Based Insurance Pools

In the holiday industry, SoLR type arrangements are run via an insurance pool, with the most risky operators required to pay more money into the scheme, see Link

Below we copy the criteria used:

Financial criteria

Your latest set of accounts will need to demonstrate as a minimum:

- *Issued share capital of £30k*
- *Net asset surplus of £30k*
- *Net recoverable current asset surplus of 4% of total principal turnover.*

If you have been trading for more than three years, your business is profitable, with stable trading and no change of ownership, then the normal bond uplift of 50% for new Members may be reduced or removed and the following criteria can apply.*

Bonding, insurance premium and financial failure insurance

*The minimum bond rate is 15% but may increase subject to an analysis of your terms of trade and booking pattern. If you have been trading for more than three years, have no change of ownership, can show profitability and business strength a minimum bond of 10% can apply.**

For travel businesses who have a high concentration of turnover within a short timeframe (for example winter sports tour operator) we may require an additional bond to cover the peak period.

*You will also be required to pay a principal shortfall insurance premium of 40.6p per £1,000 of bonded turnover minimum £350 plus IPT***. The insurance scheme will be used to pay claims in the event that the bond is deficient in any way.*

[12] Speech by Senior Parliamentary Secretary for Ministry for Trade and Industry and Foreign Affairs, March 2019, Link

[13] Singapore Retail Energy Licence 2018, Link

If you do not fulfil our standard financial criteria you can opt to financially protect by financial failure insurance and or by any other acceptable method (e.g. under an ATOL or with ABTOT) that fully protects consumers.

E. "Buyer Beware"

In the Netherlands and Germany, customer credit balances are not protected in the event of supplier failure, creating "buyer beware" where customers more closely scrutinise the retailers they are signing up to in case they lose their money.

For example, when Robin Energie went bankrupt earlier this year, the Dutch ACM warned that: *"Consumers will not be left without electricity or gas. However, when an energy supplier goes bankrupt, consumers may be affected financially."*[14]

[14] ACM Press Release, February 2019, Link