

**September 2002**

**Review of the Licensing Application  
Regulations**

**Consultation document**

## Summary

This document continues a consultation process about the current gas and electricity licence Application Regulations that began in March 2002 with the publication of guidance for applicants. It summarises a review of the current Application Regulations and proposals for their amendment. A full description of the review and proposals can be found in the supplement to the consultation document on the publications section of Ofgem's website <http://www.ofgem.gov.uk/public/pubframe.htm>.

This document restates Ofgem's commitment to careful regulation and its willingness to take enforcement action where appropriate. However, it outlines market changes since the Application Regulations took their current form: liberalised markets have proved robust to the failure of participants; industry systems have been created to ensure the stability of new entrants; the regulator has acquired considerable experience, and learned that information gathered at the licensing stage is of little value for licence enforcement. The precautionary approach embodied in the Application Regulations is therefore no longer appropriate – indeed, to the extent it implies licensees' financial plans have been "approved" by Ofgem, it is harmful. It is also clear that considerably reducing the information required with licence applications would have no negative effects on Ofgem's ability to protect consumers through regulation after licences have been granted.

The document reiterates that Ofgem can make no check at the time of granting a licence which can give confidence about a licensee's future successful operation. It explains the requirements of the current Application Regulations and invites views on proposed amendments which Ofgem considers will significantly decrease the burden on applicants without reducing the protection given to the market, other participants and customers. These proposals include:

- increasing the time within which a notice of application for a licence must be published from 7 days to 10 working days of an application being made;
- additional checks to ascertain whether an applicant's directors and principal shareholders are undischarged bankrupts;
- introducing a requirement for applicants to submit a declaration about unspent criminal convictions;

- removing the requirement for applicants to provide information about their finances, expertise and business plans; and
- reducing the amount of additional information and documents that must be submitted with an application.

The document also summarises a review of the industry testing required of new entrants. It proposes enhancements to the existing route to market.

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# 1. Rationale

## *Issue*

- 1.1 The Gas and Electricity Application Regulations ("the Application Regulations") are a core component of the gas and electricity licensing system<sup>1</sup>. They specify the information which must be provided to Ofgem before a licence is granted. This constitutes one of the most significant thresholds which all but the smallest market entrants must cross.
- 1.2 Ofgem considers that, in discharging its statutory duties, it should ensure that the licensing process and the Application Regulations are as comprehensible, clear and user-friendly as possible. The Application Regulations must also be relevant to today's gas and electricity markets, imposing only justified regulatory burdens.
- 1.3 The licensing system has been described as over burdensome and taking longer than necessary<sup>2</sup>. Ofgem considers that this perception has arisen because the Application Regulations have changed little over fifteen years, despite major changes in British energy markets.
- 1.4 It is clear that the current Application Regulations create a barrier at some level to new entry into the market. New market entry will tend to protect the long-term interests of customers through promoting competitive rivalry and reinforcing improvements in service and downward pressure on prices. The costs (in time and money) of licensing are probably not in most instances a major barrier to market entry. However, failure to address unjustified barriers to entry could, at the margin, reduce customers' access to the full benefits of competition. Therefore, for the regulator to maintain such barriers to entry requires a clear justification in terms of protection of customers' interests.

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<sup>1</sup> The Gas (Applications for Licences and Extensions and Restrictions of Licences) Regulations 2001 SI 3353 and the Electricity (Applications for Licences and Extensions and Restrictions of Licences) Regulations 2001 SI 3354.

<sup>2</sup> "Report to the DTI of the Consolidation Working Group." Ofgem 09/02

- 1.5 The current Application Regulations are based on the original regulations created fifteen years ago to control entry to the newly opening gas market<sup>3</sup>. The original gas and electricity Application Regulations adopted a precautionary approach. They were created in a context of public concern about the financial stability of liberalised markets, and the ability of competition to produce customer benefits. They were also to be used by newly created regulators with little or no experience in the UK or globally on which to draw. Moreover, at that time few well-established systems existed for interactions between non-integrated players and to prevent abuse of industry systems. Against that context, the barriers created by the substantial requirements of the Application Regulations were thought to be of value in preventing untrustworthy market entry, and in any case to be justified by the assistance they gave to the newly formed regulators in protecting customers.
- 1.6 Many of the factors applying in 1986 or 1990 no longer apply. Liberalised energy markets have proven robust to major shocks (substantial external increases in wholesale costs, the failure of a major energy trader and supplier). Ofgem is a regulator with substantial experience, and has developed an effective approach to protecting customers. Notably, Ofgem tends not to rely on information provided before a licence is granted (because most of it rapidly becomes out-of-date) but to use its information-gathering powers in a targeted way as problems arise. The appropriateness of gathering background information during the licensing process is discussed in greater detail in chapter 6 of the supplement to the consultation document which is available on Ofgem's website <http://www.ofgem.gov.uk/public/pubframe.htm>.
- 1.7 Not only has Ofgem learned to regulate effectively without much reference to pre-licensing information, we have also experience of the reactions of market players to the fact that Ofgem requests a business plan (as required by the Application Regulations). The perception that Ofgem in some sense “approves” a business plan before granting a licence is, regrettably, widespread, and Ofgem is aware of this being used to underpin licensees’ fund-raising activities. This is despite repeated public statements that Ofgem can make no check at the time of granting a licence which can give confidence about a licensee’s future successful

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<sup>3</sup> The Gas (Applications for Licences and Extensions and Restrictions of Licences) Regulations 1986 and The Electricity (Applications for Licences and Extensions and Restrictions of Licences) Regulations 1990.

operation. Chapter 5 of the supplement to the consultation document discusses the weaknesses of financial tests including the retrospective and potentially discriminatory nature of audited accounts. It explains Ofgem's view that business plans are at best an indication of an applicant's intentions and predictions. It also examines the different natures of competitive market and network licensees.

- 1.8 There is a particular need to ensure that the barriers to entry imposed by the Application Regulations do not unnecessarily duplicate the protection or barriers imposed by other forms of control. Chapter 6 of the supplement to the consultation document sets out Ofgem's view that by requiring information to be submitted about safety during the licensing process it duplicates the roles that the Health and Safety Executive and the Department of Trade and Industry's Engineering Inspectorate have in ensuring the safe operation of network companies.
- 1.9 Today's industry has devised substantial and effective industry and entry testing processes. Ofgem has recently reviewed the industry and entry testing processes which comprise the route to market for gas and electricity suppliers. Chapter 8 of the supplement to the consultation document sets out the results of this review which Ofgem has found to be robust and far reaching. The supplement proposes some enhancements and sets out the criteria Ofgem will apply in considering changes to industry entry testing.
- 1.10 Ofgem has recently consulted on its criteria for assessing licence applications<sup>4</sup>. (This earlier consultation took the current Application Regulations as given.) Respondents to the previous consultation:
- ◆ welcomed Ofgem's aims of reducing bureaucracy in the application process;
  - ◆ stated that the current Application Regulations are no more user friendly or comprehensible than the original Application Regulations; but also

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<sup>4</sup> "Gas and electricity licence applications." Guidance document. Ofgem 27/02.

- ◆ raised concerns that any attempt to reduce barriers to entry would increase the likelihood of company failure and default which would have an impact on other market participants and customer.

### *Objective*

- 1.11 The review covered in this document considered whether the requirements of the current Application Regulations are appropriate in a market which has evolved considerably since its inception. Where the review identified regulatory barriers to entry which could no longer be justified the review sought to identify amendments which would, if adopted, significantly decrease the burden on applicants without reducing the protection given to the market, other participants and customers.
- 1.12 This document should be read in conjunction with the current Application Regulations. Copies of the current Application Regulations are included in Appendix 1 of this document.
- 1.13 A supplement to the consultation document is available on Ofgem's website <http://www.ofgem.gov.uk/public/pubframe.htm>. The supplement contains a more comprehensive discussion of the issues and proposed amendments set out in this consultation document.



### ***Policy options***

- 1.14 The review identified significant aspects to the current licensing system which Ofgem considers are no longer justified. We have identified three possible options to address these regulatory barriers to entry:
- ◆ Option 1 – no change; and
  - ◆ Option 2 – amendment of the existing Application Regulations.
- 1.15 There are two possible approaches to the amendment of the existing Application Regulations:
- ◆ Option 2a – the amendment retains the requirement for some information to be submitted by applicants; and
  - ◆ Option 2b – the amendment requires applicants to submit only their names and addresses.

#### **Option 1 – No change**

- 1.16 As noted above, the licensing system has been criticised for slowness and excessive burdens. However, these complaints could relate to Ofgem's operation of the licensing system, rather than to the Application Regulations themselves. Moreover, criticisms are relatively isolated. The majority of applicants do not criticise the system (although this could be because they feel that to do so might jeopardise relations with Ofgem at a time they can ill afford this).
- 1.17 In addition, it could be argued that the barriers to entry presented by the licensing system are small, compared to other requirements for market entry. Many licensable activities require very large cash resources. Others require a prospective market entrant's systems to undergo significant testing before it can begin operation. It could be thought that, because of these factors, prospective entrants need to assemble substantial resources, regardless of the licensing process.
- 1.18 However, Ofgem does not consider these arguments to be well-founded. Ofgem needs to determine priorities against available resources. Ofgem may choose

not to attack barriers to entry created by others, if these seem small. However, it is a different matter for Ofgem through its own (in)action to create or maintain an entry barrier, even if the impact of this is small. Ofgem considers that its licensing operations are reasonably efficient, within the constraints of the current Application Regulations, but believes licensing still creates a small barrier to entry. Chapter 3 of the supplement to the consultation document examines the value delivered by the administrative barrier to entry imposed by the requirement for applicants to publish notices of application in newspapers and The London and Edinburgh Gazettes. It considers whether it would be more appropriate for notices to be published on the applicant's or Ofgem's website.

- 1.19 More importantly, Ofgem considers that current arrangements are actively damaging in certain respects. As noted above, Ofgem is aware of claims that Ofgem in some sense “approves” a business plan before granting a licence being used by licensees to underpin fund-raising activities. Ofgem has repeatedly made public statements that we can make no check at the time of granting a licence which can give confidence about a licensee's future successful operation. However, it would seem that this “moral hazard” is created inherently by the fact that we request business plan information, as required by the Application Regulations.

#### **Option 2a – Retain the requirement for some information**

- 1.20 This option would involve focusing the Application Regulations on those areas where, in today's market, they are still needed. It would involve removing from the Application Regulations obligations to provide information which create no benefit to customers. The need for customer protection means pre-licensing checks should focus on two key areas:
- ◆ ensuring that Directors and principal shareholders are not disqualified or convicted of any unspent conviction in this country or overseas; and
  - ◆ requesting information about social and environmental obligation codes of practice.
- 1.21 The former is an area which Ofgem cannot easily address after the licence is granted, as discovering that the Directors or principal shareholders fall into this

category would not permit Ofgem to revoke the licence. Chapter 4 of the supplement to the consultation document explains Ofgem's reasons for focusing on these two checks, ensuring that directors and principal shareholders are not undischarged bankrupts and do not have unspent convictions. It also examines the difficulties that exist in conducting ongoing checks.

- 1.22 The second is one of the areas in which, as a matter of regulatory practice, Ofgem routinely and proactively monitors licensees' activities. While Ofgem could meet this need through ex post requests for information, it seems more efficient to meet it by requiring information on this area to continue to be provided in the application<sup>5</sup>. Chapter 6 of the supplement to the consultation document sets out the need to protect domestic customers through the submission and approval of codes of practice and statements for social and environmental obligations during the licensing process. It draws a distinction between domestic and non domestic customers and focuses on those activities which are likely to have impact upon customers.
- 1.23 Ofgem considers that there are no significant risks attached to the proposed revision of the Application Regulations for customers. Where Ofgem requires information for enforcement or monitoring purposes, it has better means of securing it, other than in the two specific areas mentioned above.
- 1.24 Removing extensive requirements to submit information will have some (perhaps marginal) effect to reduce entry barriers. Any initiative designed to increase competitive rivalry may increase the risk of company failure and default. Ofgem accepts that from time to time, companies in competitive markets fail. While failure is regrettable for the shareholders involved, it can be a sign that competition is working effectively. Ofgem considers that the existing market arrangements have functioned successfully since their inception and will continue to protect other market participants and customers from the effects of a company's failure.
- 1.25 Ofgem has considered whether it is appropriate to continue to grant licences which remain valid indefinitely when proposing the removal of some of the existing regulatory barriers to entry. A move to a licensing system in which

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<sup>5</sup> The provision of information after the granting of a licence can be referred to as ex post provision.

licences need to be renewed every five years has been considered. However, Ofgem considers that such a scheme would impede the ability of those seeking network or generation licences to obtain the necessary funding. Such a scheme may also deter customers switching to an alternative supplier. Customers may be unwilling to switch to a new supplier when there is a risk, however small, that the supplier may not have its licence renewed.

1.26 Ofgem has also considered whether the terms of licence revocation need to be strengthened, to protect customers, if it is easier for applicants to obtain licences. Ofgem has concluded that its powers to revoke licences are adequate. In particular Ofgem has the ability to revoke licences rapidly in case of insolvency. Ofgem would also be unable to change the terms of revocation for licences already granted.

1.27 Ofgem considers that the impact on cost of the proposed amendments would be:

- ◆ marginally positive for customers with increased competitive rivalry leading to reduced costs;
- ◆ positive for new applicants, who would be required to pay a reduced fee and face reduced regulatory barriers of entry; and
- ◆ broadly neutral for existing market participants who will face no extra compliance costs. Existing participants may, however, be subject to increased levels of competition.

1.28 Ofgem considers that the impact of the proposed amendments to the Application Regulations regime would be neutral for the environment. While network operations and power generation are most likely to have a significant impact on the environment, Ofgem considers that the licensing process provides less of a barrier to entry than other factors including the need to obtain funding. Ofgem also considers that the social impacts of the proposed amendments would be neutral.

1.29 The impacts upon Ofgem in terms of staffing and costs would probably be positive. It is likely that the proposals to amend and replace the Application

Regulations would lead to a decrease in officer time needed to process an application.

- 1.30 It is not foreseen that the proposed amendments to the Application Regulations would have any impacts on licence compliance, since (as noted above) this already relies very largely on securing information from other sources.

#### **Option 2b – Removing the requirement for all information**

- 1.31 It is possible to envisage alternatives to the current licensing system. These could include a regime where those wishing to participate in the gas or electricity markets are awarded a licence to do so once they have registered their intention. This regime would allow Ofgem to know who is in the market for monitoring and enforcement purposes while eliminating the barrier to entry. This would allow applicants to provide only their names and addresses before being granted a licence to participate. Ofgem understands this is the basis for much of today's licensing of communications networks and services.
- 1.32 Such a regime could provide those who register their intent with a licence containing the same conditions as now. This regime could provide benefits to customers by removing barriers to entry. This could result in an increase in competitive rivalry which may lead to improvements in service and downward pressure on prices. However, the extent of increase in rivalry would depend on how major a barrier is presented by the current licensing regime. It is not clear the increase in customer benefits from competition would be significant.
- 1.33 This option presents significant disadvantages. Ofgem considers that the licensing process is valuable in enabling us to gather information about an applicant. In particular this regime would not allow Ofgem to check that an applicant's directors or principal shareholders were not disqualified or have unspent criminal convictions. Nor would such a regime require applicants to consider the way in which social and environmental obligations would be discharged before operations commence. Ofgem sees value for customers in our being able to ensure that applicants have in place processes to comply with their licences.

- 1.34 For these reasons, Ofgem does not intend to take forward option 2b. Identifying necessary amendments to the current Application Regulations (i.e., option 2a) would be more suitable in allowing Ofgem to retain appropriate protection for customers.

***Recommendation***

- 1.35 Ofgem has considered the merits and drawbacks associated with each of the options presented. Ofgem is not convinced that amending the Application Regulations so that applicants are not required to submit information during the licensing process (option 2b) would provide customers with an adequate level of protection.
- 1.36 The proposal to amend the requirements of the existing Application Regulations, but retain the need for applicants to submit some information (2a) has clear advantages:
- ◆ existing levels of customer protection can be maintained in a licensing system with which industry is familiar; and
  - ◆ the unnecessary burdens and misleading signals associated with the current arrangements can be removed.
- 1.37 Ofgem considers that the cost impact of the recommended policy option will be broadly positive for new applicants for whom the cost of submitting an application will be reduced. The impact will be broadly neutral for existing market participants and marginally positive for customers.
- 1.38 Ofgem therefore favours amending the current Application Regulations in line with policy option 2a, and the proposals set out in this document enlarge on that option.

## 2. Summary of proposals

2.1 Amending the current Application Regulations in line with policy option 2a will require the following amendments to be made:

- ◆ the amendment of the requirement for applicants to publish notices. With the exception of applications for restrictions, Ofgem proposes that notices should be placed exclusively on its website. Ofgem also proposes lengthening the time within which a notice of application must be published from 7 days to 10 working days of an application being made. It also proposes to change Ofgem's current arrangements for publishing notices where it proposes to grant licences for gas transportation and electricity transmission. These issues are discussed in greater detail in chapter 3 of the supplement to the consultation document;
- ◆ retaining the need for applicants to submit information about directors and principal shareholders. It proposes that Ofgem uses this information to check whether directors, sole traders, partners or principal shareholders are undischarged bankrupts. It proposes requiring the submission of a declaration about unspent relevant convictions. However it explains why Ofgem does not consider that any checks it can perform during the licensing process can guarantee the continuing probity of licensees. These issues are discussed in greater detail in chapter 4 of the supplement to the consultation document;
- ◆ significant amendments to the requirement for applicants to submit information about the financing of their business, their business proposals and their expertise. The proposals will significantly reduce the regulatory burden for applicants. It also proposes that Ofgem should, before granting a licence, check to see that applicants are not insolvent. These issues are discussed in greater detail in chapter 5 of the supplement to the consultation document;
- ◆ significant amendments to the requirements for applicants to submit information and documents under Schedule 3 which will reduce the

regulatory burden. However, it recommends that the existing measures which directly regulate how licensees deal with domestic customers are retained. Appendix 2 of the supplementary document summarises the information which applicants are required to submit by Schedule 3 of the Application Regulations together with Ofgem's proposals for amendments. These issues are discussed in greater detail in chapter 6 of the supplement to the consultation document;

- ◆ an examination of the fees charged for an application should the changes proposed be adopted. While Ofgem believes that the changes will lead to a reduction in fees, it is not yet possible to quantify the reduction. These issues are discussed in greater detail in chapter 7 of the supplement to the consultation document; and
- ◆ some enhancements to the existing route to market. An internal Ofgem review of the industry testing which forms part of the route to market for gas and electricity suppliers is set out in chapter 8 of the supplement to the consultation document. Chapter 8 presents an outline of the regulatory frameworks, a brief history of entry testing.

2.2 Greater discussion of the proposed amendments is set out in the supplement to the consultation document. The supplement is available on the publications section of Ofgem's website <http://www.ofgem.gov.uk/public/pubframe.htm>.



### 3. Timetable

3.1 This document continues a consultation process about the operation of the licensing process. This process of consultation began in March 2002 with the publication of a guidance document ("The Guidance Document") for applicants<sup>6</sup>, which assumed no change in the contents of the current gas and electricity Application Regulations. This document contains proposals to amend the regulations.

3.2 The proposed timetable for what happens next is:

- ◆ replies to the consultation should be sent by 25 November 2002;
- ◆ Ofgem will consider responses received during December 2002 and January 2003;
- ◆ the Gas and Electricity Markets Authority will be invited to make new Application Regulations in February 2003; and
- ◆ the new Application Regulations will commence in April 2003.

3.3 Ofgem will consider any comments made and, where necessary, revise its approach to the review of the Application Regulations. Comments should be sent by 25 November 2002 to:

Michael Fewes  
Licensing Policy Manager  
Ofgem  
9 Millbank  
London SW1P 3GE

Or by e-mail to [michael.fews@ofgem.gov.uk](mailto:michael.fews@ofgem.gov.uk)

3.4 Where paper copies of a response are sent, it would be helpful if responses could also be sent electronically. It is open to respondents to mark all or part of their responses as confidential. However, we would prefer it if, as far as possible, responses were provided in a form that can be placed in the Ofgem library and on our website.

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<sup>6</sup> "Gas and electricity licence applications" Guidance document. Ofgem 27/02.

3.5 If you have any queries about this consultation then Michael Fews (tel 020 7901 7085) will be pleased to help.

## **Appendix 1 The Application Regulations**

1.1 This appendix contains copies of the current Application Regulations.