



Ofgem's proposed approach to dealing with supplier insolvency and its consequences for consumers

OVO Energy's response

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# 1. Introduction

- 1.1. OVO welcomes the opportunity to respond to Ofgem's consultation in relation to supplier insolvency published on 13th June 2016 and supports Ofgem's initiative to review this aspect of the market in order to protect customers' interests.
- 1.2. The significant number of new entrants to the retail supply market in recent years has delivered much needed competition in the market. OVO fully recognises and supports the benefits of such competition, as evidenced by the ever increasing rates of those switching from incumbent to independent suppliers and the downward pressure on tariffs.
- 1.3. However, OVO strongly believes that an **increase in competition cannot come at the expense of trust and integrity in the market**. A sensible balance can and must be struck between, on the one hand, keeping the retail market competitive and vibrant, while on the other hand ensuring that customers are not exposed to undue risk and harm, specifically in respect of the security of their supply and any outstanding credit balances they may hold with their suppliers. Competition and protection need not to be mutually exclusive.
- 1.4. Trust and integrity can so easily be undermined by suppliers acting in such a manner as to place themselves at greater risk of financial instability which in turn places their customers at risk - whether through insufficient expertise, poor governance or otherwise. In OVO's view, it will take only one or two incidents of suppliers suffering financial instability (whether or not resulting in insolvency) to undermine the already precarious levels of trust and confidence amongst energy customers, pushing customers back to defaulting with large incumbent suppliers.
- 1.5. In other words, the incredible strides taken in recent years to open the retail market and increase competition will quickly become a wasted effort if the risks of supplier insolvency are not addressed upfront, before-the-fact - **the point at which a supplier actually goes into insolvency is simply too late to protect customers adequately**. Customers should not have to depend solely on the Supplier of Last Resort (**SoLR**) process to protect their supply and credit balances

(even with Ofgem bolstering powers to cover credit balances through incoming SoLRs and the industry levy).

- 1.6. Instead, in order to strike the right balance between competition and protection, OVO strongly advocates a **thorough review of the end-to-end licensing process** to ensure that only sufficiently skilled and qualified suppliers are allowed to enter and operate in the market, and all suppliers are subject to effective monitoring during the life of their licence. These broad principles apply to the regulatory frameworks of other household services such as insurance and financial services which can also involve substantial expenditure by customers and therefore risk of high outstanding credit. There is no reason why the same should not apply to the essential utility of energy.
- 1.7. **OVO wishes to stress at this point that it is not advocating closing the market entry gates to prospective suppliers. Nor is OVO advocating a higher degree of regulatory intervention.** That would be in no-one's interests. A healthy competitive market with innovative new business models is as equally vital to customers as it is to independent suppliers such as OVO - suppliers need competition and innovation to constantly enhance customer engagement and active switching.
- 1.8. However, OVO is greatly concerned by the increasing ease with which individuals can acquire supply licences. Indeed OVO understands that pre-accredited companies can now be bought "off the shelf" with minimal checks and cost. This is at too far the other extreme of 'closing the gates' - with such low barriers and few checks, we are concerned that potentially unqualified suppliers are entering the market who may be ill-equipped to deal with the complexities and volatility of trading and supplying energy. **Allowing unqualified suppliers to operate in the market not only risks harming customers directly - it unfairly undermines trust and confidence in suppliers who are operating with care and diligence, in Ofgem as the regulator responsible for adequately protecting customers, and in the retail energy system as a whole.**

- 1.9. Therefore, OVO recommends the following in response to this consultation and we set out in sections 2, 3 and 4 our views on each aspect in more detail:
- (a) With respect to the SoLR process OVO supports **option 1**, subject to a thorough review of the licence application and monitoring processes, and additional steps to review how and why a supplier became insolvent;
  - (b) With respect to the **licence application process**, OVO strongly recommends more **rigorous pre-licence assessment criteria** to ensure that prospective suppliers are thoroughly assessed in a number of commercial and operational areas prior to being granted a supply licence; and
  - (c) With respect to **monitoring of suppliers once licensed**, OVO recommends introducing a framework of **in-life checks to ensure that suppliers are continuing to meet licence application criteria**, with the power to suspend or revoke licences of those who fail to do so.
- 1.10. We recognise that the review of the licence application and monitoring processes are outside the scope of this consultation but in OVO's view **pre-emptive measures to minimise use of the SoLR process in the first place is essential to supporting a competitive market that operates with integrity and does not place customers at undue risk**. We look forward to continuing this dialogue with Ofgem following the conclusion of this consultation process.

## 2. SoLR process

- 2.1. OVO supports option 1 set out in Part 2 of the consultation, subject to:
- a thorough review of the licence application and monitoring processes in order to minimise the risk upfront of the SoLR process being invoked and the industry levy having to be utilised to cover outstanding credit balances; and
  - the SoLR process incorporating a review of how and why a supplier became insolvent, in order to identify licence condition breaches which may require redress and inform potential gaps in the licence application and monitoring processes that need to be addressed.
- 2.2. In the context of option 1, OVO agrees that tools already exist in the regulatory framework to protect customer credit balances (to a degree) in the event of a supplier insolvency. We welcome the clarification in this consultation that the tools are in fact capable of being used in this way.
- 2.3. Furthermore, in the spirit of moving towards principles-based regulation, OVO fully supports the flexibility that option 1 provides to Ofgem to assess matters on a case-by-case basis and to adjust their approach accordingly.
- 2.4. However, we believe that the industry levy should act as a last resort measure in itself - i.e., it should be a backstop to cover the shortfall in credit balances when **all other measures have been exhausted**.
- 2.5. All such measures should mean extending beyond the SoLR process and simply attempting to cover credit balances after-the-fact. Instead, implementing a more robust licence application process would minimise upfront the chances of suppliers entering the market in the first place if they are at higher risk of financial instability due to their commercial strategy, operational processes or governance framework. Without even attempting to address the front-end of the licence application process, it would not seem fair or reasonable for other suppliers - and ultimately customers - to subsidise outstanding credit balances of an insolvent supplier's customers if the insolvent supplier would be deemed not fit to operate in the first place under a thorough pre-licence assessment.

2.6. Furthermore, the SoLR process focuses mainly on bringing in SoLR supplier(s) but does not assess the insolvent supplier's circumstances. OVO believes this post-insolvency assessment is critical to identifying and understanding:

- Specific circumstances that may have contributed to the supplier's insolvency, and therefore may apply to other suppliers in the market. For example, Ofgem could investigate the timeline leading up to insolvency and identify patterns of behaviour that may apply to other suppliers;
- Issues or gaps that need to be addressed in the licence application or monitoring processes; and
- Licence condition breaches by the insolvent supplier that justify particular redress - e.g., a supplier's insolvency that was caused by operating their business in a grossly irresponsible or negligent manner should be deemed to have egregiously failed to treat customers fairly under SLC 25C, and therefore both the entity and individuals operating it should be banned from operating supply licences for a specified period. OVO believes such redress would reflect more proportionately the level of harm caused to individual customers and the market as a whole, and act as a powerful deterrent to other operators in the market.

### 3. Licence application

- 3.1. Since Ofgem introduced the pre-licence application guidance in 2010 (and even since it was last updated in 2013)<sup>1</sup>, the volume and nature of prospective suppliers has changed significantly.
- 3.2. The minimal levels of diligence and checks in the guidance understandably reflects a time when competition in the retail supply market needed to be stimulated by new entrants and therefore it made sense from a policy perspective to make the barriers of entry low. Furthermore, factors such as the downward trend in the wholesale market and the emergence of 'supplier-in-a-box' service models made the capital intensive and operationally complex aspects of retail supply more accessible to a wider range of new entrants.
- 3.3. However, the market has shifted materially in the last few years. Wholesale costs are rising and operational processes are becoming more complex with the introduction of smart meters. Conversely, usage is decreasing as products are becoming more energy-efficient and customers are becoming better equipped to control their usage through smart meters.
- 3.4. Against this backdrop, we are acutely aware of the potential impact such changes in the market may have on recent new entrants, who may not be sufficiently equipped to deal with those changes in terms of their business models, operations and trading strategies. Taking the recent rise in wholesale costs as an example scenario:
- A supplier may be offering aggressively priced 12 month fixed term tariffs, actively promoting it to new customers via price comparison sites.
  - However the supplier may not be hedging their commodity trades - i.e., they are purchasing their wholesale energy via spot trades.
  - Furthermore, as a relatively new business they may not have substantial capital or ready access to it.
  - If there is a sudden spike in wholesale costs shortly after signing up new customers on the fixed tariff, then the supplier's costs of supply may far exceed

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<sup>1</sup> [Ofgem, \*Guidance for electricity and gas licence applications\*, Sept 2010 \(updated Jan 2013\)](#)

their tariffs. However the supplier is obliged to fulfill the remaining 12 month contracts with their customers. Therefore, the supplier will start making significant losses for which they have no contingency or plan for covering.

- The situation could be exacerbated if, when faced with financial distress, the supplier offers even cheaper tariffs in an attempt to acquire more new customers and cover their losses.

3.5. This one example of a downward spiral in which a supplier may find itself, putting customers' supply and outstanding credit balances at grave risk. In OVO's view, this risk justifies the need to scrutinise prospective suppliers to a far greater degree before they are granted a licence. Minimal diligence is no longer enough - it is imperative that prospective suppliers are tested as to the robustness and sustainability of their business models, operations, trading strategy and governance.

3.6. In this context OVO makes the following suggestions of additional criteria for new licence applicants - notably, some of which are already covered by the criteria for potential SoLRs:

- (a) A thorough assessment of the applicant's **business plan** to test the sustainability of their model, either mirroring the Prudential Regulation Authority's (PRA) business plan assessment process or by comparing against existing suppliers' business models which would highlight variations that require explanation;
- (b) Testing the applicant's **financial viability** not only through standard insolvency and credit checks (which remain important) but requesting, for example, contingency plans for capital shortages in various scenarios such as the one outlined in paragraph 3.4 above;
- (c) In OVO's view it is imperative to interrogate the applicant's **wholesale trading strategy**, to give Ofgem the confidence that the applicant is capably skilled in operating a sound hedging policy and has contingencies in place for high risk scenarios (again, such as the one outlined in paragraph 3.4 above);



- (d) Given the increasing complexity of the operational aspects of supply, the applicant's **operational arrangements** should be scrutinised and stress-tested to ensure that they are robust and scalable. For example, suppliers should be able to demonstrate that their systems can on-board and bill customers at the rate of the growth ambitions in their business plan (e.g., plans to scale recruitment of call centre staff); and
  - (e) Finally, applicants should be able to demonstrate their **governance arrangements** to ensure that there is an appropriate internal risk management framework in place.
- 3.7. If a supplier meets these criteria for obtaining a licence, we would not advocate having to obtain Ofgem's consent to changes on an ongoing basis. That process would be too administratively burdensome and restrictive for suppliers who should be given the freedom and flexibility to innovate and grow. However there should be an obligation on suppliers to maintain the same levels of financial security, governance, protection - *how* they achieve that could differ during the life of their licence, but it should ultimately provide customers with the same level of protection *in substance* as the day on which the licence was granted.
- 3.8. In the spirit of Ofgem's movement towards principles-based regulation, OVO strongly recommends that Ofgem implements such additional licence application criteria through principles that it can apply in a holistic, substantive manner - i.e., taking all matters into account and making a rounded assessment of the strength of an application in light of existing market conditions and activity. Where additional criteria will fail to strike the right balance between competition and protection is if they are implemented as prescriptive tick-boxes. That approach is too restrictive and will incentivise applicants to find loopholes, thus failing to identify unsuitable applicants while preventing potentially suitable applicants from entering the market.

## 4. In-life monitoring

- 4.1. Rigorous pre-licence checks would certainly minimise the chances of unqualified new suppliers entering the market in the first instance. To supplement those checks, particularly in a fast-changing market, we would also strongly recommend that Ofgem establishes a clear framework for monitoring suppliers during the operation of their licence. This would enable Ofgem to spot early warning signs of potential financial distress and therefore mitigate the risk of customer harm.
- 4.2. We recognise that Ofgem currently carries out extensive monitoring of suppliers through recurring formal information requests. However from OVO's experience, the nature of the requests are highly quantitative and formalistic, focussing almost solely on specific data points without any holistic, substantive and qualitative assessment of circumstances that may underlie the data and issues arising therefrom. Nor do any of the requests currently focus on assessing suppliers in terms of a 'health index' of the quality and sustainability of their business - both of which could greatly impact the risk of the supplier entering financial distress and therefore the risk of customers' credit balances.
- 4.3. Taking for example the request for information accompanying this consultation, understanding the levels of credit balances held by suppliers perhaps provides to Ofgem a useful initial baseline view and an understanding of how practices vary between suppliers in terms of holding and refunding credit. However, the information requested by Ofgem in no way informs the financial viability of a supplier, the sustainability of their business model, and potential risks in their trading or operational arrangements.
- 4.4. Therefore we strongly recommend that Ofgem introduces a "red flag" monitoring system based on the **overarching principle of treating customers fairly**. This set of indicators would be designed to identify early warning signs of potential issues with a supplier's business operations or financial strength, such as:

- (a) Movements in tariffs not aligning with movements in the wholesale market - e.g., a supplier offering aggressively priced tariffs that do not reflect an upward trend in wholesale prices and therefore are likely to be loss-leading;
  - (b) Acquiring commodity on spot trades for fixed tariffs (i.e., not hedging commodity trades for the length of fixed contracts), indicating a potentially high degree of risk unless the supplier has sufficient capital reserves to cover any unexpected increases in commodity costs; and
  - (c) Material increase in complaints or customer churn, indicating that the capacity of a supplier's operational systems may not be sufficient to meet the demands of their customers.
- 4.5. OVO would stress at this point that the example indicators listed above are simply indicators of potential issues to investigate further - i.e., the indicators are not simple 'pass or fail' tests, where failure automatically leads to consequences. We would see this in-life monitoring framework going hand-in-hand with more rigorous licence application criteria, and therefore we would expect Ofgem to use these indicators to re-assess particular aspects of the criteria to test if the supplier is still fit to operate its licence.
- 4.6. In terms of consequences for suppliers who may be failing to meet their ongoing obligations, money is simply not enough. Similar to the financial services industry, Ofgem should have the powers to suspend or revoke licences to ensure the companies and individuals can no longer operate in the market if they fail to demonstrate at any point during their licence that they are not acting ultimately with trust and integrity.

## 5. Next steps

- 5.1. OVO hopes that this consultation on the SoLR process is the first step towards Ofgem reforming the end-to-end licensing process.
- 5.2. OVO recognises that its recommendations for reform would require Ofgem to change its policy on how to achieve customer protection in situations of supplier insolvency, from the current 'safety net' approach of relying on the SoLR process to more stringent application criteria upfront. Reform would also require Ofgem to develop the necessary expertise for carrying out substantive assessments of suppliers' business strategies and operations. Such assessments would need a culture shift towards more collaborative dialogue and consultation between Ofgem and prospective / actual suppliers, similar the phased series of meetings (including feedback sessions) carried out by the PRA's New Bank Start-Up Unit when assessing banks at pre-application stage.
- 5.3. Nevertheless, given the potential harm to customers, and the damage to trust and integrity in suppliers, regulators and the market, OVO is confident that Ofgem can find a way to carry out the reform, and should do so without delay.
- 5.4. In terms of practical implementation, OVO would strongly recommend that changes to the licence application and monitoring processes are introduced as outcomes-based principles under the three pillars of protection, engagement and innovation (per the 'three pillars' model we have proposed to Ofgem previously). This would be consistent with Ofgem's stated intentions to operate future regulation in a manner that supports the following three objectives.
  - Promoting innovation and competition in the retail market
  - Providing effective protections to consumers
  - Ensuring suppliers are putting consumer interests at the heart of their businesses.

We would expect the outcomes-based principles to be supplemented by specific criteria in licence applications.

- 5.5. In the meantime Ofgem could clarify that it can use existing powers in respect of licence applications and monitoring. For example, if Ofgem has reason to suspect that a supplier's activity is putting their customers' credit balances at undue risk, then under the Standards of Conduct in SLC 25C Ofgem could take action to investigate and potentially suspend the supplier's licence if it is satisfied that the activity constitutes treating customers unfairly.
- 5.6. Furthermore Ofgem does not need to implement all changes in one go - it could implement changes in phases, prioritising those changes needed to address the most pressing gaps. For example, a high-level assessment of a licence applicant's business model in reality could involve simply a discussion with the applicant in conjunction with reviewing its formal application, and we would naturally expect such discussion to cover elements of the applicant's trading and operational strategies.
- 5.7. Whatever approach Ofgem decides to take, OVO cannot stress enough the importance of reforming the licence application and monitoring processes if Ofgem is to achieve its stated objective of providing effective protections to customers. The implications of failing to do so will be serious and broad-reaching - it threatens and undermines the integrity of the retail energy system and all players within it. As such, OVO would urge Ofgem to consider reform of the end-to-end licence process without delay.