| Meeting Session | Code Administrators Code of Practice (CACoP) January 2019 Meeting |
|---|---|
| Paper Reference | 190129_CACoP SoLR Considerations (SPAA) |
| Action | For Discussion |

# CACoP Supplier of Last Resort Considerations

This document sets out a number of considerations in relation to Supplier of Last Resort (SoLR) events. It provides a brief overview of recent events and a high-level analysis of current market trends. Specific considerations in relation to CACoP have been provided for discussion at the January 2019 CACoP meeting.

## 1. Purpose

1.1 This paper sets out a number of considerations for CACoP in relation to SoLR events. It follows discussion on this topic by the SPAA Executive Committee (EC) and SPAA Expert Group (SEG) on what common issues are faced by Code Administrators and code parties when a SoLR occurs, and whether any coordinated action is required.

1.2 In the following sections an overview of recent events relating to SoLR is provided as well as a high-level evaluation of current market trends and the competitiveness of the GB energy market. Several specific considerations are then provided for discussion by CACoP members.

1.3 CACoP members are asked to consider the impacts of SoLR events on their respective codes and code parties and the actions that are undertaken when a SoLR occurs.

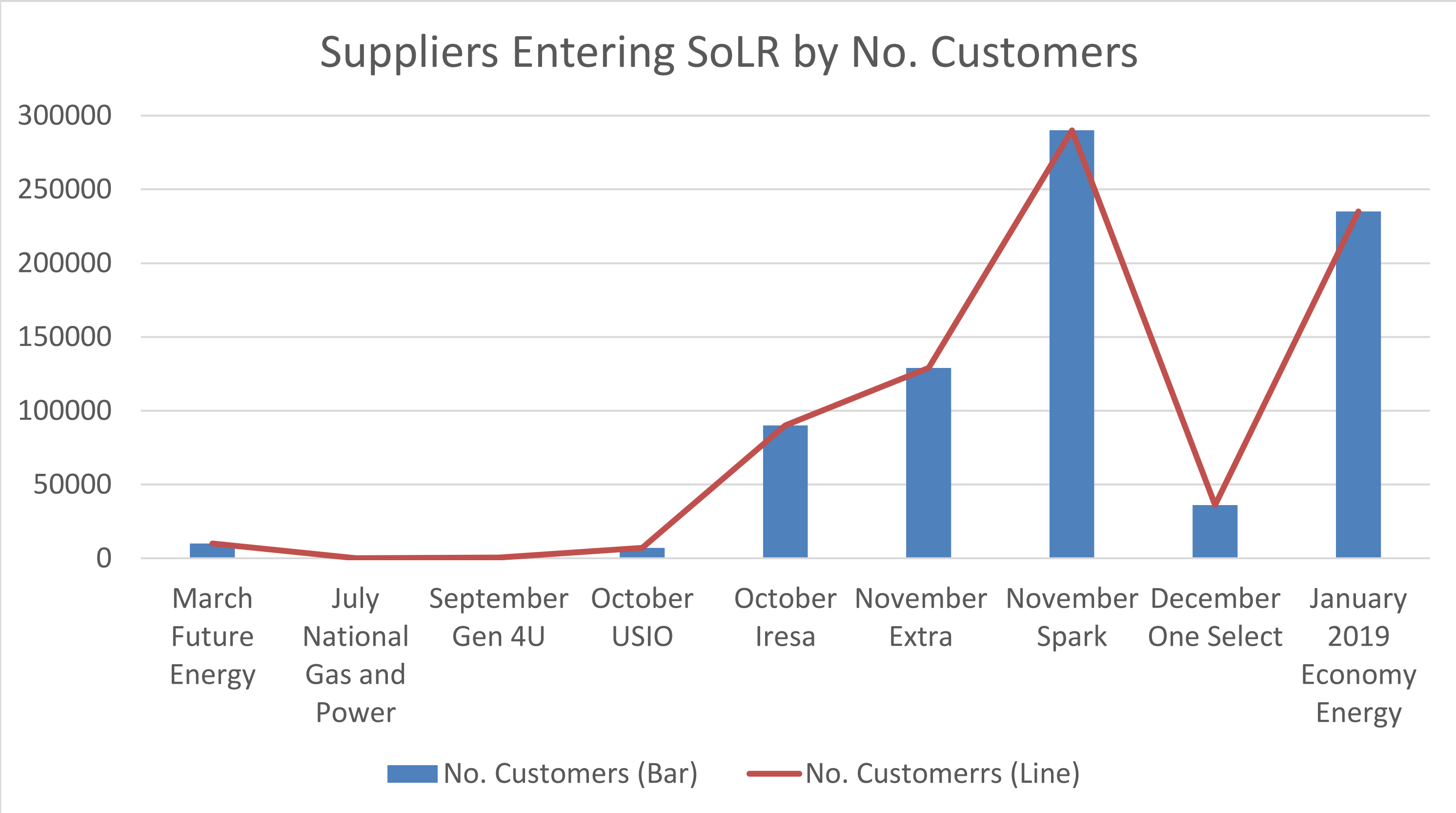
1.4 The following section looks at developments in 2018 and early 2019 in relation to SoLR.

## 2. Recent Developments

2.1 The number of energy Suppliers entering SoLR procedures within the last year has been higher than ever before. Nine Suppliers have failed since March 2018 and others have exited the market through corporate transactions.

2.2 When viewed by number of customers, the trend of failures within the energy supply/retail market is undoubtedly one where the size of the businesses failing is increasing. Economy Energy, Spark Energy and Extra Energy are the largest Suppliers to have failed in 14 years. Some industry analysts warn that up to 10 more could follow in the coming months[1] and it is widely thought that many Supplier organisations are close to failure[2].

2.3 The below table and graph provide a visual indication of this trend and support the notion that the size of the businesses failing (as measured by number of customers) and frequency of failures is increasing:




| Suppliers entering SoLR since March 2018: | No. Customers: |
|---|---|
| Spark Energy (sold to Ovo Energy) | 290,000 |
| Economy Energy | 235,000 |
| Extra Energy | 129,000 |
| Iresa | 90,000 |
| One Select | 36,000 |
| Future Energy | 10,000 |
| Usio Energy | 7,000 |
| Gen4U | 500 |
| National Gas and Power | 80 |

[1] January 2019 https://www.ft.com/content/156a9446-fc7d-11e8-aebf-99e208d3e521 [Retrieved: 11/01/19].
[2] January 2019 https://www.thisismoney.co.uk/money/markets/article-6578873/Renewable-power-provider-Bulb-Energy-slumps-24m-loss-amid-squeeze-small-suppliers.html [Retrieved 11/01/19].

2.4 Estimates of the cost to consumers from failed energy firms vary from £80m[3] to £127m[4], raising questions over whether the regulatory regime is fit for purpose.

2.5 Ofgem have announced plans to tighten market entry rules by, for example, requiring firms to have enough funds to trade for at least one year. However, there are calls for more to be done (see section 3 below).

2.6 Ofgem operate the SoLR process and a key message to the customers of a failed Supplier is 'do nothing, you will be taken care of', but the support of remaining industry parties is undoubtedly necessary in ensuring the smooth operation of SoLR. Whether a coordinated industry approach is required, for example through CACoP, is discussed in section 4).

2.7 The next section provides a discussion and a high-level evaluation of the current trends within the energy market, in an attempt to understand whether recent developments are an indicator of a properly functioning competitive market or whether cracks are beginning to emerge.

## 3. A Competitive Market

3.1 Efforts in recent years to increase competition have prompted a flurry of new market entrants. In 2018 there were 73 active gas and electricity Suppliers within the market. This is an increase from 60 in 2017 and just 14 in 2011. New technology and, arguably, low barriers to entry have fuelled this rapid rise.

3.2 There are approximately 22m Supply Points across GB, with around 860,000 being business customers.

3.3 It is well documented that volatility in wholesale prices, the price cap, regulatory change and renewable obligations are all contributing to very challenging conditions for Supplier businesses.

3.4 In attempting to evaluate whether recent developments are signs of an overly turbulent market, it is useful to consider the failure rate of new businesses in other sectors as well the average failure rate nationally. The Office for National Statistics places the five-year survival rate for UK start-up companies at a national average of 43.2%[5]. Failure rates in specific sectors vary considerably and the failure rate is far higher for the accommodation and food services sector with a five-year survival rate of just 34.2%. Survival rates also vary considerably depending on geographic location, with London appearing to be the most challenging area to start a business.

3.5 Energy supply is a diverse sector, with diverse business models in operation. There are Suppliers that could be considered risk management companies; others that would be considered technology companies, and; others that could be considered services companies. This makes comparisons with other sectors somewhat difficult however, it is clear that the survival rate among energy supply companies is above the national average.

3.6 With this in mind, it may seem reasonable to argue the energy supply market is functioning within parameters that are to be expected, relative to the national average. However, energy is a sector that requires stability and well-managed companies operating within it, to ensure the interests of consumers are protected. As noted at 2.4, estimates of the cost to consumers from SoLR events are substantial. Ofgem currently enable gaining Suppliers in a SoLR event to recover and mutualise certain

---

[3] December 2018 https://www.theguardian.com/money/2018/dec/16/uk-householders-pick-up-bill-for-bust-energy-firms [Retrieved 11/01/19].
[4] December 2018 https://www.thisismoney.co.uk/money/news/article-6500095/Households-face-extra-127-million-piled-bills.html [Retrieved 11/01/19].
[5] Office for National Statistics, *Business demography, UK: 2017* [Online]. https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/businessdemography/2017 [Retrieved 11/01/19].

costs associated with taking on a failed Suppliers portfolio, meaning it is very likely there are cost impacts across the industry for each 'last resort' event.

3.7 Many senior industry figures are also voicing concerns. The CEO of First Utility recently described newer, smaller Suppliers as operating a "house of cards"[6] model and that with volatility in wholesale prices and undifferentiated offerings, further failures were likely. The CEO of Centrica recently stated that "it's easier to become an energy Supplier than it probably is to set up a bank account" and that "some companies are becoming Suppliers with not enough financial muscle to handle risk"[7].

3.8 Ofgem has launched a review to tighten entry to the market and there have been calls for more stringent liquidity tests and more expensive entry costs. Some have argued that a lack of checks, unfair cost exemptions, loss-leading tariffs and a lack of consequences for failure have enabled a space for opportunistic newcomers.

3.9 Despite concerns from industry, there are those that argue newcomers have injected competition into a once stagnant market and that a focus on failures in the short-term may distract from the benefits brought by increased competition in the long-term.

3.10 The exact nature of a Supplier's failure is also important. Those that have been bought-out whilst in administration have often continued to operate as before, whilst others have ceased trading all together. Both eventualities will likely still cause a cost to the wider industry as there will usually be some degree of mutualisation of costs arising from the SoLR process in any event.

3.11 Overall, whilst there may be concerns regarding the stability of newer Supplier business models, it is not possible to say with certainty whether the increase in the number of Suppliers failing recently is anything beyond what is to be expected. Ensuring that the interests of consumers are protected is paramount and providing the SoLR process operates effectively, impacts on consumers should be minimised and the impact of failed Suppliers controlled.

3.12 The challenges faced within the energy supply/retail market are well documented and the concerns of existing industry parties and industry analysts are apparent. It seems reasonable to expect that more Suppliers will fail in the coming months and it is therefore prudent that CACoP considers any potential risks and impacts and whether any coordinated action is required.

## 4. CACoP Considerations

4.1 The impacts of a SoLR event on Code Administrators and industry parties may be characterised in three ways – operational and administrative, corporate and commercial.

4.2 Within SPAA, operational and administrative impacts largely centre around the update of contact information for use in escalation processes. Where this information is not promptly obtained or updated, it may cause difficulty with the escalation and resolution of operational issues such as Erroneous Transfers. The treatment and update of market participant IDs within Market Domain Data was also considered to be an area impacted and Parties expressed a desire for prompt communication on this matter when a SoLR occurs. Where prompt communication is not received, Parties have reported an increased requirement for manual intervention in the management of data flows and an increased administrative burden associated with this.

4.3 The Chair of SEG has been in contact with the SPAA Contract Managers of Octopus Energy and Ovo Energy to understand their experience of taking on Iresa and Spark Energy's customers, respectively, under SoLR provisions. Octopus Energy reported that they were having to manually deal with certain

[6] July 2018 https://www.theguardian.com/business/2018/jul/08/first-utility-says-newer-energy-firms-will-go-bust [Retrieved 11/01/19].

[7] January 2019 https://www.ft.com/content/156a9446-fc7d-11e8-aebf-99e208d3e521 [Retrieved 11/01/19].

enquiries related to former Iresa sites as they did not have full sight of all historic data and noted there is no 'SoLR manual'. Ovo Energy reported that whilst there had been a change in ownership of Spark Energy, there was no functional change in the way that SPAA Parties should interact with the organisation. The impacts therefore appear to be administrative for first organisation and nominal for the second.

4.4 SEG discussed whether a codified solution or guidance document could be created. Some members were uncertain if this would be of use, as Ofgem lead the process and SoLR has industry-wide impacts. SEG considered that, as a minimum, a checklist should be created to prompt the update of contact information and market participant IDs when a SoLR occurs. SEG also requested that the matter is raised at the Code Administrators Code of Practice (CACoP) meeting for discussion regarding the impacts across different codes.

4.5 Commercial impacts include the potential mutualisation of costs/debts owed by a failing participant, across remaining participants. This can affect the forecasted cash flow of parties and create specific risks that require nuanced management to mitigate. The types of costs/debts within SPAA that could be mutualised could include debits to the Gas Theft Detection Incentive Scheme (GTDIS) and debts to the Code Administrator for secretariat and service provision. Although unlikely, should a large Party cease trading and owe a substantial amount, there could be severe consequences for remaining parties.

4.6 The exact nature of a Parties' exit from the market may be an important factor. Where an organisation is bought-out whilst in administration, it may be reasonable to expect that any outstanding sums will be paid. Where an organisation ceases trading altogether or is otherwise liquidated, the scheme would be unlikely to receive the full amount of any sums owed. Certain codes, in order to protect industry cash-flow, already required that parties post credit cover however this is not the case for all codes. There is also an argument that requirements for Suppliers to post credit cover add to existing regulatory burdens and may act as a barrier to competition, particularly for small and independent participants, as such cover may difficult, or very expensive, to obtain, without the backing of a large parent company.

4.7 Corporate impacts to Code Administrators seem to centre around the administration of the corporate vehicles used as the foundation of the relationship between industry parties and code service providers. Within SPAA, this includes any requirements, where a SoLR occurs, to redistribute shares in SPAA Limited or to appoint/de-appoint directors. As with the commercial risks noted above, there may also be a certain mutualisation of any debts to other code parties and a risk that code corporate vehicles may suffer liquidity issues, particularly where a large or heavily indebted party ceases to trade.

4.8 The next section asks CACoP members whether there are any joint actions required by Code Administrators and provides a number of discussion points.

## 5. Discussion

5.1 Ofgem lead the SoLR process, however it is prudent that CACoP considers what can be done in support, and how the impacts on Code Administrators, code parties and consumers can be mitigated.

5.2 In practice, SoLR is not only a mechanism to replace failing Suppliers but to perform other functions also (e.g. protection of inactive customers or those with payment difficulties).

5.3 Within SPAA, SEG have recommended that a checklist is crated to assist the update and communication of certain operational information when SoLR occurs. This will assist in mitigating the impacts on 'business as usual (BAU)' SPAA processes such as the Resolution of Erroneous Transfers and Supplier Agreed Reads. An SPAA Change Proposal is also being raised to clarify and create certainty regarding the treatment of unpaid debits within the GTDIS.

5.4 CACoP members are invited to discuss the below (non-exhaustive) questions and evaluate whether there are further considerations that should be made:

5.5 What impact does SoLR have on you as a Code Administrator?

5.6 What impacts does SoLR have on the BAU and operational processes of your codes' members?

5.7 What commercial impacts can a SoLR have on your codes' members?

5.8 Is your code currently taking any specific action regarding SoLR?

5.9 What are the existing credit cover requirements of your code?

5.10 What is Ofgem's view on what CACoP can do to support the SoLR process?

## 6. Recommendation

7.1 CACoP members are invited to:

- **DISCUSS** the contents of the paper.

**Fraser Mathieson**