Credit where credit's due

PROTECTING CUSTOMER CREDIT IN THE CASE OF SUPPLIER INSOLVENCY

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CEPA

1. Ofgem's approach to insolvency and credit balances

Gas and Electricity provider GB Energy ceased trading on 26 November, leaving 160,000 customers at risk of losing £25m in credit balances. Ofgem's Supplier of Last Resort[1] (SoLR) process kicked into action and Ofgem announced that Co-op Energy had won its competitive process within the week.

Fortunately, on 21 October 2016, perhaps in anticipation of a challenging winter for smaller suppliers, Ofgem published a timely decision[2] on protecting the credit balances of customers with a supplier who became insolvent. Ofgem introduced a 'safety net' under which customers' credit balances would be protected. This protection is now provided partly by the selected SoLR, and partly through access to an industry levy. This process works by asking suppliers to submit their level of willingness to protect customers' credit balances as part of their bid. Ofgem also considers on a case by case basis whether the SoLR will be permitted to access an industry levy to recover further costs of honouring credit balances. The levy will only be applied when required.

Ofgem said that it would keep this position under review and plans to step up engagement with new suppliers to better understand business models and financial arrangements. With many market commentators predicting difficult times ahead for smaller suppliers, this seems prudent.

2. Credit protection options

The approach taken towards protection of customer credit balances is not only interesting from a GB energy perspective. As more countries move towards liberalised retail energy markets, and as global wholesale markets pick up, supplier insolvencies may become more frequent across the world. Similar issues may also be faced in sectors such as rail and, perhaps water, if it moves towards a competitive retail market.

In this short article, CEPA reviews the high-level options available to regulators who may want to consider how to protect customer credit in the case of insolvency. We present three broad options but note that there are a multitude of variations and combinations of approaches available.

[1] https://www.ofgem.gov.uk/system/files/docs/2016/10/solr_revised_guidance_final_21-10-2016.pdf
[2] https://www.ofgem.gov.uk/system/files/docs/2016/10/2016-10-21_decision_letter_on_supplier_insolvency.pdf

2.1 Option 1: Supplier levy

Under this approach, a levy is introduced through which companies collectively fund the credit balances of customers who are with a company at the time of its insolvency. Ofgem used this approach in part, supplementing it with its competitive process and SoLR contribution. ABTA also uses a levy to provide financial protection for travel and holidays, but this is a permanent levy, whereas the Ofgem levy is only applied as needed.

Pros	Cons
Low barrier to entry as little material burden on any one party for protection of credit	Encourages risk taking behaviour, since all suppliers have the same safety net regardless of riskiness
Low regulatory intervention and administrative burden	All consumers suffer from the behaviour of risky suppliers, by contributing to their insolvency costs
Cheapest option: only the shortfall from what the SoLR provides needs to be funded	

2.2 Option 2: Individual bonds

Companies would need to put an independent bond in place for each of its customers. The bond would need to be of sufficient size, or varied from time to time, to cover the maximum level of credit which that consumer is likely to have. This approach is used in the private rented housing sector, where landlords must have a deposit protection scheme in place for each of their customers.

Pros	Cons
Most cost reflective option. Level of risk taken on is reflected in bond requirements	Possible barrier to entry as more credit than final liability required to protect customer accounts
Customers of less risky suppliers are not penalised for risk seeking behaviour of others	High administrative burden and risk premium required to cover each individual customer’s credit

2.3 Option 3: Collective bonds

The overall credit exposure of each company is calculated based on its customer portfolio. Each company must then put in place bonds of sufficient size to cover this level of credit. As credit requirements need to be met collectively rather than individually, fluctuations in individual credit requirements over the relevant period can be smoothed, resulting in lower overall requirements for any one company. Similar collective bonds are used to protect railway season tickets.

Pros	**Cons**
Remains cost reflective as companies have a responsibility to put sufficient bonds in place	Not quite as cost reflective as individual bonds
Only customers of relevant company contribute so those with less risky suppliers are not penalised for risk seeking behaviour of others	Some credit still required by entry suppliers hence represents potential barrier to entry
Lower credit requirement than for individual bonds due to smoothing effect	Requires more credit to cover potential losses than the likely final liability given SoLR contribution

3. Conclusions

Supplier insolvency and credit protection may become increasingly important as more countries and markets move towards competition in their retail sectors. As Ofgem notes in its decision on protecting customer credit, '…a competitive process occasionally leads to companies failing; this applies as much in relation to the gas and electricity supply markets as it does to other markets.'

Ofgem deserves praise for successfully introducing reforms to ensure protection of customer credits in the nick of time. As it develops experience – and we may yet see the system being applied to a growing number of supplier failures – Ofgem has given itself the opportunity to review its approach. Other regulators and policy makers may want to consider which of the range of approaches may best apply in their case. CEPA provides economic and policy consultancy services across a range of industry sectors. We have previously provided expert input on issues relating to credit protection for clients such as Ofgem and the Department for Communities and Local Government. Please contact us if you would like to discuss our work in this area in more detail.