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By email to Licensing@ofgem.gov.uk

Statutory Consultation – Supplier Licensing Review: Ongoing requirements and exit arrangements

Summary

Shell Energy Retail Limited (SERL) welcomes the next stage of Ofgem's supplier licencing review. We have long been concerned that: (1) a lack of solvency requirements, (2) the ability to take unlimited customer cash upfront without in some way ringfencing it, and (3) the ability to default on government debts such as ROCs, which are then mutualised; have together allowed irresponsible suppliers to fund their day to day operations not through equity or bank financing, but through their own customers' credit balances OR through failing to accrue sufficiently for government schemes.

SERL therefore welcomes Ofgem's proposed new financial responsibility principle. We ask, however, that it is implemented in the most transparent, predictable and robust means possible via:

(1) Ensuring ROCs are paid quarterly rather than annually - in line with all other schemes of lesser value such as FiTs (quarterly), Capacity Market (monthly) and CfDs (daily) - to avoid the excessive build-up of debt. Ahead of any such legislative change from Government, Ofgem should require monthly assured statements from financial directors that they are setting aside funding for industry schemes.

(2) New rules to limit the excessive use of customer credit balances; Upon entering a new contract, suppliers should be banned from taking payment before Supplier Start Date ("SSD"), and from taking more than one-month payment at SSD, unless they fully protect this extra credit taken.

(3) All supplies to provide an Annual Certificate of Adequacy, measured against clear, transparent metrics e.g. solvency ratios.

In Detail:
1. Financial Responsibility and 2. Operational Capability Principles

Society needs a domestic energy market that is fair; simple; protects the vulnerable; benefits all consumers and enables innovation. However, we believe the current domestic market is struggling to deliver this due to a combination of regulatory distortions which have grown up over time.

First, domestic suppliers have previously had no solvency requirements (and most suppliers in the market today entered without solvency checks): many of the most significant defaulting suppliers have had just a few pounds shareholder capital which, in our view, heightens both the risk and extent of default because it means a supplier must fund their day to day operations not through equity or bank financing, but through their own customers' credit balances.

Whilst the rules for new suppliers are welcome, we note a number of current suppliers have similar low levels of capitalisation, and urge Ofgem to evaluate these suppliers first against the proposed new financial responsibility principle, along with those (shippers and suppliers) seeking to obtain network deferrals.

Second, domestic suppliers can take unlimited amounts of customer money upfront to fund working capital without liability: instead, the entire industry underwrites lost credit balances via a

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mutualised levy. This is unusual: in other domestic retail markets we have evaluated, either suppliers are liable for protecting customer credit balances (such as in Texas, where 100% of balances are ring-fenced in escrow) or else customers lose their money when a supplier collapses (e.g. Netherlands and Germany - a policy we would not support but which also prevents moral hazard through “buyer beware”). In GB, it has been estimated that failed suppliers’ accumulated credit balances are three times those of other suppliers[1].

Third, a wide set of industry costs are mutualised when a domestic supplier collapses: not only lost credit balances but the Renewables Obligation (ROCs), Feed in Tariffs, the Capacity Market, Contracts for Difference and the Warm Home Discount. Indeed, even ombudsman fees for poor service are mutualised in case of supplier default. In practice, ROCs followed by credit balances make up the bulk of mutualised costs.

The combination of the above allows an irresponsible supplier to fund their day to day operations not through equity or bank financing, but through their own customers’ credit balances and through failing to accrue sufficiently for government taxes.

Such a model is ultimately unsustainable because:

- **The model depends on endless growth:** the first set of credit balances taken was used to not to buy gas and power, but to fund operations. This means the irresponsible supplier will need more credit balances from new customers to fund the energy for existing customers, encouraging loss-leading tariffs to get more cash into the business.

- **Many of these suppliers price their tariffs below cost (at negative Gross Margins)**: using the credit balances from new customers to fund the existing losses on energy supply.

- **Unhedged suppliers benefit from stable or declining wholesale prices;** however, given wholesale is at 11-year lows, this could soon reverse and suppliers will collapse (with customers paying)

- **Sudden or poorly accounted for costs could tip them over:** the annual £75 per customer Renewable Obligation payment has frequently pushed suppliers into insolvency.

Responsible suppliers must either lose money to retain customers (and write loss-making business), or lose customers to retain margin. We estimate irresponsible suppliers enjoy a c. £130 per customer pricing advantage[2] over responsible suppliers, plus another £50 advantage from being below the small supplier thresholds (see below), leaving responsible suppliers under water if they try and match these prices.

Indeed, in SERL’s view, the domestic energy industry is not on a path to profitability: 2019 was the first year in more than a decade where the industry as a whole was loss making and, in our view, 2020 domestic energy losses are on track to exceed 2019 losses, even before Covid-19, driven by acquisition pricing remaining below cost, combined with price caps limiting margins on existing customers. We note even the larger suppliers are now pricing below cost, driven not only to retain market share but to get cash into the business due a concern about unforecasted costs, above all mutualisation, appearing in short order. The structure of the market, with the majority of tariffs being either Price Capped variables or Fixed 1, 2 or 3 year contracts, leaves responsible suppliers exposed when unexpected costs arise; note there is no mutualisation allowance in the Default Tariff Cap and fixed tariff pricing cannot be adjusted during the term of the fixed price.

A negative margin situation across the entire industry due to the distortive effects of regulation is highly problematic; if larger non-incumbent suppliers cannot retain market share without being loss-making, there is a real risk that competition will contract: the wealthiest, not the most

[1] Unpublished research for shared with Ofgem, Cornwall Insight, July 2019

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

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innovative, will survive, and international companies could exit e.g. Engie and Vattenfall have already exited, as have RWE and SSE, and the remaining Local Authority businesses are also seeking to exit.

Furthermore, if larger non-incumbent suppliers cannot retain market share without being loss-making, funding for net zero will by necessity contract: SERL stands ready to support the decarbonisation of power, heat and transport but investment in propositions with long payback is difficult without underlying profitability.

As well as these distortionary market effects, responsible suppliers then lose again by paying the cost of mutualisation as others fail, or default on their obligations: Cornwall found that a fifth of suppliers offering the cheapest tariffs have exited the market[3]; Citizens Advice concluded that this was at a cost to other domestic consumers of £255 million[4].

SERL therefore welcomes the intent of <u>Ofgem's financial responsibility principle,</u> as it enables Ofgem to focus on the risk of disorderly exit BEFORE it happens, thereby reducing the risk and cost to consumers of such exits happening in the first place. We believe this "ex ante" approach will both better protect consumers from detriment and safeguard the sustainability of the industry.

In this respect<u>, we especially welcome the commitment of Ofgem to evaluate the business plans of those seeking network deferrals and those who have already obtained them</u>. We urge Ofgem to conduct such assessments swiftly, given that suppliers in financial distress already - irrespective of COVID - would otherwise have licence to run up significant additional debts, only for these to be mutualised should they fail. We are concerned that deferred charges become due in March 2021, a post-winter period when most suppliers will have negative cash flow even in the best of times, and where we expect the impact of COVID in terms of customer non or slow payment to be far more acute than it is today. There is a real risk that responsible smaller suppliers could themselves be pushed into SoLR due to the need to pay mutualised costs which Ofgem must take every care to guard against.

In general, we support Ofgem's proposal to conduct milestone assessment at 50,000 and 200,000 customer accounts for domestic suppliers, although in our view further assessments should be taken at 500,000 and 1 million domestic customers: to date we have not had a large supplier fail, and Ofgem should consider the likelihood, cost and impact of one that does - especially where the holding of excessive credit balances has been incentivised, given the high cost to the consumers of other suppliers of repaying those excessive credit balances should such suppliers later fail.

SERL likewise broadly supports the intent of "<u>Dynamic Assessments</u>" where warning signs are evidenced, such as for example poor customer service; missed industry payments or below cost tariffs where these are unfunded, or funded through credit balances, rather than by shareholders; and also of an overarching principle to have "**<u>Operational Capability".</u>** However, given these principles overlap / bring together existing licence conditions, it will be important for Ofgem to issue clear guidance to ensure suppliers understand how and when Ofgem may intervene under these new principles.

Ofgem should likewise seek to publish a notice whenever it is launching a "Dynamic Assessment", explaining who the party is and the reason in order to ensure transparency over this process.

However, in our view, the above responsibility principles are best met by clear, "ex ante" rules. For operational capability, these are already in the licence conditions. For financial responsibility, our view is that Ofgem should explicitly set out how ROCs and credit balances should be appropriately managed, supplemented with an Annual Statement of Supplier Adequacy. Taking these points in more detail:

[3] Cornwall Insight research, January 2020, top 10 cheapest tariffs; appeared in Energy Spectrum (no public link)

[4] ,*Failed energy suppliers cost consumers £255m since 2018, says Citizens Advice*, December 2019, Link

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First, industry schemes should be restructured to reduce the risk and cost of default, with ROCs the priority given they represent the bulk of policy costs and are paid annually (and 5-7 months after the end of the relevant supply period) vs quarterly (FiTs) or monthly (as per the Capacity Market), allowing excessive costs to accumulate.

Ofgem should continue to press the Government to amend the payment period for ROCs from annually to quarterly via simple changes to secondary legislation.

Alongside this - and ahead of any legislative change - Ofgem should require all suppliers to provide monthly signed accounts demonstrating they are setting aside money in anticipation of the various industry scheme payment dates, which should be assured by the supplier's Financial Director. This would have real teeth, as a Director could be struck off (and lose also their professional accountancy accreditation) if they knowingly produced inaccurate information. Whilst SERL supports the proposed Fit and Proper Test, in our view this proposal would institute more meaningful change.

Second, Ofgem should ban the excessive use of customer credit balances by preventing suppliers from taking more than a month upfront, unless this was fully protected. Pay as You Go, Quarterly Direct Debit, and Pay On Receipt of Bill markets all in our view have more rational pricing because there is no consumer credit balance to leverage in these markets vs. the Direct Debit market.

Third, Ofgem should audit the financial responsibility principle by asking suppliers to provide an annual Certificate of Adequacy, again assured by the Financial Director, against clear and comparable metrics such as solvency / liquidity ratios. Where suppliers fail to prove solvency on an annual basis or immediately when they fail to pay into an industry scheme, Ofgem should institute a formal "escalation" process, moving from enhanced monitoring through to tougher fines and licence suspension. It is important this process is rapid to prevent irresponsible suppliers continuing to incur increasing liabilities for the future. Any use of independent audits should be tied to an incomplete or inconsistent Certificate of Adequacy.

2. More responsible governance and increased accountability

SERL supports the proposed "Fit and Proper" requirement and agrees this should apply to all suppliers although, as discussed above, in our view Director Assurances in terms of solvency and the accrual towards industry schemes will be more important for forcing responsibility into the system.

With implementation of the FCA's new Senior Managers and Certification Regime (SMCR) – the equivalent of Ofgem's proposed fit and proper requirement – companies were given one year from entry (from 9 December 2019 to 9 December 2020) to establish the necessary internal systems and process and conduct their first round of fit and proper assessments (the 9 December 2020 transitional period was then subsequently extended to 31 March 2021).

Based on experience within the Shell group with the above, we consider that a one-year transitional period (i.e. the time provided to companies to conduct and complete their first fit and proper assessments) for Ofgem's "Fit and Proper" requirement will also be necessary to ensure and facilitate timely and compliant implementation.

In terms of the "Principle to be open and cooperative" with the regulator - SERL agrees that an open and constructive dialogue with the regulator is the mark of a well-run business, and we value SERL's relationship with our Account Manager. We would like to think that such a principle is not needed but recognise that supplier approaches here may vary. As with the other principles being proposed, Ofgem should set out its specific expectations here, including how it is intended to work with other licence conditions, e.g. the fairness principle, the requirement to provide information and also with the duties of directors in general terms. We would also like to understand how this proposed principle (and any guidance) would work with the enforcement guidelines and the potential credit given for such openness and cooperation.

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3. Increased Market Oversight

In general, SERL agrees with the proposal for "Customer Continuity Plans" to better help a SoLR-winning supplier to support their new customers as effectively as possible: the details of key staff; third party suppliers and account information will all be valuable. However, we believe there are limits to what this proposal can achieve, given suppliers as they fail may exhibit increasingly less control over core data management processes. Ofgem should conduct a series of workshops to create a set of workable expectations which would inform suppliers in meeting this requirement and Ofgem in monitoring and enforcing against it.

As stated above, in our view any use of independent audits should be tied to an incomplete or inconsistent Certificate of Adequacy.

4. Exit Arrangements

We do not object to Ofgem adding references in supply contract terms and conditions relating to treatment of customers in payment difficulty, the proportionate use of warrants, and taking reasonable steps to produce a final bill should be reflected in contracts, in order to guide administrator behaviour. However, the impact could be limited in practice, given the circumstances and administrator's duties.

For this amongst other reasons, a trade sale is always to be preferred - a rare occurrence at present given incoming suppliers have little wish to take on significant industry debts in terms of ROCs and credit balances, rather than waiting for a SoLR and receiving the customer book with many of these costs offset via the Industry Levy. With the right regulatory changes to avoid the build-up of costs which are then mutualised, administration should be rare and trade sales should be the norm.

We would however caution including this in T&Cs beyond domestic customers.

We do not object to the proposal to introduce a licence condition that "*prevents licensees from engaging in commercial transactions that subvert or distort, or are likely to subvert or distort, the Supplier of Last Resort process and/or make it more likely, in the Authority's opinion, that costs will be mutualised".* However, our first preference is that such deals - whereby a supplier buys customers without the industry debts, leaving a rump of customers to go through SoLR with all of these costs attached - becomes impossible because of structural changes to the payment of ROCs and treatment of credit balances combined with Ofgem's assumption that loss-making tariffs should be honoured.

We have some concern regarding the *"new requirement for suppliers to take all reasonable steps to honour the terms of the bid they provide as part of the SoLR selection process"*, e.g. in terms of repaying credit balances**.** Gaining SoLRs submit bids based on the data available at the time, which can be extremely poor quality. It will be important that new suppliers are not held liable / responsible for the regulatory failings of those who default.

Finally, we welcome Ofgem's statement that it has "identified a potential option to enable the portfolio of a failing supplier to be split and assigned to multiple Suppliers of Last Resort" and await next steps. In our view, such splits could be between domestic / microbusiness / nondomestic and I&C; between prepay and credit and potentially in large mixed "tranches" should a large supplier fail, which would benefit customers (and industry as a whole) by encouraging more competitive bids; spreading the peak workload and likely giving a better customer experience than assigning 1m customers to a single supplier. However, consumers' interests would not be served by allowing suppliers to cherry pick beyond this, e.g. allowing them to only take DD customers.

Conclusion

Ofgem's new "Financial Responsibility Principle" enshrines the principle that it is better to prevent a disorderly exit than to seek to mitigate its effects. In our view, the clearest, fairest and most robust means to do so would be via (1) tougher auditing of risky companies and early enforcement action, especially during COVID-19, targeted first at those suppliers with low levels of capitalisation or who have sought network deferrals ; (2) new rules to ensure the ability to pay ROCs, FITs and other industry schemes is guaranteed, ideally through legislative changes but with a monthly Directors Assurance ahead of this; (3) new rules to limit the excessive use of customer credit balances to fund working capital; and (4) an Annual Certificate of Adequacy.