

## **1. Background**

### *1.1 Market Code requirements*

The 'Provider of Last Resort' (POLR) is the Licensed Provider appointed by the CMA, under section 5.3.6 of the Market Code, to take over responsibility for the provision of services to particular supply points. POLR arrangements will come into effect when a Licensed Provider has defaulted on payments or obligations under the Market Code (as set out in section 10.7) and the CMA has issued a Termination Notice ending that Licensed Provider's status as a Trading Party.

Section 5.3.6 of the current version of the Market Code contains provisions on POLR arrangements. These are reproduced in Annex 1 to this paper. In summary:

- SPIDs will be allocated by the CMA on a random basis;
- Each Water Services Licensed Provider will be allocated an equal number of Water SPIDs and each Sewerage Services Licensed Provider will be allocated an equal number of Sewerage SPIDs; and
- If there are fewer SPIDs than LPs, the SPIDs will be allocated to Licensed Providers in date order of the grant of their permanent licences.

The Market Code requires that a change proposal be introduced to either amend or replace the process set out in section 5.3.6(iv). Following consultation on POLR provisions, the CMA will introduce such a change proposal.

### *1.2 Objective*

The objective of the POLR arrangements is to provide a safety net for non-domestic customers (by ensuring that they are not without a Licensed Provider), and to provide commercial protection for Scottish Water (by ensuring that every customer has an associated Licensed Provider that will be responsible for wholesale charges).

### *1.3 Principles*

POLR arrangements must take account of the principles and objectives for market documents set by the Commission (reproduced in Annex 2 to this paper).

In addition, the Technical Panel agreed at their meeting of 17<sup>th</sup> January that the implementation of POLR arrangements should be based on a principle of cooperation in the interest of the market. This entails that all parties commit to finding pragmatic solutions to facilitating the handover of customers, and that they work together to mitigate any adverse effects when the operation of POLR arrangements is required.

## **2. Responding to this consultation**

The closing date for responding to this consultation is Monday 4<sup>th</sup> April, 2008. Responses to this consultation should be sent to:

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All responses to this document will be published.

## **3. General issues**

### *3.1 Operational burden on Licensed Providers*

It should be recognised that the POLR arrangements could place an additional operational burden on Licensed Providers, if Licensed Providers are required to accept an allocation of customers from a defaulting Licensed Provider. The POLR arrangements can establish a set of rules to facilitate the transfer of customers (for example, rules on the handover of information), but the implementation of those rules may require cooperation from outgoing Licensed Providers, and careful management from receiving Licensed Providers.

While the CMA holds the full postal address for each SPID, it does not hold customer names, contact details or business details. To the extent that the receiving Licensed Provider requires this data, it will be reliant on data provided by the Licensed Provider in receipt of a Termination Notice.

Furthermore, a Licensed Provider could enter liquidation because it has a high proportion of non-paying customers – these same customers will be allocated receiving Licensed Providers.

### *3.2 Self-suppliers, specialist suppliers and small suppliers*

There is a need to consider the appropriate scope for the POLR arrangements. Self suppliers cannot be part of the POLR arrangements by virtue of their licences, which do not allow them to supply third parties. In addition, self suppliers and specialist suppliers are excluded from POLR arrangements by the Market Code.

It may be that some suppliers holding a full licence are relatively small organisations providing services for a similar number of SPIDs as self-suppliers or specialist suppliers, raising the question of whether they should be included in the arrangements.

We believe that the CMA should not be required to assess a Licensed Provider's financial or operational capacity to receive SPIDs through the POLR arrangements (either in terms of the services offered to the new customers or the Licensed Provider's existing customers). Rather, the framework should be designed to ensure that POLR obligations fall on Licensed Providers consistent with the requirements set out in their licenses, and in particular their obligation to provide a universal service.

### *3.3 Triggering POLR arrangements*

In principle, POLR arrangements could be triggered only as a last resort, after time has been allowed for market-based solutions. There are possible steps before POLR arrangements are triggered: customers may switch to a new licensed provider of their own volition; there may be a trade sale of the customer base of a Licensed Provider in receipt of a Termination Notice. Alternatively, POLR arrangements could be triggered immediately when the CMA becomes aware of a default.

### *3.4 Customers who have paid retail charges in advance*

One difficulty that could be faced by the market is the situation where a customer has paid for retail services in advance. If that customer's Licensed Provider is in default and receives a Termination Notice, POLR arrangements will ensure that the customer has a new Licensed Provider. Should that customer be expected to pay charges to the new Licensed Provider? If not, how should the Licensed Provider recover any costs associated with providing services to the customer?

### *3.5 The legal basis for POLR*

Finally, it is worth considering whether the CMA has the authority to assert that a POLR has a deemed contract with each of the failed supplier's customers. Although these arrangements may be accepted by all market participants by virtue of their acceptance of the Market Code, it may be the case that they are subject to challenge by a particular customer.

#### 4. Questions and options

##### ***Question 1: When should POLR arrangements be triggered?***

###### *Issue*

As noted above, the market could expect to allocate customers to a new Licensed Provider when an existing Licensed Provider receives a Termination Notice. The issue is how long should be allowed for customers to switch, or be bought in a trade sale, before POLR arrangements are triggered.

In the event of a Licensed Provider defaulting, there is a trade-off between allowing the market time to find a solution and imposing an administrative solution. If the market is given time to find a solution there is the potential to reduce disruption for Licensed Providers and transactions costs for CMA and its members. However, there is also the risk that customers will be left without a Licensed Provider, and that there will be uncertainty over the collection of wholesale charges for Scottish Water.

###### *Options*

The default by the Licensed Provider could be the immediate trigger for the issue of a Termination Notice by the CMA and for POLR arrangements to come into effect. Alternatively, the CMA could allow a defined period of time for 'active' customers to switch, and/or for the customer base of the exiting Licensed Provider to be sold in a trade sale.

###### *Comments/recommendations*

If a period of time is allowed for active switching and a trade sale, this will reduce the number of customers requiring to be allocated through the POLR arrangements. However, if the period of time is too long, there could be risks associated with unattached customers. We therefore recommend that the CMA should define this period, and propose that the period should be one month.

***Question 2: Should SPIDs be auctioned or allocated?***

*Issue*

Market Code arrangements are required to ensure that all SPIDs are transferred from a Licensed Provider in receipt of a Termination Notice to another Licensed Provider. These arrangements are the POLR arrangements.

*Options*

In the event of default, the defaulting Licensed Provider's SPIDs could be auctioned to other Licensed Providers, or they could be allocated by an administrative process.

*Comments/recommendations*

In some utility markets, suppliers bid in terms of the tariffs they will offer to customers, and all suppliers are obliged by their licences to provide a bid. The regulator accepts the best bid on behalf of customers.

The existence of default tariffs in the non-domestic retail market for water services in Scotland suggests that this approach would require modification, for example, if no Licensed Provider were willing to bid below the default tariffs. Neither is it clear that Licensed Providers would be willing to bid a lump sum to take on a defaulting License Provider's customers.

The Market Code currently envisages an administrative process for allocating SPIDs. Even with an auction arrangement, we believe that an administrative process would be required.

**Question 3: If SPIDs are allocated to LPs, how should they be allocated?**

*Issue*

Not all SPIDs are likely to be as valuable to retailers, both in terms of the gross margin and percentage margin that they offer. Some SPIDs may be valuable and carry a high margin; others may be less valuable and carry a low margin. Similarly, not all SPIDs carry the same level of risk for retailers; some may carry very little risk, whilst others may be a potential liability (for example, those with bad debt). The issue is how the allocation of SPIDs should take account of these differences.

*Options*

There are a number of possibilities for allocating SPIDs, including the following:

- Return the SPID to the Licensed Provider that previously held it.
- Allocate an equal number of SPIDs to each Licensed Provider; use a random allocation.
- Allocate an equal number of SPIDs to each Licensed Provider; stratify SPIDs by connection size, but use a random allocation between Licensed Providers for each connection size.
- Allocate SPIDs to each Licensed Provider in proportion to their existing market share measured by 'weighted SPID'; use a random allocation.
- Allocate SPIDs to each Licensed Provider in proportion to their existing market share measured by 'weighted SPID'; stratify SPIDs by connection size, but use a random allocation for each connection size

*Comments/recommendations*

The approach to allocation used should balance fairness of outcome, administrative simplicity and effectiveness in maintaining market stability. 'Fairness of outcome' could be interpreted as ensuring equal possibility for all Licensed Providers to experience gains and losses as a result of the arrangements. 'Administrative simplicity' could be interpreted as the option that minimises the costs of the CMA in discharging its POLR responsibilities. 'Effectiveness in maintaining market stability' could be interpreted as allocating SPIDs to those Licensed Providers best able to service them – it may be inappropriate for a very small Licensed Provider to receive a large number of SPIDs in the event that a Licensed Provider with a large share of the market receives a Termination Notice.

If a period of time is allowed before POLR provisions are triggered, then the number of SPIDs requiring allocation should be reduced, reducing the risk that a small Licensed Provider will be faced with receiving a large number of SPIDs. This should mean that there is not such a great difference between options in terms of effectiveness in maintaining market stability'.

We proposed that the third option (*'Allocate an equal number of SPIDs to each Licensed Provider; stratify SPIDs by connection size, but use a random allocation between Licensed Providers for each connection size'*) would provide the appropriate balance between fairness and administrative simplicity.

**Question 4: Should associated water and sewerage SPIDs be kept together?**

*Issue*

Water SPIDs and sewerage SPIDs are separately switchable under the current market arrangements. This is to allow for the fact that some customers may seek the services of specialist water services or sewerage services providers. However, in practice it is likely that the majority of customers will use a single services provider for both water and sewerage services.

Where a customer has chosen to use a single Licensed Provider for water and sewerage services, and POLR arrangements have been triggered in connection with that Licensed Provider, the issue is whether the arrangements should keep the water and sewerage SPIDs together. On the one hand, if water and sewerage SPIDs must be allocated separately, this is likely to create an administrative cost for the CMA and customers. On the other hand, if associated water and sewerage SPIDs are kept together, this could be seen as disadvantaging water only and sewerage only service providers.

*Options*

The options are:

- To keep associated (i.e. belonging to the same customer) water and sewerage SPIDs linked.
- To allocate water and sewerage SPIDs separately.

*Comments/recommendations*

We believe that customers are likely to prefer their water and sewerage SPIDs to remain associated in the event that POLR provisions are triggered.

**Question 5: Should the allocation of SPIDs to LPs take account of 'small' licensed providers?**

*Issue*

It may be that some suppliers holding a full licence are relatively small organisations providing services for a similar number of SPIDs as self-suppliers or specialist suppliers. These providers could be structured and organised with a view to servicing only a limited number of customers, and may face difficulties under some approaches to POLR arrangements.

*Options*

There are a number of options for the handling of small Licensed Providers:

- Include all Licensed Providers in the POLR arrangements
- Establish a threshold number of SPIDs required before a Licensed Provider becomes part of the POLR arrangements
- Assess the capability of each Licensed Provider to become part of the POLR arrangements

*Comments/recommendations*

We believe that the CMA should not be required to assess a Licensed Provider's financial or operational capacity to receive SPIDs through the POLR arrangements (either in terms of the services offered to the new customers or the Licensed Provider's existing customers).

Rather, the framework should be designed to ensure that POLR obligations fall on Licensed Providers consistent with the requirements set out in their licenses, and in particular their obligation to provide a universal service. As all Licensed Providers are required to offer default tariffs to all customers, we do not believe that there should be a threshold number of SPIDs required before a Licensed Provider becomes part of the POLR arrangements.

**Question 6: What arrangements should be put in place to assist LPs in gaining access to customer data not held by the CMA?**

*Issue*

As noted above, the POLR arrangements can establish a set of rules, but the implementation of those rules may require cooperation from outgoing Licensed Providers in the form of the provision of customer data. The issue is whether arrangements can be put in place to improve the likelihood that the relevant information is provided in the event that POLR arrangements are triggered.

*Options*

There are three potential options:

- Licensed Providers accept POLR obligations and work within any constraints resulting from data availability under the current arrangements;
- Licensed Providers seek stronger obligations, either under the Market Code or through a licence condition, on exiting parties to provide the necessary information to the best of their ability; or
- Licensed Providers seek a change to market arrangements, to the effect that the CMA should hold the required customer data.

*Comments/recommendations*

We believe that it would be expensive for the CMA to hold and provide customer data, relative to the potential benefits of such an arrangement. However, we believe that there may be merit in Licensed Providers seeking stronger obligations on exiting parties, either in the Market Code or in licences.

**Annex 1: Extract from the Market Code**

**1.1.1 Provider of Last Resort**

- (i) If and when the CMA issues a Termination Notice under Section 10.7.2 to a Licensed Provider which has become a Defaulting Trading Party, and provided that any Supply Points are still Registered to the Defaulting Trading Party ("POLR Supply Points"), the CMA shall:
- (a) allocate the POLR Supply Points to any one (1) or more Licensed Provider(s) (other than any Specialist Licensed Provider, any Self Supply Licensed Provider and the Defaulting Trading Party) that is entitled to Register Supply Points in accordance with Section 5.2.2 in accordance with the Allocation Process; or, in the absence of an approved Allocation Process,
  - (b) allocate the POLR Supply Points to each Licensed Provider (other than any Specialist Licensed Provider, any Self Supply Licensed Provider and the Defaulting Trading Party) that is entitled to Register Supply Points in accordance with Section 5.2.2 as follows:-
    - (b)(1) the particular POLR Supply Points allocated to each Licensed Provider shall be allocated on a random basis; and
    - (b)(2) each Water Services Licensed Provider shall be allocated an equal number of POLR Supply Points for Water Services and each Sewerage Services Licensed Provider shall be allocated an equal number of POLR Supply Points for Sewerage Services subject, in each case, to any rounding up or down required in order to allocate a whole number of Supply Points; and
    - (b)(3) if, at any stage in the process set out in this Section 5.3.6(i)(b), there are fewer POLR Supply Points than there are Licensed Providers (for either or both Water and Sewerage Services) each remaining POLR Supply Point shall be allocated to the Licensed Providers by the CMA in date order based on the date of grant of each Licensed Provider's Permanent Licence with the earliest date of grant being given priority.

- (ii) the CMA shall Register the POLR Supply Points so allocated to the relevant Incoming Licensed Provider(s) in accordance with CSD 0003 (Provider of Last Resort) with the Designated Time being the date of issue of the Termination Notice; and
- (iii) where any Licensed Provider is required, pursuant to its Licence, to provide Water Services or Sewerage Services in Designated Circumstances, the Licensed Provider shall be responsible for all Supply Point(s) Registered to it by the CMA from the Designated Time in accordance with this Section 5.3.6; and
- (iv) the CMA shall introduce a Market Code Change Proposal in accordance with Section 8.7 that contains a proposed Allocation Process which either amends or replaces the process set out in Section 5.3.6(i)(b) as soon as possible after the Effective Date and shall, to the extent that the CMA is able to do so, seek to ensure that the Market Code Change Proposal process is completed in respect of that Change Proposal prior to the Go Live Date.

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## Annex 2: Market Documents: Principles and Objectives

### Principles for the Market Documents

The following principles have been established by the Commission in relation to the core industry documents:-

- a. **Proportionality** - the rules and arrangements established by or under each core industry document should be proportionate within the context of their respective objectives; in particular, those established by the market code should be proportionate to the size of the market for the provision of licensed services and the anticipated number and frequency of transfers of eligible customers for the provision of licensed services from one licensed provider to another;
- b. **Transparency** - the rules and arrangements established by or under each core industry document should be concise, clearly expressed, well structured and readily accessible to both existing and prospective licensed providers;
- c. **Simplicity, cost effectiveness and security** - the systems and processes established by or under the market code and operational code should be as straight forward and as economical as possible (whilst being capable of development over time) and should contain appropriate data integrity and security controls;
- d. **Non-exclusivity** - the rules and arrangements established by or under the market code should be sufficiently clear, simple and cost effective, to support the majority of trading activity in the market for the provision of licensed services whilst allowing for relevant identified activities to be carried out, on a bilateral basis, outwith the scope of the market code;
- e. **barriers to entry** - the rules and/or arrangements established by or under each core industry document should not create barriers to entry in respect of the market for the provision of licensed services.
- f. **customer contact** - the rules and arrangements established by or under the operational code should ensure that, save in exceptional circumstances, the primary contact with each eligible customer should be interfaced through the relevant licensed provider;
- g. **non-discrimination**- the rules and/or arrangements established by or under each core industry document should not unduly discriminate, or create undue discrimination, between licensed providers; and
- h. **core functions**- the rules and/or arrangements established by or under each core industry document should not be detrimental to the exercise of Scottish Water's core functions; and (for the purpose of paragraph 3a above) the objective of each wholesale services agreement shall be taken to be the establishment of terms and conditions that are to apply as between Scottish Water and a licensed provider for the supply of water, or, as the case may be, the provision of sewerage to, or disposal of sewage from, premises in accordance with section 16 of the 2005 Act.

**Objectives of the Market Code**

The objectives of the market code shall be:

- a. To enable the registration of data concerning eligible customers or eligible premises which is or may be relevant to the provision of licensed services;
- b. To enable the transfer of eligible customers from one licensed provider to another;
- c. To enable the calculation of charges to be recovered by Scottish Water from licensed providers;
- d. To make provision in respect of the amendment of the operational code; and
- e. To make provision for any related transitional, supplemental and ancillary matters.