

Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

23 January 2019

Email to: licensing@ofgem.gov.uk.

Supplier Licensing Review

EDF Energy is one of the UK's largest energy companies with activities throughout the energy chain. Our interests include nuclear, coal and gas-fired electricity generation, renewables, storage, and energy supply to end users. We have over five million electricity and gas customer accounts in the UK, including residential and business users.

EDF Energy fully supports Ofgem conducting a review of its approach to licensing and ongoing scrutiny and oversight of operating suppliers. We have for some time been calling for Ofgem to conduct such a review as we strongly believe that change is required in order to better protect consumer's long-term interests and reduce the risks faced by operating suppliers at times of supplier failures.

Key Points

- **Material risks to consumers and participants arise when suppliers are of a material scale. Developing ongoing oversight and financial resilience arrangements that apply to all operating suppliers should be a priority for Ofgem.**
- **It is deeply unsatisfactory that suppliers with more robust business models and funding arrangements are paying the bills of higher risk ventures through mutualisation (primarily RO, FiT and consumer credit balances).**
- **The primary objective should be to ensure that each individual supplier bears the cost of the risk they impose on the system.**
- **Ofgem should allow the pass through of mutualisation payments through the Default Tariff Cap. The current headroom allowance does not adequately mitigate the adverse risks faced by suppliers.**
- **There is a strong case for better checks on new entrants and in particular on the applicant's funding arrangements.**

Aims of the review

We welcome Ofgem's review and believe that it is right for Ofgem to seek change to its supplier licensing regime in order to strengthen its approach and ensure that consumers are better protected and that risks are minimised for existing suppliers. We agree that Ofgem should be looking to strengthen requirements at entry, impose new requirements on suppliers to improve its ongoing oversight and promote higher financial and risk management standards, and ensure that there are robust supplier exit arrangements.

We are supportive of the overarching principles Ofgem has set out which will guide its reforms in this area. However, as described further below, we consider that Ofgem should include an additional principle that suppliers should, as far as is reasonably practicable, bear the costs of the risk they impose on the system.

We note within Ofgem's draft Forward Work Programme that it has targeted by mid-2020 for implementation of changes in this area. We believe the events of 2018 (see below) have demonstrated that timely action is required to protect consumer interests and that ideally Ofgem should seek to introduce change in 2019 where possible.

Events of 2018

While strengthening its approach to assessing licence applicants and granting market entry should form part of a reform package, material risks to consumers and participants arise when suppliers are of a material scale. This suggests that the ongoing oversight and financial resilience arrangements are at least as, if not more, important than those which apply at the licensing stage.

The events of 2018 have clearly demonstrated this. A string of supplier failures, together with a number of defaulting suppliers has, for the first time, resulted in shortfall levels for the Renewables Obligation (RO) and Feed in Tariff (FiT) schemes being sufficient to trigger mutualisation. This results in suppliers with more robust business models and funding arrangements having to pay the bills of higher risk ventures.

This is deeply unsatisfactory and must change. Ofgem should;

- Firstly work with BEIS to investigate whether proportionate and sustainable risk based credit cover arrangements could be established for the RO, FiT and Warm Home Discount schemes. Such arrangements, which could be modelled on existing best practice found in industry codes, would help shield other participants from the default risk of other suppliers. The need to provide cover (for example a letter of credit from a bank) could provide an additional incentive to ensure that suppliers take appropriate steps to remain financeable (otherwise the cost of such cover will increase).
- Secondly, Ofgem should allow the pass through of mutualisation payments through the Default Tariff Cap. Ofgem's current position that allowed headroom addresses such risks is unsatisfactory. While we accept that the headroom

allowance can be used to mitigate uncertainty in setting cost allowances under the cap, both positive and negative, mutualisation costs will always be adverse thus skewing the probability of cost recovery in respect of such uncertainties. Market conditions may result in the impact becoming systemic and a general cost of market participation from which SVT customers should not be excluded.

- Thirdly, Ofgem should take rapid and appropriate enforcement action against defaulting suppliers. Greater transparency is needed in this regard.
- Finally, Ofgem should look to alternative measures to better protect customer credit balances without the need for mutualising such costs through use of the industry levy in instances of supplier failure. This should include some form of protection (see below).

In 2019 we have already seen a further supplier exit the market and we note that recently the Minister for Energy and Clean Growth stated that she expected that more energy suppliers would exit the market. We therefore believe Ofgem should look to make timely progress on the matters set out above.

Protecting customer account balances

There is a shared concern amongst stakeholders that entrant suppliers have been using a business model that finances their growth out of advanced payments made by consumers. In the context of unsustainable low energy prices seen in the competitive market, such a model will inevitably result in financial collapse once the flow of new customers slows down (or there is some cost shock). Having consumers, or other suppliers with respect to mutualised costs, bear this risk is inappropriate and unacceptable.

Rather than wholly relying on a mutualised levy arrangement, we think that Ofgem should consider alternative measures designed to better protect customer credit balances in the event of supplier exits. The primary objective of any such measures should be to ensure that each individual supplier bears the cost of the risk they impose on the system. We welcome Ofgem examination of options that would limit the exposure of customer credit balances to supplier failure and we look forward to working with Ofgem on their development.

Our initial view is that some of the measures being considered could be relatively intrusive and complex to administer depending on how they are implemented. For example, the identification of credit at an individual customer account level would be likely to create operational difficulties and complexity – the amount of credit balances will change each time a bill is made available or amended. Moving money between supplier and “client” accounts (should that be proposed) would be onerous and would have to occur regularly, and in any case may not protect consumers making payments but who have not yet been billed.

An alternative to ring-fencing credit balances (and restricting suppliers from using them as working capital) would be to require suppliers that cannot demonstrate to robust level of

creditworthiness (e.g. supplier who do not have an investment grade credit rating) to provide some form of surety.

In terms of providing security cover, flexibility should be provided as to the particular choice of instruments used. The size of cover provided would have to be determined in an unambiguous and enforceable way, perhaps by creating a value at risk formula that could be set out in a licence condition. Design of the credit cover approach will be important. For instance, if it is designed to cover the tail risk then it can be onerous even for creditworthy businesses, it could increase costs to consumers and in some cases it can contribute to failures. We believe maintaining mutualisation/industry levy arrangements could be a better way of addressing any residual shortfalls. Consideration would also need to be given as to who would be the beneficiary, for instance the letters of credit need to be available to offset the industry levy, but this would not seem to be an insurmountable issue.

The key to designing any measure will be determining the relevant credit balance level to be protected. We believe this should be done at a domestic portfolio level that takes account of a supplier's net position i.e. the negative impact on working capital of credit customers. In introducing such measures there will be a need for Ofgem to issue guidance as to how the credit balance should be determined, including for instance how unbilled energy is treated, in order to prevent any abuse of the requirements.

Separately, we consider there to be a need for Ofgem to conduct a wider review of the existing credit cover arrangements across the energy market given the mixed approaches adopted. In particular, we would question whether the ability to build up a level of unsecured credit on the basis of good payment history is robust enough to adequately protect consumers and market participants.

Entry Criteria

Policy

We consider there is a balance to be struck between minimising undue barriers of entry and ensuring that new entrants are suitably prepared, resourced and fit to operate in the market. We believe the current licensing approach has arguably over focussed on the former and has in some cases led to ill prepared entities entering the market to the detriment of customers and the market as a whole.

Consequently, there is a strong case for better checks on new entrants and in particular on the applicant's funding arrangements. We believe that Ofgem should develop a process which allows for such arrangements to be tested against, and be able to survive, a range of plausible "stretch" scenarios. For example, entrant suppliers must demonstrate that their funding arrangements can cope with 'market shocks' such as sudden increases in wholesale energy costs resulting from extreme weather events or from other causes. Such tests should exclude financing obtained from customers through advanced payments as these should not be regarded as investor funds subject to speculative risks.

Of the three options presented by Ofgem, we consider a proportionate approach would be option 2 (increased information requirement with qualitative assessment criteria) which would increase the information requirements around financial resources, market understanding and capabilities and introduce a fit and proper person test. This will enable Ofgem to perform an enhanced risk based qualitative assessment of potential entrants.

The case for change is strong and so we do not support option 1 which retains the status quo. While we do not totally discount option 3 (detailed information requirement with financial scrutiny and/or specific capital requirements), we believe it is likely to be a complex and challenging approach to design. Furthermore, we agree that any detailed assessment upon entry will not provide ongoing assurance and as such any risk reduction achieved through this approach would be short-lived. On this basis, we believe option 2 is the most proportionate approach to protecting consumers.

Any enhanced Ofgem process should also not facilitate “supplier in a box” applications. Applications should only be accepted from persons who themselves will operate the licence. Only in this way can Ofgem have some assurance that the plans submitted at the time of licence application represent those of the eventual operators who intend to deliver upon them.

Whatever arrangements are put in place to mitigate the risks to consumers and market participants, we do not believe the requirement to provide information alone will be sufficient. This is because it will not be possible for Ofgem to know in advance the full risks that a supplier (whether new or established) is taking. This will be particularly true in respect of any innovative business models. Any new arrangements must ensure that the cost of risks automatically falls on the supplier taking those risks as described above.

Initial proposals

In terms of Ofgem’s initial proposals regarding the assessment criteria and the specific questions posed, we offer the following views:

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

Yes, we consider the proposed assessment criteria are appropriate. Applicants who can adequately demonstrate to Ofgem that they satisfy the requirements should be afforded a licence.

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?

We agree that applicants should provide reasonable evidence as to their ability to fund their activities and that this should be supported by a written declaration from a Director of the applicant. However, we believe it is reasonable to require such evidence that covers the initial start-up period of the business, which may be longer than the 12 months proposed. We recommend that this requirement is extended to a minimum three year period. This timeframe would be akin to the approach adopted by rating agencies when

assessing the credit ratings of companies. We note that Ofgem has provided no justification for limiting the requirement to only 12 months.

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?

We are generally supportive of the specific information that will be sought from applicants.

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

Yes. However, it is important that this is not simply a tick box exercise for applicants and that the evidence provided must be robust and reliable. It is in the interests of all consumers and other market players that there is a level playing field regarding compliance with all customer-related obligations. Ofgem should also consider conducting an audit on suppliers on key compliance areas within 12 months of start-up as a means of identifying early any issues regarding customer service obligations.

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

Yes.

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

Yes, although we would welcome additional clarity as to how this test would work in practice.

Timing of licensing

We support Ofgem's proposal to move the timing of the licence application process to closer to proposed market entry. We believe this approach will have two primary benefits. Firstly, it will improve the relevance and robustness of the applicant's entry information requirements (which will be assessed by Ofgem) as it could be expected that the applicant will have a much greater understanding of its obligations and the impact these have on its business proposition in terms of costs and funding much nearer to the time of market entry. Secondly, this should ensure that Ofgem is engaging with the actual operator of the business and not simply a managed service provider who facilitates 'off the shelf' market entry.

Ongoing requirements

While checks undertaken on market entry will have some benefits, we believe that Ofgem should have a greater, more effective, role in monitoring the financial resilience of all suppliers on an ongoing basis. Ofgem's approach needs to be effective, targeted and proportionate and aim to reduce the risks to consumers and suppliers. We believe that

Ofgem should look to make timely progress in this area and we look forward to Ofgem bringing forward proposals in early 2019.

Of the options presented, some form of cyclical reporting would appear to be the most appropriate. For all suppliers to provide annual/periodic information e.g. audited certificates of adequacy, should promote the maintaining of robust risk management standards and greater inform Ofgem's ongoing market monitoring.

However, it would be important to understand what course of action Ofgem could undertake if through such reporting significant concerns were raised regarding the financial stability or effective management of a particular supply business. While increased monitoring is unlikely to prevent all business failures, it is important that timely and effective measures are undertaken to minimise or limit the risks of such failures. This could include, for instance, Ofgem imposing restrictions on suppliers from acquiring any new customers until such time as resilience concerns are addressed or ramping up the required credit cover percentage.

Of the other options proposed, we do not believe that imposing prudential/financial requirements would be required in the event that suppliers bear the costs of the risks they impose such as providing security through reasonable and sustainable risk based credit cover arrangements or ring-fencing customer credit balances, as proposed earlier in this response.

In terms of introducing an ongoing 'fit and proper' test, if as proposed Ofgem implements such a test as part of the entry process it would seem appropriate for such a test to be an ongoing requirement, allowing Ofgem to reassess suppliers following changes in circumstances. However, we would welcome more clarity as to how such an ongoing requirement would work in practice.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre on 0208 186 1356 or myself on 01483 489576.

I confirm that this letter may be published on Ofgem's website.

Yours sincerely,

A handwritten signature in blue ink that reads 'Paul Delamare'.

Paul Delamare
Head of Customers Policy and Regulation