Measures to protect customer prepayments and updates to the Provider of Last Resort

November 2018

In September 2018 the Commission published a notice setting out its intention to carry out a comprehensive review of the non-household retail market and providing an indicative timeline and scope for the review. This consultation sets out our proposals to introduce customer protection measures to protect customer prepayments and update the Provider of Last Resort arrangements. We are seeking stakeholders' views on both these proposals.

Comments should be sent by email by 4 December 2018 to **CompetitionTeam@watercommission.co.uk**

This consultation document has been sent to:

- Licensed Providers;
- The Scottish Government;
- Scottish Water;
- Citizens Advice Scotland; and
- The Central Market Agency Limited.

This document is also available on the Commission's website: www.watercommission.co.uk.

Introduction

The Commission has a statutory duty to promote the interest of customers (as a whole) in the provision of water and sewerage services. The Commission must also exercise its functions relating to Licensed Providers for the purposes of securing the participation of Licensed Providers in a manner which is orderly and not detrimental to the exercise of Scottish Water's core functions.

The retail non-household market has now been operating for over ten years and there are 27 retailers competing in Scotland. As more Licensed Providers have entered the retail market, customers have benefitted from greater choice, more tailored service and lower prices. However, the Commission is mindful that this increased competition may adversely impact on Licensed Providers' credit-worthiness and may increase the likelihood of a Licensed Provider's financial failure. The Commission wants to ensure that the market continues to work well for customers.

Since 2008 only two Licensed Providers have failed[1] in the Scottish retail non-household market. Both defaults have occurred for reasons not directly connected with the retail market in Scotland and involved two very small Licensed Providers. In the second of these defaults, the Commission was unable to rely on the company administrator to secure a potential buyer for the Licensed Provider's customer base. Mindful of the risk to Scottish Water in such cases, in 2016 the Commission extended the prepayment[2] required from Licensed Providers to ensure that the market arrangements protected the core business of Scottish Water from any detriment.

The Commission has now reviewed customers' risks in the event a Licensed Provider enters an insolvency process. The current Provider of Last Resort (POLR) process administered under the Market Code[3] ensures that customers of an insolvent Licensed Provider will have a new Licensed Provider appointed to take over and continue their supply. That process does not, however, provide any protection for customer prepayments that were made to the insolvent Licensed Provider. In light of this, the Commission is proposing new customer measures to protect customer prepayments.

This consultation sets out these proposed measures to protect customer prepayments and consults on changes to the POLR arrangements. We are seeking stakeholder's views on both these proposals.

Background

Licensed Providers offer customers a variety of payment options including payment in arrears and payment in advance. By way of example some customers may choose to prepay for services in order to access a lower price or receive a discount. Unmeasured customers[4] typically pay their Licensed Provider in advance (often annually in advance) for water services based on the rateable value of the premises.

If a Licensed Provider in financial distress enters an insolvency process and the business cannot be sold as a going concern, customers who have made prepayments would rank as unsecured ordinary creditors. As consequence it is unlikely that all unsecured creditors would satisfy their claims and there is a

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[1] The Commission served Aquavitae and Satec with a Notice of Revocation of the general water and sewerage licences respectively in 2008 and 2012.

[2] For more information on the Notice of Commission Decision on credit terms can be found: https://www.watercommission.co.uk/UserFiles/documents/Credit%20terms%20Decision%20doc%20FINAL.PDF

[3] The Provider of Last Resort arrangements are enshrined in Paragraph 5.3.6 of the Market Code and CSD 0003 (Provider of Last Resort).

[4] Scottish Water fitted water meters to all non-household premises through their Full Business Metering (FBM) programme in 2009. As part of this programme Scottish Water may have not fitted a meter if the premises had for example a complex, or shared pipe configuration that made the installation of a meter uneconomic.

significant risk that customers would suffer from a material loss in the event of a Licensed Provider's insolvency[5].

The UK Law Commission[6] has been reviewing options to provide payment protection in several sectors and reported on its key recommendations to Government in July 2016. Some industries have already put in place customer protection measures: the energy[7] and transport[8] sector for example have taken steps to protect customers in the event of a supplier's failure.

The Commission has reviewed the risks associated with customer prepayments and has asked Licensed Providers to provide information on their use of prepayment terms. The Commission notes that most Licensed Providers offer prepayment terms and that not all customers may be aware of the risk associated with a Licensed Provider's financial failure. As a consequence, the reputation of the industry would suffer if this risk were to crystallise.

Given its statutory duty to promote the interest of customers (as a whole) the Commission considers that it is appropriate to introduce customer protection measures to protect customers from a loss in the event of a Licensed Provider's financial failure.

Measures to protect customer prepayments

The Commission is consulting on new customer protection measures which would prohibit a Licensed Provider from offering prepayment terms to, and taking prepayments from customers. Such measures would protect customers from a loss incurred from a Licensed Provider's financial failure.

The Commission is aware that prohibiting Licensed Providers from offering prepayment terms would reduce payment options available to customers and may, in some cases, increase the price that customers pay their Licensed Provider for water and sewerage services. The Commission is therefore also consulting on allowing Licensed Providers who still wish to offer prepayment terms to collect monies in advance from their customers provided that certain criteria are met.

The customer protection criteria that could be applied to allow a Licensed Providers to offer prepayment terms to its customers include the following:

1. Licensed Providers satisfy the Commission that customer prepayments are fully protected in the event of an insolvency. Licensed Providers could, for example, establish a trust account[9] to protect customers' credit balances and place all prepayments (including the retail gross margin) in this account. Licensed Providers would also need to demonstrate to the Commission's satisfaction its processes to update the balance of the account in a timely and accurate manner to reflect any change in the overall level of customers' prepayments held;

[5] In the event the insolvent business is sold and the proceeds of this sale are distributed to creditors, it may still be that all the sale proceeds are required to satisfy the claims of creditors ranking above unsecured creditors in the statutory hierarchy and that there are no funds remaining to reimburse customers.

[6] In UK insolvency law does not give customers any special protection and consumers will not receive any due monies until all secured and preferential creditors have been satisfied in full as highlighted by the Law Commission in the Consultation Paper No 221, "Consumer Prepayments on Retailer Insolvency", June 2015. More information can be found at: https://www.lawcom.gov.uk/project/consumer-prepayments-on-retailer-insolvency/

[7] Ofgem has special Administration Powers and through the Supplier of Last Resort (SOLR) mechanism runs competitive auctions for one or more supplier's customer base. In assessing each bid Ofgem takes into account protection of customers' credit balances and has prioritised bids that secure customers' balances.

[8] UK travel companies are required to hold an Air Travel Organiser's Licence (ATOL), an industry-wide scheme run by the Civil Aviation Authority (CAA) that protects customers who have booked and paid for their holidays in advance. In the event of an ATOL travel company's failure customers can received a refund for prepaid monies.

[9] This would involve, for example, similar governance arrangements to the ones used for trust-based pension schemes.

2. Licensed Providers have put in place an appropriate process to explain to the customer the risks and the consequences associated with making payments in advance;

3. A duly authorised and appropriately senior representative of the customer has signed a written statement accepting the risk (countersigned by an auditor or lawyer);

4. The prepaying customer is above a certain size; for example, the business has at least ten full time employees;

5. Licensed Providers cooperate with any monitoring or audit by or on behalf of the Commission relating to its customer protection measures for prepayments.

We are therefore seeking stakeholders' views on the impact of our proposed measures and are interested to receive comments on the criteria proposed above and on any other criteria that may be relevant.

The Commission has also considered and reviewed alternative options to protect customers' prepayments, which include:

1. An outright ban on customers' prepayments;

2. An industry-wide insurance scheme;

3. An option requiring Licensed Providers to transfer all customer prepayments to Scottish Water, who would then hold these funds on behalf of the customer in a ring-fenced account; and

4. An option requiring Licensed Providers to place all of customers' prepayments in a trust account.

The Commission has carefully reviewed all these alternative options. It has considered the complexities, administrative costs and the residual risks of all these options. The Commission has provisionally concluded that the proposed customer protection measures, which prohibit Licensed Providers from collecting customer prepayments unless Licensed Providers demonstrate they have met customer protection criteria, to be the most cost effective and proportionate approach.

The proposed customer protection measures will ensure that customers are made aware of the risks associated with a Licensed Provider's insolvency and will avoid complex and costly changes to the market. Such measures also place the onus on the Licensed Providers who still wish to offer prepayment terms to their customers to demonstrate that they have put in place measures to safeguard customers' prepayments and to meet the costs associated with these measures.

The Annex to this consultation sets out, in greater detail, the alternative options that have been considered and provides the Commission's assessment of the risks and effectiveness of each option.

The Commission recognises that it would be important to provide Licensed Providers with sufficient time to prepare for such measures. It suggests allowing for a period of transition with final implementation from 1 April 2020. We are therefore interested to receive views on the proposed period of transition.

Following receipt of consultation responses by 4 December 2018, the Commission intends to publish its provisional decision in relation to the future use of prepayments in the market by the end of December. As previously noted, given the broad scope of the market review and to ensure consistency and completeness, we will publish a final decision at the end of the review and finalise any changes to market documents and the terms of any direction required to implement our decision on the protection of customer prepayments at that time.

Updates to the Provider of Last Resort

The Provider of Last Resort (POLR)[10] arrangements set out in the Market Code guarantee the continuity of water and sewerage services to customers by transferring customer Supply Points on a random basis from a defaulting Licensed Provider to other Licensed Providers who have opted into the POLR process. During the reallocation process water Supply Points and sewerage Supply Points are allocated to Licensed Providers in pairs and, where possible, multi-site Supply Points with the same Licensed Provider. The Central Market Agency (CMA) carries out an annual test to ensure that the central systems can cope with different scales of failure and to perform a smooth reallocation of Supply Points through POLR.

In 2012 the Commission changed the POLR arrangements to allow smaller Licensed Providers who hold less than a 20% market share to opt out of the POLR allocation process. As already noted, the Commission is concerned about the increased risk of Licensed Provider insolvency and the impact that could have on customers. Whilst the failures that have occurred to date have impacted very few customers, there is no guarantee that will remain the case. The Commission has, therefore, reviewed the risks associated with a large Licensed Provider's financial failure to ensure Licensed Providers who do opt-in to the POLR mechanism have sufficient financial and operational capability to serve all customers transferred to them if POLR is triggered. The Commission wants to ensure that the reallocation of the POLR Supply Points [11] does not cause a domino effect on other Licensed Providers who have opted in to the scheme.

To this end we propose applying a maximum threshold rule for Licensed Providers who have opted-in to the POLR mechanism. This could involve capping the number of Supply Points that a Licensed Provider could receive through the POLR reallocation process. Under such a proposal, a Licensed Provider would only receive a number of POLR SPIDs equal to twice[12] the number of the SPIDs registered to the Licensed Provider when the POLR is triggered.

We believe that a cap would reduce the risk that small Licensed Providers receive an excessive number of POLR SPIDs which could give rise to difficulties in meeting the needs of a significantly larger customer base in the short and medium term.

Following receipt of consultation responses by 4 December 2018, the Commission intends to publish its provisional decision in relation to the proposed maximum threshold rule by the end of December 2018 along with provisional changes to market documents. We also recognize that any such change would involve system changes which would require to be developed by the CMA.

As previously noted, given the broad scope of the market review and to ensure consistency and completeness, we will publish a final decision at the end of the review and finalise any changes to market documents at that time.

Next steps

[10] The Provider of Last Resort arrangements are enshrined in Paragraph 5.3.6 of the Market Code and CSD 0003 (Provider of Last Resort).

[11] Paragraph 5.3.6 of the Market Code defines POLR Supply Points as Supply Points that are still or were at the designated time registered with the Defaulting Party.

[12] For example, a Licensed Provider with 1000 registered Supply Points could only receive 2000 POLR Supply Points and as a result end up with a total of 3000 registered Supply Points after the allocation process is complete.

The Commission welcomes comments on the proposals for new customer protection measures to protect customer prepayments in the event of a Licensed Provider's insolvency and updates to POLR. Comments should be sent by email using the details provided on the cover page by 4 December 2018.

Annex - Alternative options to protect customers' prepayments

Option		What it involves	Assessment
Alternative options that have been considered:			
1	Ban on prepayments	Licensed Providers (LPs) are banned under any circumstance from taking any payment in advance from their customers.	Protects all customers in a cost-effective manner. May not be proportionate.
2	Insurance scheme	- All LPs are free to offer prepayment terms. - Set up an industry-wide scheme to provide insurance protection to customers' prepayments in the event of a LP's default. - A private insurance scheme would leave an unsecured residual risk. As a consequence, an additional industry-wide fund would be required to cover any residual unsecured risk.	Disproportionate set up and ongoing cost to provide an industry-wide insurance scheme.
3	Transfers to Scottish Water	- LPs who wish to offer prepayment terms transfer all customers' prepayments (including the retail gross margin) to Scottish Water (SW), who holds the monies in an appropriately ring-fenced account. - LPs transfer prepayments accurately and timeously to SW. - To allow SW to identify what funds are due to each customer in the event of an insolvency, LPs provide detailed information about customers' prepayment balances. - SW reconciles amounts held monthly in the account and receives /makes appropriate balancing payments from/to Licensed Providers. - SW is responsible for any credit authorisation or financial services compliance duties. - Additional changes to customer contracts to ensure compliance with GDPR.	- High administrative costs to set up and manage the account. - Costly to audit. - Residual risk that SW does not have correct information on the monies due to each customer. - Residual risk that LPs may under-report prepayments and do not make accurate transfers of monies. - Reputation damage to the market if customers suffer a material loss and are not fully aware of the risks. - Requires significant changes to market codes and/or Wholesale Service Agreements.
4	Trust fund set up and managed by LPs	- LPs who accept prepayments establish a trust fund and place all prepayments (including the retail gross margin) in this fund. - Trustees need to protect the fund and ensure that all customers who prepaid are appropriately protected. - Extensive auditing requirements to mitigate the risk that prepayments are not fully or timeously transferred in the trust fund.	- Complex to set up and costly to audit and monitor. - Reputation damage to the market if customers suffer a loss and are not fully aware of the risk of a LP's insolvency. - Leaves a residual risk that LPs may not transfer timeously and accurately all monies.

Proposed option:			
5	Customer protection measures	- LPs who wish to offer prepayments should satisfy four criteria: 1. LPs satisfy the Commission that customers' monies are fully protected in the event of an insolvency. LP demonstrate to the Commission's satisfaction its processes to update the balance of the account in a timely and accurate manner to reflect any change in the overall level of customers' prepayments held; 2. LPs put in place an appropriate process to explain to the customer the risks and the consequences associated with making payments in advance; 3. A duly authorised and appropriately senior representative of the customer has signed a written statement accepting the risk (countersigned by an auditor or lawyer); 4. The prepaying customer is above a certain size; for example, the business has at least ten full time employees; and 5. LPs will cooperate with any monitoring or audit by or on behalf of the Commission relating to its approach to prepayments.	- Ensures all customers are protected and made aware of the risk to them in the event of a LP's insolvency. - Fairer – costs are met by the LPs who wish to offer prepayment terms. - Residual risk that LPs may under-report prepayments and do not make accurate transfers of monies. - Additional protection measures ensure customers were made aware of the residual risk associated with prepayment terms.