



By Email Only

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## Supplier Licensing Review

Dear Lisa & Jeremy,

Within our response to the Ofgem 2018/19 forward work plan, we noted concerns regarding the financial adequacy / operating model sustainability of new entrants to the supply market and the implications for all customers when a supplier ceases trading. As you may be aware, our long-held view has been that Ofgem should do be doing more when assessing a prospective applicant's financial fitness before granting them a supply licence. Given the high volume of supplier withdrawals and related cost mutualisation during the 2018/19 period, we remain concerned and, therefore, welcome this Ofgem review. A test that Ofgem should consider is what positive (or negative) impacts any of the proposed changes could have had on, if they had been implemented prior to, the 2018/19 supplier exits.

Financial adequacy requirements for market entry should not be onerous and these should not be barriers to market entry. However, they need be balanced against the important requirement to protect customers. There must be enhanced testing before a supply licence is granted. We are supportive of the proposed fit and proper person testing, but would suggest Ofgem needs to review new entrant risk to the market for longer than the 12-month period proposed.

We are broadly supportive of the principles proposed by Ofgem. A further principle should be included that requires suppliers to pay for the risk that they pose to the system and therefore protect the wider market and all customers. Customers that are supplied by a party that exits the market may have benefited from unsustainably low tariffs and will have credit balances protected, these costs will be smeared across the wider bill paying customer base of other market participants. This is socially and economically unjust and needs to change. On a similar note, we would urge Ofgem to review the administration of all other forms of mutualisation within the market (Renewables Obligation / Feed in Tariff) and consider options to significantly reduce costs paid for by the market when a supplier defaults on payment or ceases trading. Equally, Ofgem should consider how all of these costs should be accounted for within the next default tariff energy price cap review.

Further to this we would ask Ofgem to consider a change to its messaging when a Supplier of Last Resort (SoLR) event occurs: 'Ofgem protects customers of failed supplier...' does not convey that this cost is more than likely passed to other customers and creates unforecastable financial risk for other market participants.

This response is not confidential. We respond to the consultation within appendix 1, please contact me if you have any questions.

Yours sincerely,

Richard Vernon / Regulation

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## **Appendix 1 - Responses to Ofgem Questions**

### **Chapter 2 - The case for change and our aims**

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

We are broadly supportive of the principles proposed by Ofgem, however a further principle should be included that requires individual suppliers to pay for the risk that they pose to the system, including upon market exit therefore protecting the wider market and all customers.

For the principle 'We maintain proportionate oversight of suppliers, and effective protections for consumers exist in the event of failure' we would suggest that visibility is less of an issue than the impact of mutualised cost. Ofgem need to be clearer on what they will do with this visibility with a view to implementing appropriate mechanisms to reduce risk to other suppliers and their customers in addition to the customers of a failing supplier. We would welcome further information on whether this proportionate oversight will extend to responsible supplier pricing i.e. not below the direct costs of supply (wholesale, networks, metering & policy costs).

Licence transfers can be different from market entry if conducted within an established supplier organisation or group, for example when related to a reorganisation type activity. Presently the Ofgem process for new market entrants and transfers of licences is the same. We would suggest that any new criteria should not apply to intra-group licence transfers as any potential risk is already present within the market and will be addressed as part of the ongoing requirements. Including the suggested new criteria within the licence transfer process will have cost and time implication for both Ofgem and the supplier.

### **Chapter 4 - Entry criteria: policy options**

*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?*

We are very supportive of the Ofgem proposal to introduce tougher market entry requirements for prospective suppliers. However, we would suggest that some of the more rigorous tests from option 3 should be considered for inclusion within the Ofgem preferred option 2. For example, scrutiny of financial planning combined with stress testing (financial / operational customer service) and monitoring for a period of greater than 12 months would provide a greater protection for customers and the market. We expand upon this within our response below and within chapter 7, as this could equally be included within the ongoing market monitoring. We do not see any other broad options over those provided within the consultation.

We agree that a minimal capital requirement would not be beneficial, and it would be difficult to determine a requirement that would be fair.

### **Chapter 5 – Entry criteria: initial proposals**

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

As noted above, we believe there is scope to assess whether steps from option 3 could be included within option 2 and welcome more information from Ofgem on this point.

*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 are supportive of the proposal to require a declaration of adequacy. Ofgem should consider increasing the financial assessment period, perhaps to either 5 years or on a rolling basis until the regulator is satisfied that the supplier is established. This longer-term approach could reduce risk to customers of the new supplier and those supplied by other market participants. There should be ongoing liquidity within the company linked to customer numbers not based on customer credit balances.

*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?*

Yes. The information provided in appendix 1 is comprehensive. We would suggest that Ofgem also consider adding, in addition to directors, a requirement to confirm key people and expertise that are required to fulfil the specific regulated functions. The expertise could be either direct or procured, and are important for running a successful business.

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

It is an important principle that processes and controls are in place. We are supportive that new market entrants should provide a narrative and awareness of their key customer related obligations, how they will be delivered and noting any key individuals that will be responsible for delivery. This reinforces that supplier entry should be taken seriously and protects the market. Ofgem need to consider how to manage the risk that these narratives could simply be regurgitations of available industry guidance materials. One approach could be to appoint an independent industry panel to review these narratives, perhaps linked to the Retail Energy Code?

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

Yes. The areas presented by Ofgem are relatively complete, we would suggest that Ofgem also consider adding additional criteria relating to:

- Specific back billing requirements for domestic and microbusiness customers.
- The requirement to offer a variety of payment methods from the off (at the moment, this applies only when a supplier supplies 50,000 or more domestic customers).
- Current and forthcoming industry change, for example the new switching requirements and market wide HH settlements
- Back office settlement functions (BSC/UNC – if also a shipper). We acknowledge that bespoke compliance and entry arrangements exist within these codes. However, insufficient forward hedging of commodity is a potential risk for new entrants. Ofgem could require companies demonstrate that they have access to adequate funds and strategy to weather a reasonable worst-case market movement. A short term hedging strategy using customer balances carries significant risk and should be avoided.

*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. We are supportive that fit and proper person testing should be carried out prior to market entry, for example have the directors previously presided over or been involved with supplier defaults within the last 3 years. We would welcome further detail on what additional information will be asked for and how this will be used by Ofgem to determine whether to grant a licence or not. We would suggest that this testing should disclose any other interests that could be linked to the energy industry. Also, the holding company structure must be clear, particularly those offshore. Any investigations / defaults should also be taken into account.

It would be prudent to consider how other similar markets conduct entry test, for example there are synergies between supplying energy and providing bank services – are there any tests that the FCA conduct that could be adopted?

## **Chapter 6 – Timing of licensing: initial proposals**

*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?*

Yes, we agree that there should not a loophole to bypass the proposed new additions to the market entry criteria. We are supportive of any form of market entry, however testing should be for the organisation and individuals that are going to be responsible for and operate the supply licence. For the reasons previously given, there would be no value in additional testing where licences are transferred as part of an internal restructure for an established supplier or supplier group.

## **Chapter 7 – Ongoing requirements**

We are supportive of ongoing requirements that reduce risk to other market participants and welcome Ofgem's further thinking on this as part of the next set of consultations. We provide some specific thoughts on the Ofgem suggestions below, however Ofgem need to be expand on what actions they are likely to take as a result of this additional reporting and what the impact / timescales of those interventions will be. For example, would Ofgem prevent cash being taken out of a failing supply business and therefore reduce customer and market risk?

Any additional reporting will be a burden to suppliers and a simpler more effective strategy may be to reduce risk to the wider market by making suppliers responsible for the financial risk they pose to the wider market. We expand upon this within the mutualisation section below.

*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?*

Reporting as part of cyclical or annual basis may best be linked to new market entrants only as an extension of the entry process, with Ofgem deciding whether to extend this to 3 years / 5 years or even longer if needed. A supplier offering below cost tariffs for a number of years increases risk for new customers and the wider market. Access to funding should be a key part in this and an indicator of risk.

Certificate of adequacy - We would suggest that this requirement should link to the statutory accounts process in which the directors are required to sign off as a going concern and is subject to audit. If this process were to be continual and / or outside the timeline for the statutory accounts, then this would lead to additional cost (audit) and time (Finance / directors) to ensure that sufficient information is available.

Annual viability statement - Similar to above, workload for this statement would be a significant increase, at least initially, if this statement if not aligned with statutory accounts process.

Milestone assessment - Perhaps the point at which suppliers increase size and meet thresholds where they become responsible for additional industry costs would be appropriate.

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

We agree with Ofgem that supplier failure can be linked to customer service issues, therefore a reasonable approach may be to monitor certain key metrics and employ a targeted/strategic approach if warning signals were identified, for example a case by case assessment where enforcement action has been taken. Equally late payment on any obligation should result in enforcement action and additional financial scrutiny. We have

noticed that suppliers who have rapidly increased prices or seen significant deterioration in customer service metrics are those likely to be most at risk.

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

Further information on this option would be welcome. Initially, we would question whether the resource requirements and the subsequent actions that would be open to Ofgem would warrant the resource and cost requirements. Reduced mutualisation risk may be a more effective approach. Ofgem would need to consider how working capital may fluctuate throughout the year for a supplier, for example the impact of when ROC's are paid in August/September.

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

We are supportive of the principle of an ongoing 'fit and proper' person requirement, again Ofgem would need to demonstrate how this additional requirement could have led to a better outcome in recent SoLR events. Can Ofgem expand upon how this new requirement would work alongside and be an enhancement to existing director requirements? Would the regulator consider a more proactive legal approach where appropriate?

## **Mutualisation**

We would urge Ofgem to review all forms of mutualisation within the market and consider options to prevent suppliers ceasing trading before these costs are covered wherever possible. As Ofgem states: *'Market exit is a normal occurrence in any competitive market, and supplier failure can occur for a number of reasons'*, therefore the main benefit to all customers and the market would be to protect customers supplied by both the exiting supplier and as much as possible reduce costs being allocated to other suppliers and their customers. The impact from non-payment on each of these government schemes needs to be considered as part of this review (for example, RO costs must be found in order to pay generators; this is not the case for ECO).

With the increasing prevalence of electric vehicles that are often charged at home and a general move to electrification, suppliers will be responsible for larger customer credit balances. Therefore risk to customers and the wider market is likely to also increase over time.

Protecting customer credit balances may be the right thing to do for the individual customer; however it also allows savvy customers to benefit from risky business models with lower-than-cost tariffs that come at a direct cost to other bill-paying customers. Invariably costs are more likely to fall to customers who are on a standard variable tariff where there is a higher proportion of individuals that can be considered vulnerable.

Options that Ofgem should consider:

- Ofgem to take earlier action and cease new customer take-on where customer credit balances are at risk and then prevent this money being taken out of a failing business. If a supplier cannot satisfy liabilities, it should not be taking on new customers as a matter of principle. Suspected failing businesses have been visible on Price Comparison Websites for extended periods before actual market exit. This action should also be taken where there is late payment of any regulated industry charge – the build-up of debt should be limited as much as possible.
- Ofgem to increase compliance monitoring of new entrants to the market. It would also be helpful if Citizens Advice supplier performance covered all suppliers, providing a more comprehensive view for customers.

- Increased credit cover arrangements for government schemes where significant costs have been mutualised. This is likely to create a cost; however, it will be predictable and significantly less than recent mutualisation costs. Performance bonds could also be considered.
- Increase regularity of payments for government schemes e.g. monthly/quarterly, to reduce the overall risk to other market participants. This could be combined with swifter action from Ofgem where there is a late payment.
- Ofgem may consider greater use of the Companies and Insolvency Acts, CMA and Serious Fraud Office to enforce where there is risk. This could be done today, without any changes to the licensing approach. Companies should be going concern with adequate funds and not reliant on customers credit balances.

## **Chapter 8 – Exit arrangements: managing supplier failure**

We welcome a review of industry processes to manage supplier failure. In particular, to increase clarity on levy payment coverage for the scenario where customers choose to leave a failing supplier prior to any SoLR event.

We do not agree with the Ofgem suggestion of restricting suppliers from using credit balances as working capital as this is likely to be burdensome and difficult to execute in practice. Equally, some business models may require higher customer credit balances. Ofgem should therefore focus on ensuring that suppliers are able to meet the cost of their obligations and also prevent customer cash being taken out of a business as part of a SoLR.

There should be consideration of how the SoLR smart targets may be impacted as a result of taking on the new customer base. Where the supplier either did not have a rollout obligation or a poorly performed rollout this will have a negative impact.