Gas and electricity licensees,
potential new entrants,
consumer groups and any other
interested parties.

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Direct Dial: 020 7901 7437
Email: mark.feather@ofgem.gov.uk

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Dear colleague

Decision letter: Gas and electricity licence Application Regulations and Guidance Document

Introduction

On 5 April 2007 we published a consultation document[1] setting out proposed changes to the Gas and Electricity Application Regulations[2] and our Guidance Document[3] on licence applications. Some of the proposed changes were required as a consequence of the Supply Licence Review. We also proposed other changes intended to reduce the administrative burdens on applicants while ensuring that we continue to protect the interests of consumers.

In addition, we proposed to clarify the checks we will generally make and factors that we will generally take into consideration in seeking to determine if an applicant is insolvent[4] and to identify situations where a "phoenix company" is using a prohibited name[5].

Respondents' views

We received two responses to the consultation. One from EDF Energy ("EDF") and the other from energywatch. Both responses have been published with this letter.

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[1] Gas and electricity licence applications - Application Regulations and Guidance Document Consultation. 5 April 2007. Ref: 82/07
http://www.ofgem.gov.uk/LICENSING/WORK/Documents1/Application%20Regs%20and%20Guidance%20Cons%20FINAL.pdf

[2] The Gas (Applications for Licences and Extensions and Restrictions of Licences)(No. 2) Regulations 2004 SI No. 2983 and the Electricity (Applications for Licences, Modifications of an Area and Extensions and Restrictions of Licences)(No. 2) Regulations 2004 SI No. 2952.

[3] Gas and electricity licence applications. Guidance document. March 2005. Ref: 86/05.
http://www.ofgem.gov.uk/Licensing/Work/Documents1/10070-8605.pdf

[4] "insolvency" means as defined in the revocation conditions of the relevant licence.

[5] Section 216 of the Insolvency Act 1986 – otherwise known as the "phoenix" company provision - states that where a company has gone into insolvent liquidation, any person who was a director or shadow director of that company in the 12 months before it went into liquidation may not, for 5 years, be a director of, or be concerned in the management of, any other company that is known by a "prohibited" name.
A "prohibited" name is the name by which the liquidating company was known in the 12 months before its liquidation, or a name that is so similar as to suggest an association with that company (section 216(2)).
There are some limited exceptions to this rule set out in the legislation. In addition, directors can apply to court for consent to act as a director of a phoenix company with a prohibited name (section 216(3)).

EDF supported the key policy and procedural changes we proposed in the consultation. energywatch supported our proposals to minimise the administrative burden on licence applicants.

Network licences

Whilst EDF welcomed our proposed review of procedures for assessing Network[6] Licence applications it stated that one way of "...minimising insolvency risk (at source) is to increase the stringency of financial checks on new entrants to ensure that any prospective network licensees fully understand the financial commitment required and have the necessary backing to enter the market."

EDF considered this to be the reverse of our current position of not requiring network licence applicants to submit financial information[7] and stated that this was "...arguably an abdication of Ofgem's legal duty to exercise a proper discretion when considering whether to grant a licence".

Related companies and revocation of licences

energywatch considered that we had not gone far enough in protecting consumers from "phoenix companies" and this was "...a significant deficiency in the current proposal". energywatch also stated that, in circumstances where a licensee has failed and exited the market, consideration of "...past conduct should remain a factor when either that same company or substantially the same directors (or shadow directors) or shareholders subsequently apply for a new licence".

energywatch stressed the need to ensure that we apply an appropriate level of scrutiny when considering licence applications, particularly where the applicant is related to a previously failed licensee. It stated that adequate protection of consumers' interests should act as the key consideration before granting a licence.

While recognising that this consultation "...does not deal directly with licence revocation...", energywatch reiterated its concerns regarding "...the circumstances in which Ofgem can revoke a licence". It suggests that we adopt a more proactive approach and also consider whether there is presently scope within the law for us to revoke a licence "...where, in all practical respects, a licensee is insolvent if not necessarily so by the legal definition".

Ofgem's view

Network Licences

We are required to carry out our functions in the manner which we consider best calculated to further our principal objective having regard, inter alia, to the need to secure that licence holders are able to finance the activities which are subject to obligations imposed by or pursuant to the relevant statutes[8].

Applicants for network licences are expected to demonstrate that they will be able to comply with the conditions of their licence, including those conditions imposing financial requirements on them. Although the mechanism for incorporating such conditions into the licence is different for gas transporter and electricity distribution licences.

As mentioned in the April consultation we will be reviewing our procedures for assessing Network Licence applications over the coming year.

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[6] Gas transporter, electricity distribution and transmission licence applications.
[7] The requirement to provide financial information such as audited accounts and business plans was removed in April 2003, following a review of licensing policy.
[8] The Gas Act 1986, the Electricity Act 1989 and the Utilities Act 2000

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Related companies and prohibited company names

We agree with energywatch on the importance of protecting consumers. We consider it important that consumers and other market participants are protected from any confusion which may arise from the naming of "phoenix companies" in those cases where there is a failure to comply with the phoenix company provisions of the Insolvency Act 1986 (the "Act") and the Insolvency Rules 1986 (the "Rules")[9].

The concept of a 'prohibited name'[10] is legally defined by section 216(2) of the Act. Where we suspect that a licence applicant may be using a prohibited name in breach of the Act/the Rules we will liaise with the relevant Insolvency Practitioner and, where appropriate, the Insolvency Service.

However, it is for the Insolvency Service and ultimately the courts to decide whether a company is unlawfully using a prohibited name, not Ofgem. Accordingly, in our consultation we proposed that we would not grant a licence to a company where there is a court decision[11] that the company is using a prohibited name in breach of the Act/the Rules. We remain of that view. In addition, we shall ordinarily await the final outcome of any court proceedings to determine that question and/or pursuant to which a claimant has sought the leave of the courts to use a prohibited name, before granting a licence to the applicant company.

We note energywatch's comments that it considers that we have not gone far enough in protecting consumers from "phoenix companies" and that consideration of 'past conduct' should remain a factor when either the same company or a related company[12] subsequently applies for a new licence.

As noted above, the "past conduct" of a person seeking the leave of the court to act as a director of a phoenix company with a prohibited name, pursuant to s 216(3) of the Act, would ordinarily be considered by the court in the exercise of its discretion to grant or refuse leave.

In view of this we do not think it is appropriate to introduce a separate process for assessing the past conduct of a related company/director in the absence of a formal determination by the courts[13]. Indeed, to establish and undertake such a process in the absence of a formal determination from the courts would be potentially speculative and discriminatory. Further, given that a legal process already exists for "phoenix" companies it is difficult to envisage how Ofgem would set objective and non-discriminatory criteria[14] for assessing past conduct, particularly when past performance may not always be a good indicator of future performance.

However notwithstanding the above, it should be noted that we may refuse a licence application if we consider it to conflict with our principal duty to protect the interests of

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[9] The circumstances in which a person to whom s 216 of the Insolvency Act applies is not required to obtain the leave of the court to use a prohibited name are prescribed by rr 4.228, 4.229 and 4.230 of the Insolvency Rules 1986.

[10] Section 216 of the Insolvency Act 1986 – otherwise known as the "phoenix" company provision - states that where a company has gone into insolvent liquidation, any person who was a director or shadow director of that company in the 12 months before it went into liquidation may not, for 5 years, be a director of, or be concerned in the management of, any other company that is known by a "prohibited" name.
A "prohibited" name is the name by which the liquidating company was known in the 12 months before its liquidation, or a name that is so similar as to suggest an association with that company (section 216(2)).
There are some limited exceptions to this rule set out in the legislation. In addition, directors can apply to court for consent to act as a director of a phoenix company with a prohibited name (section 216(3)).

[11] Under the Insolvency Act there are certain exceptions to the prohibition on the use of a prohibited name – see footnote 10 above. In addition, a court can grant leave authorising the use of a prohibited name.

12 That is, a company with substantially the same directors (including shadow directors) or shareholders as a failed licensee.

[13] That is, a formal court decision in respect of insolvency, use of a prohibited name or to disqualify a director.

[14] In accordance with Directive 2003/55/EC - Concerning Common Rules for the Internal Market in Natural Gas http://europa.eu.int/eur-lex/pri/en/oj/dat/2003/l_176/l_17620030715en00570078.pdf.

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consumers - for example, where the applicant is related to a licensee[15] that has previously been subject to enforcement action by us.

As we stated in our April consultation document we consider that, in most cases, the credit assessment arrangements contained in the industry codes provide sufficient protections for consumers and market participants. The codes aim to strike a balance between ensuring that an appropriate amount of collateralisation is in place (thus managing the risk of the market being exposed to bad debt), whilst enabling users to assign their resources appropriately as opposed to excessive amounts of money being ring-fenced by credit arrangements. This helps protect the best interests of consumers both by reducing the amount of debt ultimately passed through to them and by creating market efficiencies which can result in lower consumer costs.

The credit arrangements in place in the industry codes are likely to be either of the 'energy balancing' type or the 'network operator' type. The former aspires to full collateralisation of market exposures, whilst the latter involves the extension of lines of credit by the network operators based on a party's history or credit score. Where a company is not capable of receiving a rating it is likely they would seek to establish a line of credit based on their payment history. Clearly a new company will not have any payment history and would therefore be unlikely to be extended a significant amount of credit by a network operator for some time.

Revocation of licences

We note energywatch's comments suggesting that we take a more pro-active approach in revoking a licence in circumstances where a particular licensee is in financial difficulty but is not insolvent in legal terms. The concept of "insolvency" for the purposes of triggering our discretion to revoke a particular licence is defined in the revocation conditions of the relevant licence[16].

As we stated in our recent decision letter on licence revocation policy[17] and also in the April consultation, our view is that it will generally require a formal determination[18] of insolvency for the relevant revocation conditions to be triggered. We cannot unilaterally and definitively determine whether or not a company is 'unable to pay its debts' nor would should we seek to pre-empt the outcome of any formal insolvency steps by the company or its creditors.

While every case will turn on its particular facts, in our view, to revoke a licence before a formal determination of insolvency is made would not generally be in accordance with the relevant terms of the licence.

New application regulations and guidance

After careful consideration of the issues raised in our consultation on the Application Regulations and Guidance Document, the proposed changes, as set out in the April consultation document, together with minor clarifying corrections[19], have now been made.

The existing Applications Regulations have been repealed and replaced by new Application Regulations[20]. Also, we have today published a final revised version of our Guidance

[15] An existing licensee or a company that has previously held a licence.
[16] Paragraph 1(f) of schedule 2 of the licence.
[17] Decision letter – Review of policy on licence revocation. 27 February 2007.
[18] This would include a court decision, appointment of a receiver, or if a resolution for winding –up is passed by the company.
[19] On 4 May 2007, we published an open letter to clarify an issue with respect to the consultation, specifically, the letter proposed to omit a specified paragraph from the proposed new electricity Application Regulations in respect of electricity generation licence applications. EDF commented in its response that it supported the proposed omission. No other comments were received and this paragraph has been omitted from the new Electricity Application Regulations

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Document on licence applications. The Guidance Document includes in its appendix a copy of the new Application Regulations.

Yours faithfully,

Mark Feather
Associate Director, Industry Codes and Licensing

[20] The Gas (Applications for Licences and Extensions and Restrictions of Licences) Regulations 2007 SI No. 1971 and The Electricity (Applications for Licences, Modifications of an Area and Extensions and Restrictions of Licences) Regulations 2007 SI No. 1972

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