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Dear Vlada and James

Supplier Licensing Review Consultation: Ongoing requirements and exit arrangements

This response represents the views of SSE Group ("SSE"), which includes our Business Energy[1] supply business together with our networks and generation businesses. Please note that our domestic retail business[2] is currently being held separately for sale and it will be submitting its own response.

SSE welcomes the proposed new framework...

We welcome the steps that are being taken by Ofgem to address the impact of supplier failure. Over the course of 2018 and 2019 we have become increasingly concerned regarding the extent of default that has occurred; the impact that this has had on the rest of the industry; and, ultimately, on consumers. The vast sum of defaulted payments, across a range of regulated schemes, has undoubtedly put additional pressure on those still operating in the industry. We consider that mutualisation of costs has exacerbated the problem by creating a snowball effect on smaller suppliers, who may be unable to withstand the additional cost pressure. This snowball effect will continue to be observed, and unfair outcomes for customers experienced, until something decisive is done by Ofgem and/or by BEIS.

...but more could be done in the interim period

We recognise that the licence changes proposed by Ofgem will take time to be fully implemented and there may be a lag in seeing the desired outcome in practice. Meantime the issue continues to be a very much a real and present danger to the industry.

We would urge Ofgem to consider what further action could be taken in the meantime under its existing powers. For example, Ofgem has access to a range of market monitoring information, along with widely drafted information request powers. We would encourage Ofgem to take action as early as possible when encountering evidence that a supplier is financially struggling. For example, the breach of a code credit requirement or non-payment of a bill relating to a regulatory obligation should prompt Ofgem to require suppliers to provide evidence of their ability to meet their other regulatory obligations, even where these payments do not fall due for several months (such as the RO). In the case of the RO, which is

[1] SSE Energy Supply Limited
[2] SSE Electricity Limited and Southern Electric Gas Limited (together "SSE Energy Services")

clearly a substantial contributor to the mutualisation costs in question, Ofgem could issue a Provisional, or indeed a Final Order, to a struggling supplier at any point in the Scheme Year when faced with evidence that the supplier is likely to contravene its obligation to pay. Section 25 of the Electricity Act provides such Orders "as is requisite" if it appears to Ofgem that the supplier is "likely to contravene" an obligation. Therefore, actual failure to pay is not a prerequisite to Ofgem taking action.

Accordingly, we believe that Ofgem already has the power, in cases where there is evidence that a supplier is likely to fail, to require that supplier to guarantee payment through a credit or similar facility in order to secure compliance with its obligations. Whilst we appreciate that this suggestion would require Ofgem to dedicate additional resource to this issue, we would expect that such additional resources would be required anyway in relation to the proposed new framework. We are suggesting that Ofgem accelerate the timetable to put in place such new monitoring and compliance processes/staff and that these should be dedicated to actively monitoring and taking action under Ofgem's existing powers, whilst waiting for the proposed new licence framework to take effect.

In addition, there are alternative approaches that could be considered

As we set out in our detailed response below, SSE also considers that alternative approaches would warrant consideration by Ofgem as part of this review, specifically in respect of the Renewables Obligation. For example, we believe that, as a viable alternative to posting credit, suppliers should be given the opportunity to redeem held ROCs against their obligation earlier in the scheme year period as part of, or in lieu of, an alternative payment guarantee method. We think this approach is attractive as it should represent a cheaper alternative overall. For example, a letter of credit would represent an additional overhead for suppliers, whereas suppliers should theoretically be purchasing ROCs throughout the period to meet their obligation. Therefore, the early redemption of ROCs should not incur additional expense for suppliers. For this reason, we believe that 100% of a supplier's obligation as regards the RO should be guaranteed in this way.

We would welcome the opportunity to discuss our response in more detail on a bilateral basis.

Kind regards,

Lesley Halliday

Regulation - SSE Group

Annex - Response to Ofgem's Consultation Questions

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?

In general, we agree that Ofgem's proposed package will facilitate the earlier identification of potential supplier financial failure and enable Ofgem to take action to minimise the market and consumer impacts associated with a disorderly exit. However, as noted in our introductory comments, we also believe that immediate action on this issue is required. The benefits that will be delivered by the proposed reforms will necessarily be subject to a time lag, as Ofgem is bound to follow the necessary modification processes required. In addition, we would expect that it will take a while for the requirements to "bed in" before the benefits are realised in practice. For this reason, we urge Ofgem to take stronger interim steps in the shorter term in order to protect the market from the destabilising effects of continued disorderly market exits. We consider that immediate action is possible under Ofgem's current suite of powers. This could take the form of the following:

- **The establishment of a dedicated unit focused on monitoring supplier health**, with a specific focus on identifying where a supplier may default on a regulatory obligation to pay (or enhancement of such a unit, where it already exists). This unit would utilise Ofgem's existing information gathering powers and access to market intelligence to identify likely failure as early as possible. This would allow Ofgem to take targeted action against failing suppliers;
- **The introduction of a new quarterly recurring Information Request to all suppliers**, requiring information relating to financial health – this does not require to be onerous but could, for example, include questions similar to that asked in SOLR Information Requests together with details regarding how the supplier is ensuring it can meet its financial obligations, e.g. as regards the RO;
- **Greater use of targeted information requests** - i.e. where Ofgem has identified evidence that a specific supplier is likely to be struggling to meet its obligations, then more detailed information could be requested through Ofgem's enforcement powers;
- **Establishment of regular information sharing processes between Ofgem and Code Administrators/ Ofgem and DNOs** to ensure Ofgem is fully aware of any credit defaults or any other credit risk issues that may have been identified. This could simply be the provision of a named contact or inbox to the various industry bodies that are submitting invoices to suppliers (and/or managing processes relating to the posting of credit) together with a request that Ofgem is kept regularly updated regarding any defaults that have occurred;
- **The enhancement of Ofgem's existing compliance and enforcement team** to ensure that it is properly equipped to undertake additional enforcement actions where it has been identified that a supplier is likely to contravene their obligations;
- **Increased transparency for the industry regarding how Ofgem is utilising its powers in practice.** This should also include information regarding sums that Ofgem has been

able to recover, e.g. through Ofgem's claims in the administration processes of failed suppliers.

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

We generally agree with the conclusions of the impact assessment, except as regards Living Wills. We have provided specific comments against two aspects below:

Promoting more responsible risk management

We would note that Ofgem has assumed that the cost of mutualisation falls with consumers. However, we would point out that not all costs are capable of being passed through. This depends on supplier's contracting arrangements and, for domestic, the extent to which the cap enables these costs to be reflected in their entirety. Accordingly, a relevant factor is not only the cost of mutualisation to consumers but also the cost to suppliers. This may be relevant to suppliers' continuing ability to finance their activities in the market. The impact of these additional costs, which by their nature may not always be easily forecasted, and which may not be fully recoverable from customers, is that additional financial pressure is experienced by suppliers in already difficult market conditions. We do note, however, that the cost of providing the cost mutualisation protections may similarly be a concern for some suppliers. However, we would expect that the price cap for domestic suppliers could be amended to take account of these costs going forward and, given the modelled benefit to customers overall, we think that Ofgem's proposed policy still represents a better option than the current position.

We agree with Ofgem's comments as regards poor supplier behaviour as a result of moral hazard. As regards Ofgem's comment on risky hedging, from our own observations it is hard to confirm that risky hedging has pushed suppliers to use cash reserved for obligations (namely RO) to buy energy, though we agree this could be a contributor. We believe that the funding of supplier operations where suppliers are growing at speed, combined with unrealistic tariff launches that are priced below cost have particularly encouraged suppliers towards the behaviour identified This is also supported by Ofgem's next set of data on Continuous rapid growth without adequate resourcing can contribute to failure. However, regardless of the reason, we strongly agree with Ofgem that suppliers have been inappropriately utilising cash that should have been reserved for obligations.

Increased Market Oversight

On Living Wills we do not agree that the benefits set out will be achieved in practice:

- Whilst better data is important to improve the SOLR process, we believe that this would be better achieved through alternative measures. We do not consider that the requirement to produce a Living Will of itself will consequently improve availability of information upon supplier failure. The supplier will not be providing the required level of information in a Living Will and will have no incentive at failure to provide this information simple because a Living Will says that they will. Once insolvent, and in a SOLR scenario, the exiting supplier cannot be relied upon to take any further steps that would assist the appointed SOLR.

- On competition, there is no evidence provided as to the positive effect on market confidence or the availability of more competitive deals from service providers. We do not agree that these expected benefits will be observed in practice.
- Similarly, we do not agree that the existence of a Living Will would bear any impact on investment in supplier obligations such as ECO or that there will be increased confidence from those that engage contracts with suppliers. Ofgem has offered no evidence to support this ambitious expectation.
- Ofgem expects the Living Will to be a "one off" investment of cost and resource from suppliers. This cannot be correct if Ofgem anticipates that Living Wills to continue to be relevant on an ongoing basis. It will not be possible to future-proof Living Wills - the circumstances of a business will evolve over time and for a Living Will to remain relevant then it will require to be regularly adapted in order to respond to these changes. If the Living Wills policy were to be implemented, we would expect this to represent an ongoing cost to suppliers.

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

Please see Confidential Annex, which outlines that SSE's proposal to include the redemption of ROCs as an option for mutualisation protection is cheaper overall.

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.

This is covered in our response to Question 2 above.

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.

Subject to our further comments below, we agree with Ofgem's proposed introduction of arrangements to protect a minimum of 50% of their domestic customer credit balances and scheme obligations.

Credit Options

We agree that a range of options should be made available to suppliers regarding how they should guarantee payments, however any method that may be made available must be capable of being relied upon in the event of supplier default. We note, for example, that Ofgem recently reported that Nabuh and Breeze were both able to persuade Ofgem of their ability to pay through assurances that later turned out to be unreliable. There is no detail as to what form these assurances took in practice, however clearly those methods were insufficient. Any payment guarantee used must be capable of being called upon and utilised against a supplier's obligations in the event of a default scenario. We believe that parent company guarantees; insurance; letter of credit or other third-party guarantee; or suitably robust escrow arrangements could all be suitable.

Scheme Obligations

In relation to Scheme Costs, we are of the view that 100% should be covered. A responsible supplier should be collecting sums against their scheme obligations over the course of the

course of the scheme year in order to have the cash available to either purchase and redeem the required number of ROCs or else make payment to the buy-out fund. It should therefore be uncontroversial to increase the sums to be secured. To our point below, we would expect that the credit requirement would increase in value from 0% to 100% over the course of the year to reflect the increasing value of the obligation and the sums being collected against that obligation.

In respect of the RO obligation in particular, we consider that an alternative suitable option would be to offer suppliers the opportunity to redeem ROCs earlier in the year as part of, or in fully in lieu of, another form of credit for this aspect of the sums requiring to be guaranteed. Many suppliers have in place arrangements to purchase ROCs over the course of the year. Clearly this represents a cost to carry as these ROCs are not technically required until the 1 September. If suppliers require to carry the cost of ROCs and also, for example, purchase a letter of credit, then this would increase the compliance cost beyond what should be necessary. If Ofgem accepted evidence of redeemed ROCs against a supplier's credit requirement then this should reduce the overall cost to the supplier. We are assuming that Ofgem's systems are capable, or can be made capable, of redeeming ROCs against a supplier's obligation at any point in the Scheme Year.

Structure of Credit Requirement

It is not clear when Ofgem intends the obligation to make a payment guarantee crystalise in practice. Would this be a stepped requirement, or is Ofgem intending suppliers make available the full 50% at the beginning of the year or some other specific date? As noted above, for the RO, we believe that the credit requirement should increase over the course of the year to mirror when these payments would be collected by suppliers in practice. This same point applies to other government schemes.

The position relating to credit balances would appear to lend itself more towards establishing a set point in the year at which the full credit requirement will fall due. We note that these will fluctuate over the course of the year. It is not clear in the consultation how Ofgem suggests these fluctuations be accounted for in practice. However, we would suggest that an average over the year would be the simplest approach, acknowledging that this average may account for more than 50% of credit balances at certain points of the year, and less than 50% at other times. An annual mechanism to set the level of credit required for credit balances will obviously be required to be created as part of the further policy design.

Ringfencing of credits

In relation to payment guarantees, we are not clear who the beneficiary is intended to be in practice. Every PCG and third-party guarantee will have both a guarantor and a beneficiary who will be the party guaranteed in the event of supplier default. It is important that these securities are drafted in a way to avoid any proceeds being considered part of the failed supplier's general estate. For example, the supplier itself should not be the named beneficiary. A similar point applies to Escrow Accounts. We consider that, in the absence of an appointed industry administrator for these purposes, Ofgem should be named as the beneficiary. However, specialist legal advice should be sought by Ofgem as to the enforceability of this. As regards credit balances, the sums recovered by Ofgem under this process could then be passed to the SOLR that is appointed, for ultimate re-distribution back to customers. The sums

relating to government schemes would be applied against the failed supplier's obligations by Ofgem.

Credit Default

In the workshop of 26th November, a number of suppliers posed the question as to what would happen if a supplier could not put in place the required guarantees. Our view on this is that, where faced with such a failure, Ofgem should prevent the defaulting supplier from taking on any new customers. This action should be taken without delay. The supplier should be provided a clear (short) timetable within which a suitable guarantee or other suitable measure must be put in place. If the supplier is still unable to comply with the requirement then we would ultimately take the view that the supplier is not fit to operate and that Ofgem should take steps to revoke its licence and appoint a SOLR.

Compliance reporting

In order for Ofgem to ensure adequate oversight of supplier's continuing compliance with this requirement, we would suggest that this provision is accompanied by a regular reporting requirement in order that Ofgem maintains an up-to-date view of how suppliers are continuing to comply with their guarantee requirements in practice.

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?

Yes - we think this is a sensible policy. We have no strong opinion on the last milestone, as to whether this should be closer to 500k customers or 800k customers. Anywhere within this range would seem reasonable. We agree that unique customer accounts may be appropriate, rather than meter points – however we note that for most other regulatory reporting purposes and RFIs, it has been meter points that SSE Business Energy has reported rather than customer numbers. Therefore, Ofgem should be aware there may be discrepancies in customer numbers, depending on what source of information is being referred to.

We consider that the potential for additional milestone checks, outside of the set milestones, will be of particular importance in order that Ofgem may investigate signs of supplier difficulty promptly. A supplier failure could very likely occur between milestone checks. Signs of supplier difficulty might include:

- Failure to pay invoices on time;
- Customer service failings;
- Customer complaints relating to the return of credit balances or excessively high direct debit requests;
- Below cost tariffs repeatedly being offered in the market

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. In addition, we think Ofgem should consider an explicit requirement to ensure relevant senior managers take full responsibility for understanding and delivering on their regulatory

obligations. This would include ensuring that compliance reporting/frameworks are in place so that senior managers have visibility of regulatory performance and compliance issues that may be arising. The energy supply market is complex and highly regulated. We are concerned that some new entrants may be entering the market without adequate understanding of their regulatory obligations. In terms of conducting checks, a confirmatory statement from the senior manager that an appropriate compliance framework has been put in place and that he or she has processes to ensure that there is adequate oversight should be sufficient in the first instance. Ofgem can request further detail regarding the framework where it has encountered specific concerns.

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 are unconvinced that living wills will deliver benefits over and above those already secured under Ofgem's other proposals. Our primary concern is whether these would be enforceable in an insolvency situation, which is realistically the scenario where a disorderly exit is most likely to happen. Neither the consultation nor the impact assessment provides adequate detail to explain how this policy would work in a practice to protect customers during an insolvency scenario. We therefore do not agree this proposal should be progressed any further. We think Ofgem's time and effort would be better spent on the remaining proposals. This is primarily because the administrative burden and cost associated with maintaining a living will does not appear to be proportionate when considering the likely benefits such a policy is capable of delivering in practice.

We are aware that the concept of a Living Will has been actively explored in the context of financial services for large banking and investment institutions, however we do not believe that there is enough regulatory experience at this stage in order to draw analogies across to the energy industry. The impact of failure in respect of large banks could have ramifications for the global economies – however the risks associated with the failure of an energy supply company do not compare. As these are likely to be onerous requirements, we do not believe there is justification to pursue a regulatory intervention of this nature unless Ofgem has clear evidence that such an intervention would bring significant benefits.

We would therefore suggest that Ofgem waits until the other measures have been implemented and been given an opportunity to address the problems identified before re-considering the introduction of Living Wills. If Ofgem judges that the other measures are not enough and that Living Wills are also required, then Living Wills could be re-examined in more detail as a stand-alone policy intervention, rather than being tacked on to other proposals relating to supplier health.

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

Yes, however we are concerned regarding the potential for scope creep. The licence conditions need to set out a strict test for when an independent audit may be required by Ofgem. The criteria set out in para. 4.19 of Ofgem's consultation seem reasonable, but the cost of the audit may be an issue for smaller suppliers, particularly those who are already financially struggling. We note that Ofgem would expect suppliers to bear the cost of any audit to be conducted. For this reason, we believe that a pre-requisite for any audit should be that Ofgem does not possess the technical expertise to conduct the audit itself. In addition,

suppliers should be consulted on the Terms of Reference for the Audit and Ofgem should be obliged to take any comments into consideration. As independent Audits can be expensive, it is important to try to keep these as focused as possible to avoid escalating costs.

We agree suppliers should be able to select the most cost-effective option so long as the auditor is suitably independent and qualified. If the auditor is being brought in because specific technical expertise is required, then it is obviously important to demonstrate that the auditor selected has the requisite level of experience in order to fulfil the requirement as technical expert.

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?

Yes.

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?

We agree Ofgem should seek to look at ways to facilitate portfolio splitting in a SOLR scenario. SSE may wish to bid for business energy customers in a SOLR, but we are shortly due to exit the domestic market. Without a portfolio splitting option, we would not be able to offer to become SOLR for those suppliers with mixed portfolios.

On trade sales, we agree with Ofgem that some trade sales that have taken place in the past have resulted in poor outcomes for customers and the wider industry. We agree that Ofgem should look for ways to better protect customers in this space, for example, by preventing the transfer of customers in scenarios where the corresponding liabilities associated with those customers, e.g. Environmental Scheme costs, are not also transferred.

Question 12. Do you think our draft supply licence conditions reflect policy intent?

Operational Capability

We note that the DNOs have a similar requirement in their licence (SLC 30). It may be worth borrowing the requirements and processes that are already in place for DNOs.

Independent Audits

The licence conditions relating to independent audits are not drafted to reflect the intent outlined in the consultation. The proposed condition provides Ofgem with wide discretion as regards the use of independent audits, whereas Ofgem has stated that it intends that audits should only be necessary in limited circumstances. These circumstances have been strictly defined in the consultation, but this is not reflected in the draft condition. The drafting of this licence condition should therefore be reviewed to ensure that independent audits are only required where a strict test has been met. Please see our response to Question 9 for further commentary on this issue.

Duty to cooperate

On duty to cooperate, we also consider that this has been drafted too widely. In section 1.2, Ofgem requires suppliers to disclose anything to Ofgem that "the Authority would reasonably expect notice". In the policy consultation, Ofgem notes that it should be notified of matters

that could cause detriment to customers or the market. The drafting in the proposed licence condition is therefore much wider than would appear to be intended, requiring suppliers to notify (or self-report) to Ofgem issues where there is no detriment, or likely detriment, to consumers or to the market. Further it is unclear as to what Ofgem would reasonably expect notice of – this is a very open-ended and subjective requirement, which would require suppliers to make a judgement call of what they think might interest Ofgem. Each supplier may take a different approach to assessing this, which would lead to uneven implementation. It could also result in Ofgem being inundated with issues, many of which may be immaterial. That would only serve to distract Ofgem from the important issues where real market detriment is being caused.

Mutualisation

We note that there is no drafting associated with the proposed credit arrangements. We would encourage Ofgem to make draft licence conditions on this topic available for comment as soon as possible, prior to these being consulted on in a Statutory Consultation.