

Supplier licensing review – Ofgem consultation

23 January 2019

Cornwall Insight

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1 Scope

1. This paper is a response by Cornwall Insight to Ofgem's supplier licensing review consultation of 21 November 2018.
2. Cornwall Insight is an independent consultancy and research company with more than 15 years' experience of providing market intelligence, training and project support on the retail energy market in Great Britain. Over this time, we have witnessed and sometimes helped to facilitate considerable changes in the market, as new suppliers have entered, and the low-carbon transition has hit its stride. We frequently work with new suppliers to help them achieve market entry and run a monthly Energy Supplier Forum. This is particularly aimed at small companies and helps them keep track of industry developments and connect with other suppliers.
3. This paper consists of four elements:
 - 3.1. Our summary opinion
 - 3.2. Comments on the issues faced by entrant and growing suppliers in the energy market, especially since the start of 2018
 - 3.3. Responses to specific questions raised by Ofgem in its consultation
 - 3.4. A short summary of prudential measures for energy suppliers in other markets (to be added)

1.1 Summary opinion

4. New entry has spurred a considerable increase in competition in energy markets and brought considerable benefits to consumers. On many measures, Great Britain's domestic energy markets are both the most competitive they have ever been and the most competitive of their kind in Europe. While aspects of conduct by some suppliers have caused concern to consumers, rivals and others, it is important to maintain confidence in the market arrangements. Even with the exits outlined below, the share of domestic customers outside the Big Six has surged through 25% as 2018 has seen historically high levels of market engagement.
5. In our opinion, the fundamental issues raised are the organisational and technical capacity of new entrants and the financial resources behind them. Independent suitability tests should help Ofgem assess when these issues may be arising and help it address them should they risk detriment to consumers. Failings have led to detriment to consumers and other stakeholders from the actions of suppliers that exit the market in a disorderly fashion.
6. For customers of these failed suppliers, this detriment includes:
 - 6.1. Concern and distress caused by poor customer service
 - 6.2. Financial distress, should large unexpected payments be taken from them
7. For other customers there are financial costs that arise from industry mechanisms that act to underwrite payments to other parties that exiting suppliers fail to make. This money is levied on them by their suppliers, who have the extra transaction cost and reputation risk for administering these payments.
8. For suppliers there are the direct costs of underwriting payments that should have been made by failed suppliers. Arguably, they also face indirect costs from the failed suppliers while they are in the market should the latter compete through unsustainably low tariffs.
9. We estimate that the direct financial costs of the exits seen since the start of 2018 could exceed £150mn with the vast majority of costs arising from:

- 9.1. Underwriting the credit balances of customers of the failed suppliers through Ofgem's supplier of last resort (SoLR) process
- 9.2. Making good unmade payments for renewables policy schemes, especially the Renewables Obligation (RO).
10. Ofgem needs to focus remedial measures on these areas by:
 - 10.1. Implementing a fit and proper persons test for directors of entrant suppliers to ensure they understand industry cashflows and customer service standards
 - 10.2. Ensuring that all entrant suppliers are capable of operating business risk management and regulatory compliance plans that cover the entire value and service chains
 - 10.3. Imposing prudential tests on suppliers once they are in the market that assess their ability to fund their liabilities in current and future periods
 - 10.4. Increasing the minimum frequency of payment for the RO from annual to quarterly without diluting the incentive for suppliers to trade RO certificates
 - 10.5. Using its existing customer service reports and the results of the prudential tests to create a performance dashboard about suppliers, which it can use to monitor performance and, where necessary, intervene early to challenge poor performance.
11. Considerable good practice has been developed in other markets for both entry and ongoing performance measurement. In terms of financial prudence and fit-for-purpose tests, examples from Texas and the Australian national market are relevant. We also believe that the more challenging and bespoke approach taken by the CRU in Ireland to entrant supplier business plans is worthy of consideration by Ofgem.

Perspective on 2018

12. New entry has spurred a considerable increase in competition in energy markets and brought considerable benefits to consumers. These benefits can accrue directly from customers being served by the new suppliers and indirectly as incumbents have to raise their games. The CEER's report, Performance of European Retail Markets in 2017¹, shows the British retail energy market to be amongst the most competitive in the continent on several measures:
 - 12.1. The third highest external² switching rate for electricity and the highest for gas
 - 12.2. The highest internal³ switching rates for electricity and gas
 - 12.3. The highest total switching (internal plus external) for electricity and gas
 - 12.4. The greatest variety of products from which to choose
 - 12.5. The highest number of household gas suppliers, and amongst the highest number of electricity suppliers

¹ See <https://www.ceer.eu/documents/104400/-/31863077-08ab-d166-b611-2d862b039d79>

² Switching from one supplier to another

³ Switching from one tariff to another with the same supplier

- 12.6. The lowest level of market concentration for gas and fourth lowest for electricity as measured by the Herfindahl-Hirschman Index (HHI).
13. Energy UK has highlighted a further increase in switching on the levels referenced by CEER for 2018⁴. 2018 was a record year for switching with 5.8mn domestic electricity switches, up 6% on 2017. According to Energy UK a net 1.7mn customers moved to small and medium suppliers in 2018.
14. Our own market share survey⁵ has tracked increasing competition through these and other measures on a national and regional basis. Through 2018⁶ it tracked what turned out to be one of the most tumultuous years seen in the energy supply market since full liberalisation in the late 1990s. For the first time in a decade we witnessed multiple suppliers falling out of the markets and Ofgem triggering mutualisation processes to recover unpaid renewables policy commitments for the first time ever. There were 13 exits during 2018, and a further failure in early January 2019 when Economy Energy left the market. Since the start of 2018 Ofgem has used its SoLR process nine times.
15. This multitude of failures arose as fierce competition and rising costs proved too much for some. All suppliers faced challenging conditions early in the year, as the Beast from the East caught many by surprise and resulted in large, unforeseen wholesale energy costs. Throughout the year wholesale prices steadily increased, electricity imbalance prices became more volatile, and confirmation of the default tariff price cap made the need to hedge wholesale costs more important for those with the resources to do so.
16. Early signs of distress from some suppliers included customer service problems, delays in refunding credit balances to departed customers and unilaterally increasing monthly direct debits from customers, either on a one-off basis, or reflecting a seasonal pattern of higher payments in the winter. Many of the suppliers that exited had been charging their customers monthly in advance for their energy instead of monthly in arrears, as normally used by the large suppliers. Charging in this way greatly reduced the credit and transaction costs for these suppliers but meant that they carried higher credit balances from their customers. On their failure these credit balances were underwritten through the SoLR process. For Iresa, Ofgem reported a £13mn industry charge mainly for underwriting the credit balances.
17. Administrators' reports for three of the exited suppliers have attributed reasons for the failures of the businesses:
- 17.1. For Iresa, the extra costs and inability to secure new cashflows through a ban on new sales caused by Ofgem's licence compliance actions for it to improve its customer service
 - 17.2. Usio was in dispute with a smart meter installer
 - 17.3. Ephase was unable to secure investment to fully commercialise its business model
18. During Autumn 2018 it became apparent that there were outstanding and large cash calls required under the buy-out rules of the RO. In November Ofgem confirmed that it would trigger a mutualisation process for the first time ever following a £58.6mn shortfall into the 2017-18 RO late payment fund. The regulator also announced that a shortfall of payments into the levelisation fund for the Feed-in Tariff (FiT) scheme had similarly triggered a mutualisation process.
19. In the immediate aftermath of the late payment deadline for the 2017-18 RO of 31 October 2018, there were five SoLR exits, including the three of the four largest exits of any kind of the year (Extra Energy, Spark and Economy Energy).

⁴ See <https://www.energy-uk.org.uk/publication.html?task=file.download&id=6997>

⁵ See <https://www.cornwall-insight.com/market-research/supply-markets/domestic-market-share-survey>

⁶ See <https://www.cornwall-insight.com/newsroom/white-papers-and-industry-info/2018-the-year-of-living-dangerously>

20. We estimate RO mutualisation for 2017-18 will cost remaining suppliers about an extra £0.20/MWh with a further minimum £0.10/MWh for 2018-19. We expect suppliers to be making RO mutualisation payments for at least two years from September 2019.

Figure 1: Supplier exits in 2018

Supplier	Exited	Details
Future Energy	February 2018	Customers taken on by Green Star Energy under Ofgem's SoLR mechanism
Flow Energy	May 2018	Acquired by Co-operative Energy
Iresa	July 2018	Customers taken on by Octopus Energy under Ofgem's SoLR mechanism
GEN4U	July 2018	Customers taken on by Octopus Energy under Ofgem's SoLR mechanism
National Gas and Power	July 2018	Non-domestic market. Ofgem appointed Hudson Energy as SoLR for its 80 business customers
Affect Energy	September 2018	Acquired by Octopus Energy
Snowdrop Energy	October 2018	Snowdrop Energy transferred its customers (approx. 6,000) to Nabuh Energy due to the pressure of rising wholesale prices
USIO Energy	October 2018	Ofgem appointed First Utility as SoLR for USIO Energy's 7,000 customers
Extra Energy	November 2018	Ofgem appointed Scottish Power as SoLR for the company's 108,000 domestic customers and 21,000 business customers
Spark	November 2018	Ofgem appointed Ovo Energy as SoLR for the company's 290,000 domestic customers
OneSelect	December 2018	Ofgem appointed Together Energy as SoLR for OneSelect's 36,000 customers
EPhase	December 2018	Entered administration in August after the directors had started winding up the company
Economy Energy	January 2019	Ofgem appointed Ovo Energy as SoLR for the company's 235,000 domestic customers

Source: Cornwall Insight

21. The mutualisations for FiTs and the RO reflect the perverse incentive for suppliers to use cash collected under tariffs today from their customers (and that they are obligated to collect on behalf of others) as working capital to meet commitments tomorrow. We believe rule changes are required in response to incentives like these, and also the way suppliers serve their customers, given the way that service problems were identified for the likes of Extra and Iresa as they failed.
22. We also believe that perverse incentives are created by SoLR for shareholders of companies that failed, and also those that gain their customers. Guaranteeing of credit balances through SoLR – ultimately underwritten through all customers – means incentives to price rationally are reduced as there will be no liability for credit balances for shareholders on exit. We also believe that incentives for companies to acquire distressed-but-not-yet-failed suppliers are reduced as SoLR allows buyers to take on the customers without the liabilities.
23. Further information on this submission is available from info@cornwall-insight.com / 01603 604400.

2 Response to Ofgem questions

2.1 Chapter 2

2.1.1 Do you agree with the principles we have set out to guide our reforms?

24. We agree with the principles Ofgem has set out. However, we believe that the principles can only be seen to have been applied (or not) with hindsight. Therefore, as we discuss below, it is important for Ofgem to apply tests and regular monitoring based on quantifiable values of suppliers' financial and operational performance.

2.2 Chapter 4

2.2.1 Do you agree with our proposal to introduce new tougher entry requirements and increase scrutiny of supply licence applicants? Do you agree this can be achieved with increased information requirements and qualitative assessment criteria?

25. We do not agree that entry requirements need to be "tougher", rather that Ofgem needs to have greater oversight of when and how suppliers are intending to enter the market and grow their businesses. In our experience many suppliers have traded actively for some time before coming in to contact with the regulator. Should they be operating financially and operationally according to their licence there is no need for direct regulatory contact.

26. As a minimum Ofgem should satisfy itself that all energy retailers at all times:

26.1. Employ directors who meet a fit and proper persons test that ensures they understand industry cashflows and customer service standards

26.2. Are capable of operating business risk management and regulatory compliance plans that cover the entire value and service chains

26.3. Meet financial prudential tests that assess the strength of their balance sheets

27. While Ofgem's "Option2 Increased information requirements with qualitative assessment criteria" appears a better benchmark to scrutinise market entrants than the current regime, we have concerns including:

27.1. A one size fits all assessment process not being suitable for entrants looking to enter niche or local markets only

27.2. The potential for the leakage of sensitive information on, or undue scepticism of, innovative business models by regulatory staff unused to entrepreneurial business models

28. In this regard we believe that the supply licence exemptions regime needs to be reviewed so that it can better recognise non-traditional business models, especially those that involve local supply or peer-to-peer trading. The current supply exemptions regime dates back to market opening and pre-supposes that in all but de-minimis situations a licensed supplier will be the customer's primary point of contact with the energy industry.

29. We fear there is a risk that well-intentioned assessment criteria could be misapplied leading to the reinforcement of established business models. We believe that the fundamental concerns for regulation for new entry should be that entrants can clearly demonstrate that they understand:
- 29.1. The cashflows that they will be managing, and their business models demonstrate the ability to pay all industry charges as they fall due
 - 29.2. The licence requirements on them in how they serve customers, especially the vulnerable, and that their business plans demonstrate the ability to meet these as the companies grow
30. We believe that the above better lends itself to a “fit and proper persons” test where company directors demonstrate their understanding and ability to comply with the above. We believe that passing the fit and proper persons test becomes the prerequisite for acting as a director of an energy supplier. Ofgem should have the powers to reapply the test at any time.
31. We believe it is important that directors who may have been involved in supply failure have the chance to re-enter, potentially being able to benefit from their experience and meaning that the market is not automatically cut off from their expertise. However, no person should pass the test if they have been a director of three companies that have left the market under SoLR.

2.3 Chapter5 : Entry criteria: initial proposals

2.3.1 Do you agree that our proposed assessment criteria for supply licences applications are appropriate?

32. We agree that the proposed assessment criteria 2 and 3 will help Ofgem in assessing new market entrants, as they centre on the expertise and credibility of the leadership teams of these companies. For the reasons noted above (Chapter 4), we are sceptical that a regulator will be able to judge the appropriate level of resources across diverse business models and therefore criterion 1 could become an undue barrier to entry. As noted below, we believe there could be a role for an independent auditor to provide a verification statement for this criterion.

2.3.2 Do you agree that applicants should provide evidence of their ability to fund their activities for the first 12 months, and provide a declaration of adequacy?

33. We note that the application process for supply licences in other territories includes such requirements. For example, Texas requires applicants to demonstrate the source of their capital to meet industry funding requirements with special provisions required should they wish to use customer deposits or residential advance payments.
34. We believe that applicants should provide an independently audited statement that verifies their ability to fund their first 12 months of industry and working capital requirements. This statement should demonstrate how these requirements will be met as headline metrics such as revenue and costs develop. We also believe that companies need to establish a regulatory compliance plan in which they set out how and when they will meet all their obligations under all aspects of supplier regulation. This plan should include a statement of resources and entrants should be asked to self-assess their compliance with it on a six-monthly basis, with all areas of potential non-compliance highlighted to the regulator.
35. Ofgem should scrutinise and challenge this statement, with different assessment criteria depending on the source of working capital (e.g. equity finance, debt finance and customer credit balances). As business plans often change in response to market activity, this statement should be updated on a six-monthly basis by the auditor for at least the first two years of their operations.

2.3.3 Do you agree with the specific information we would generally expect applicants to provide (in Appendix 1)? If not, why/what would you add or change?

36. As set out above, we believe that applicants need to provide the independent statement of proof of funds to meet industry capital and credit requirements and first year working capital.

2.3.4 Do you agree that applicants should provide a narrative in respect of their key customer-related obligations under the licence?

37. Applicants should provide narratives concerning how they will meet:

37.1. Their customer service obligations

37.2. Their bills for industry services and policy obligations

2.3.5 Do you agree with the areas we would generally expect applicants to cover (in Appendix 1)? If not, why/what would you add?

2.3.6 Do you agree that we should ask additional ‘fit and proper’ questions as part of the application process (as set out in Appendix 1)?

38. We agree that a fit and proper persons test should be applied. Taken across a management team the fit and proper persons test should be applied such that applicant companies have, or have contracted access to, sufficient skills in:

38.1. Customer service including energy sector regulation

38.2. Industry cashflows

38.3. Trading and risk management

2.4 Chapter 6. Timing of licensing: initial proposals

2.4.1 Do you agree that Ofgem’s licensing process should be undertaken closer to proposed market entry? Do you identify any barriers to this approach or any adverse impacts of this change?

39. We believe that full licences should be awarded on completion of controlled market entry (CME) by companies and directors that “pass” qualitative tests of the kind set out above.

40. Provisional licences that allow CME to be undertaken and applicants to test their systems should be awarded by Ofgem on request to applicants directly or indirectly through companies selling pre-accredited supply businesses. As with other service providers and intermediaries, supply licence holders should be responsible at all times for the conduct and quality of service provided by these companies (i.e. suppliers are responsible for registration and/or billing problems caused by third party systems providers even if the system in question is used by multiple suppliers).

41. We do not believe there will be significant adverse consequences from taking this approach.

2.5 Chapter 7. Ongoing requirements

2.5.1 Do you consider that suppliers should report on their financial and operational resilience on an ongoing basis? If so, do you have any initial views on the content of these reports/statements?

42. We believe that regular but light touch reporting on financial and operational resilience will enable better outcomes for consumers. Concerning the latter, Ofgem, Citizens Advice, the Energy Ombudsman, Elexon and others already collate and/or publish information on aspects pertaining to customer service. Ofgem should draw this information together in to a “dashboard” and use its judgement when the combination of these indicators may show that a supplier may be failing to meet its customer service or industry obligations.
43. Concerning financial resilience, we believe the core concern is of businesses being undercapitalised in relation to their likely industry and working capital needs. Regular reporting of capital reserves in proportion to expected and future needs for these two indicators would be a useful enhancement. A minimum threshold for this ratio could be set to allow contingency for unexpected events. The frequency of this reporting could be tailored to the size, longevity and quality of the indicators reported so, for example, a new supplier may be obligated to report six-monthly for its first two years of operations.

2.5.2 Do you have any initial views on the potential introduction of targeted or strategic monitoring/requirements on active suppliers?

44. As stated above we believe monitoring of capital reserves relative to expected industry and working capital commitments will be a useful enhancement to Ofgem’s monitoring. We also believe that Ofgem should make full use of accounting data from network companies, metering companies and industry bodies about payments made by all suppliers. These bodies should be tasked with automatically informing Ofgem should a supplier pay late or seek alternative payment arrangements.

2.5.3 Do you have any initial views on the potential introduction of prudential/financial requirements on active suppliers?

45. Reflecting the direct costs to other consumers from the SoLR exits, there are primarily two areas of concern:
 - 45.1. Insufficiently robust payment terms for the Renewables Obligation (RO)
 - 45.2. Use of payment in advance with domestic consumers by undercapitalised suppliers
46. We believe there is a strong case for more regular, in arrears payment of RO costs. RO costs are much the biggest non-energy cost faced by suppliers. At around 15% of total consumer expenditure, RO costs are equivalent to the entire gross margin a domestic energy supplier may hope to earn. This money is collected from consumers as they pay their bills through a year and, at the latest, not payable until the last day of October following the charging year which ends on 31 March. Unlike many industry arrangements, the RO is not collateralised.
47. We believe that for several companies RO costs became a significant source of working capital, to the extent that some left the market on being unable to meet the late payment deadline. Ofgem reported that the exits through the SoLR resulted in an RO shortfall of the order of £60mn for 2017-18 and we expect on events to date a shortfall of as much as £20mn for 2018-19. This money will be recovered from other suppliers, in effect consumers.
48. We do not believe it is appropriate to collateralise the RO, but the payment mechanism needs to be refined to limit the exposure to shortfall from forced supplier exits. A quarterly-based payment process is used for the microgeneration Feed-in Tariff (itself also seeing a shortfall to be recovered from the wider

market). A similar on-account payment mechanism could be established for the RO with moneys only available to the supplier to purchase RO certificates or pay the buyout fee at its discretion. Alternatively, Ofgem may wish to consider a self-insurance scheme for all, or groups, of suppliers.

49. Use of payment in advance by suppliers means they will normally hold higher credit balances from direct debit consumers than if they were charging in arrears, as has been the convention in the industry. There is low customer awareness of the difference between the two terms and that, should a supplier fail when charging in advance, they could need to pay again for energy they thought they had bought. Presently it is at Ofgem's discretion whether credit balances are covered as they have been in the SoLRs to date, with money drawn from the incoming supplier or from the SoLR levy on other suppliers (and therefore other consumers).
50. Suppliers offering payment in advance and intermediaries marketing such tariffs should be obligated to display this feature prominently highlighting this feature and the discretionary nature of the rules in protecting credit balances. Money collected from advance payments should initially at least be deposited by suppliers in an escrow account or securitised by an on-demand letter of credit from a minimum A-rated bank. Access to these funds for commercial use should only then be permitted when financial health checks of the kind outlined in Chapter 7 of Ofgem's document are satisfactory.

2.6 Do you consider that Ofgem should introduce a new ongoing requirement on suppliers to be ‘fit and proper’ to hold a licence?

51. Ofgem should be wary of measures by company such as a “fit and proper” award that could imply positive endorsement of suppliers.
52. The combination of management and financial tests above should allow suppliers to demonstrate they have the technical competence and resource adequacy to provide services of sufficient quality to be credible market competitors.
53. Where Ofgem is not satisfied that its requirements are being met by a company or individual it needs to have in place an effective sanctions regime that it can put in place in a timely manner. The licence compliance investigation into the non-payment of the RO by Economy Energy extended for the best part of three months before it exited the market, increasing the potential liability to shortfall under the RO and other industry charges.

3 Prudential measures from other markets

54. Markets including Texas⁷, Australia⁸, Ireland⁹ and the Netherlands¹⁰ impose prudential requirements on suppliers either at the point of entry and on an ongoing basis, or a combination of both. The arrangements differ depending on individual circumstances but incorporate a number of consistent principles on:

- 54.1. Market entry
- 54.2. Qualification of directors
- 54.3. Business operation.

55. In order to enter the market to supply gas or electricity to customers, the entrant company must typically obtain specific authorisation from the appropriate national or state level regulator. Typically this involves the completion of a standard questionnaire by the applicant, the provision of supporting information and the opportunity for the regulator to review and challenge where necessary the information that is provided.

56. Key requirements to be demonstrated to permit market entry by a company include:

- 56.1. Organisational and technical capacity, whether provided in-house or by a third party
- 56.2. Key staff must have energy market experience, or outline how such experience will be gained if not present
- 56.3. Ability to comply with regulatory procedures and understanding of industry cashflows
- 56.4. Reliable access to wholesale energy, including the ability to fund the business during potential wholesale price spikes
- 56.5. Ability to fund start-up and ongoing business, especially if the business is initially expected to be loss making.

57. Key requirements to be demonstrated to permit participation in the market by individuals as company directors:

- 57.1. Relevant professional qualifications and experience
- 57.2. Character and/or reputation references as an indicator of future conduct
- 57.3. Reputation from any past business dealings, especially concerning honesty and integrity

⁷ See <https://www.puc.texas.gov/agency/rulesnlaws/subrules/electric/25.108/25.108ei.aspx>

⁸ See <https://www.aer.gov.au/retail-markets/authorisations>

⁹ See <https://www.cru.ie/professional/licensing/electricity-supply-license-2/#supporting-documents-and-procedures>

¹⁰ See <https://www.acm.nl/nl/onderwerpen/energie/energiebedrijven/vergunningen/regels-voor-energievergunninghouders>

57.4. Previous involvement in the retail energy sector, especially involving suppliers that subsequently exited the market or any involvement in supplier of last resort processes.

58. Key requirements to be demonstrated to permit continued retailing of energy by a company include:

58.1. Compliance with regulatory reporting and timescales

58.2. Ability to serve customers consistent with regulatory standards

58.3. Passing such financial prudence test as may be set out by the regulator

58.4. Directors continuing to meet standards of the kind set out above.

59. Passing the above tests on an ongoing basis can lead to either conditional (consent applies until it is withdrawn) or timebound (consent applies for a set period) ability for directors to be involved in and companies to trade as energy retailers.

60. Likewise failure of any of the tests can lead to one or more of:

60.1. A timebound opportunity for remedial measures to be put in place subject to agreement with the regulator

60.2. Fines or other sanctions

60.3. Restricted ability of the companies to trade, for example limiting their ability to sign up new customers or renew existing contracts

60.4. Exit from the market and transfer of customers to a new retailer under a last resort transfer mechanism

60.5. Barring of directors from participating in energy retail companies.