

**Attention**

Vlada Petuchaite,  
James Proudfoot  
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3rd December 2019

Dear Vlada and James,

**SUBJECT: Orbit Energy response to Supplier Licensing Review: Ongoing requirements and exit arrangements**

***1. Do you think the proposed package of reforms will help to reduce the likelihood of disorderly market exits, and the disruption caused for consumers and the wider market when suppliers fail? Are there other actions you consider we should take to help achieve these aims?***

No, we believe these proposals will significantly increase the chances of disorderly exit by smaller suppliers from the market, resulting in higher SoLR costs. As we set out below, the annual costs for the additional credit to cover customer balances and government schemes to the level proposed will be considerable. The seasonal changes in customer credits, peaking in September, prior to the deadline for paying a number of government schemes, will mean that the financial strain on suppliers is likely to be exacerbated just prior to the winter. The overall cost burden for smaller suppliers will be crippling as they will need to procure Letters of Credit at high rates or pay in cash. The requirement to sterilise cash will also severely limit supplier ability to manage cashflow. This will force many smaller suppliers out of the market.

By contrast Larger Suppliers, who will be able to rely on existing assets, will not be impacted as much as they can rely on Parent Company Guarantees or source credit at much lower rates. These proposals will therefore skew the market toward large, asset-backed organisations and will severely limit the ability for smaller players to compete and survive.

***Are there other actions you consider we should take to help achieve these aims?***

Imposition of blanket requirements regarding credit requirements will not achieve the long-term aims that have been set out by Ofgem; as we have stated above the strong likelihood is that many smaller parties will exit the market if they are implemented.

We understand the primary deficiency in the market is a lack of visibility to the regulator as to the true financial status of a supplier, hence the need for blanket obligations. Instead of imposing such requirements to the detriment of all suppliers, the regulator should seek to require all suppliers (irrespective of size) to undertake annual financial audits, in the same manner as that of listed companies. Audits that are undertaken to the International Standards on Auditing (UK)<sup>1</sup>, must include an assessment on the appropriateness basis of accounting and the long-term viability of the organisation. They are also publically available, being filed at Companies House.

This gives Ofgem the understanding of a supplier's status, provides public understanding of a supplier's resilience and means it can target appropriate actions, such as limiting or preventing procurement of additional customers, to those suppliers that need them without disrupting the market. It also can be applied to all suppliers equally, so not benefiting one set of suppliers over another.

## ***2. Do you agree with the outputs of our impact assessment?***

We do not agree. We welcome the assessment of the impact of SoLR costs on the industry, but there seems to be no assessment of the impact of covering scheme costs.. As we set out below in question 5, the costs for doing so will be prohibitive and would have a material impact on assessing whether these proposals are ultimately beneficial to the market. This costs needs to be assessed against the cost savings to customers, to give a true understanding of these proposals.

There also seems to be no appreciation in the outputs of the impact assessment that these additional costs will have on competition, as larger suppliers will be able to cover the additional credit requirements with little additional costs, compared to smaller suppliers. There will need to be a clear assessment of the impacts on competition from these proposals.

There is also no examination of impact on the cashflow of an organisation, which the use of escrow will have a significant negative effect upon (see question 5).

## ***3. What further quantitative data can industry provide to inform the costs and benefits of the impact assessment, particularly for cost mutualisation protections?***

Ofgem should seek to use information on domestic credit balances that are currently held by domestic suppliers to assess the impact of any additional credit requirements based on covering 50% of credit balances. It is our estimate that domestic suppliers hold

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<sup>1</sup> <https://www.frc.org.uk/auditors/audit-assurance/standards-and-guidance/2016-auditing-standards>

approximately £40 per dual-fuel customer at summer peak. Ofgem should seek to use this information to assess the true cost of the market for covering credit balances.

In addition as stated above, the cost of covering government schemes should also be assessed as we believe them to be material. Using the 2019-2020 ROC buy-out price of £48.78/ROC, with the liability of 0.484ROC/MWh<sup>2</sup>, result in a cost of £23.61/MWh. At 50% the credit liability will be £11.80/MWh, which will have a higher impact than the individual consumer cost per SoLR event.

In addition we believe that the assumed cost for procuring third party letters of credit is too low; would expect that the true cost of a Letter of Credit for a smaller supplier would be in excess of 8% (if they are even able to secure these).

Using this information we assess the typical cost for a medium consuming domestic customer, using the Typical Domestic Consumption Values<sup>3</sup> of 2,900 kWh for annual electricity consumption, the cost for a single consumer will be:

Typical Consumption	ROC Cost @ £11.80/MWh	Credit Balance/ consumer	Total Cost (50% coverage) to 2s.f.	Cost per customer @ 8%
2.9MWh	£34.22	£40	£37.11	£2.977

This cost of £2.977 is very heavy in comparison to the current cost to suppliers of £0.44 per customer.

Please note we have not included the cost of FITs in these calculations, which will represent a significant increase in the obligation for many parties. We believe that this value needs to be taken into account when assessing the impact of these proposals as it overshadows the cost of a n SoLR.

**4. Do you agree with the assumptions used to calculate the costs and benefits in our impact assessment? If not, please provide evidence to support further refinement.**

No. There are a number of areas that do not correspond with our understanding of the market.

- The current cost calculations do not include the potential of covering government schemes or the true cost of covering credit balances, which will believe will be a significant cost if these proposals are taking forward.

<sup>2</sup> <https://www.ofgem.gov.uk/publications-and-updates/renewables-obligation-ro-buy-out-price-and-mutualisation-ceilings-2019-20>

<sup>3</sup> <https://www.ofgem.gov.uk/publications-and-updates/review-typical-domestic-consumption-values-2019>

- In addition the assumed third party cover cost rate of 0.5% does not correspond with the true cost of Letters of Credit for suppliers, with typical annual funding rates of 8%+ being more typical for smaller suppliers without an established credit history.
- There is also no account taken of the seasonal impact on the proposals. The coincidence of the time to pay ROC bills with the peak level of customer credit balances will exacerbate the negative impact of these proposals.
- It assumes that all credit tools are available to all suppliers.

**5. Do you agree with our proposed option to cost mutualisation protections? Are there other methods of implementing this proposed option? Please provide an explanation and, if possible any evidence, to support your position.**

No. The proposals to cover credit balances and government schemes will have a significant negative impact on the market by imposing substantial costs on suppliers (please see our response above for details). As we have covered above, it will impact smaller suppliers disproportionately who will not have access to cheap credit in the same manner as larger, asset-backed, former monopoly suppliers. We agree that suppliers should not be utilising direct debit payments as working capital and that the balance sheets of suppliers should clearly separate credit balances from the funds needed for the development of the business.

This proposal does not require this however. It expects the credit balances for domestic customers to be sterilised in an account. All domestic suppliers, irrespective of size, will utilise the cash from credit balances to manage the daily cashflow of their business. Sterilising the cash from those credit balances will have a significant negative effect on supplier's ability to manage its cashflow as it removes this source of liquidity. This will compel suppliers to undertake borrowing to cover, for example, the transient customer debts from those whose direct debits are too low. This will significantly increase costs, and ultimately will result in the effect that Ofgem is seeking to avoid; a number of suppliers will exit the market in a disorderly fashion as they cannot afford these new requirements.

***Other Methods to Address:***

Looking at the issues these proposals are trying to address, there are three key causes for the rise in disorderly exits from the market:

1. Suppliers not hedging their wholesale energy needs against any significant market swings, so exposing themselves to market volatility.
2. Unrealistic market offerings at below breakeven price. We estimate that the cheapest dual-fuels tariffs are around £150-200 below the cost to serve.
3. A lack of transparency on the financial resilience of any supplier to the regulator creating uncertainty as to whether a supplier's activities are sustainable.

This lack of knowledge on supplier behaviour is the reason as why a blanket requirement is proposed.

### *Monitoring Supplier Resilience*

Instead of imposing costly uniform obligations, Ofgem should seek to mandate regular annual financial auditing to provide it with the understanding it requires. Such audits that are undertaken to the International Standards on Auditing (UK), must include an assessment on the appropriateness basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to the entity's (or where relevant, the group's) ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention to this in the auditor's report. These auditing reports can be filed at Companies House so allowing Ofgem to have ready access to public information at any time to allow them to assess the robustness of an organisation. This will also give public transparency to all parties (such as market counterparties and potential customers) as to the strength of any one supplier. The costs of these audits are not substantial (approximately £10,000 per organisation) when compared to the costs of these proposals.

We therefore strongly urge that Ofgem instead mandates the requirement for all suppliers (including new entrants and large established players) to be audited on an annual process, to the standard expected for listed companies. The result of this audit would be published on Companies House Ofgem and other market participants will then have a clear understanding of the resilience of a supplier; for example it will give clarity as to whether below-cost pricing is a reasonable market acquisition strategy, or represents an ultimately unsustainable business model.

This will allow a risk-based approach to be developed, where Ofgem can target their activities at those parties who do represent a risk, rather than imposing substantial cost in the market. So rather than imposing a blanket requirements, a more appropriate process would be operate a more risk-based approach with Ofgem taking action to slow or stop customer acquisition, depending on the risk that the supplier represents based on robust annual auditing.

Our comments above notwithstanding, the timescales proposed for delivery is too short. With the standard notice period of any licence changes, 3-6 months after implementation is insufficient time to allow suppliers to put in place new credit processes based on dynamic cost assessment which this process would require. Realistically it will take at least 12 months from the new licence obligations becoming live for any new process to be put in place.

**6. Do you agree with our proposal to introduce new milestone assessments for suppliers? Do you think the milestones we have proposed and the factors we intend to assess are the right ones? Are there additional factors we should consider to help us to identify where suppliers' may be in financial difficulty?**

We do not agree. We understand Ofgem's desire to engage with market participants and to monitor the progress of suppliers as a mechanism to ensure that suppliers can maintain customer standards whilst growing. The current proposals however do not provide the rigour necessary to ensure a robust assessment of suppliers and do not believe that Ofgem will have the ability to fully understand the state of a supply business, without requiring a full audit. There is also the possibility of reputational damage to any supplier where Ofgem undertakes an unscheduled assessment.

Instead of relying on arbitrary delivery points, Ofgem should instead ensure on annual auditing by suitably accredited firms to provide an understanding of a supplier's performance, with an initial assessment during Controlled Market Entry.

Our comments above notwithstanding, if these requirements are brought in by Ofgem, then they should apply to all suppliers in the market, not simply new entrants as we note that most licence breaches have occurred mainly through failures of large domestic suppliers, rather than new entrants. To not do so would introduce an unfair burden on smaller suppliers and mean that existing issues with large suppliers may not be picked up and allowed to continue to the detriment of the market.

**7. Do you agree with our proposal to introduce an ongoing fit and proper requirement? Are there additional factors, other than the ones we have outlined, that you believe suppliers should assess in conducting checks?**

We do not agree. There are already a number of criteria that a company director must fulfil under corporate law. These are sufficient as they have legal backing and can be used to remove/ban a director<sup>4</sup>. Adding additional criteria will not have the same legal backing. We note that the wording of the draft licence condition, 1.4. simply requires that the supplier "*must have regard to and take account all relevant matters including..*". As currently worded this obligation will not be effective as a supplier is not obliged to ban or restrict the activities of any senior individual, even if they fail a number of the proposed tests.

Even if the wording of the licence was improved, we are concerned about placing restrictions on any individual who has worked for a company subject to enforcement action or an SoLR event. These individuals may have been brought in to remedy known

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<sup>4</sup> <https://www.gov.uk/guidance/money-laundering-regulations-apply-for-the-fit-and-proper-test>

problems in that supplier, or be unaware of the circumstances leading to the SoLR or licence breach.

In summary the focus should be ensuring that the existing fit and proper criteria are enforced, rather than creating new obligations.

**8. Do you agree with our proposal to require suppliers to produce living wills? What do you think we should include as minimum criteria for living will content?**

We believe there is some value in having a list of critical contact information, such as the external parties that suppliers have relationships with (Data Aggregators, etc) which can be utilised by the SoLR supplier when taking over the meter points of the failing supplier. We believe that this could be provided to Ofgem in a standardised template on an annual basis.

Outside of this we do not believe that the information that would be included in the proposed living will would be of much benefit. It is likely to have become invalid in the run-up to any insolvency event and in many cases the information will not be easily available from the defunct supplier. We would prefer that supplier resources concentrated on effective engagement with mandatory annual audits.

**9. Do you agree with our proposed scope for independent audits? Please provide rationale to support your view**

Yes. As we have stated above, requirement to undertake annual independent financial audits will address the issues identified by Ofgem regarding disorderly supplier exits arising from poorly funded and managed companies. We therefore support rigorous annual audits for all suppliers, irrespective of size as this will provide a clear insight into the health of the company. If Ofgem relies on common auditing standards for listed companies then we believe this option will be easy to implement.

**10. Do you agree with the near terms steps we propose to take to improve consumers' experience of supplier failures? Are there other steps you think we should be taking?**

We are sympathetic to the concerns that Ofgem raises regarding their ability to oversee and monitor administrator activities when they are seeking to recover costs from customers of failed suppliers. The proposals set out in this consultation will have comparatively little impact on the situation in our view, but we are not opposed to including the suggested additional information in customer contracts.

**11. Do you think there is merit in taking forward further actions in relation to portfolio splitting or trade sales? What are your views of the benefits of these steps? Are there any potential difficulties you can foresee?**

We do not see how any restrictions on trade sales or portfolio sale is feasible. Company directors have responsibilities to run their businesses as per the Companies Act 2006; sales and purchases of company assets are part of this process. Any restrictions on such activities are therefore likely to contradict those obligations and so may be subject to challenge.

**12. Do you think our draft supply licence conditions reflect policy intent?**

We have not undertaken a legal review of the proposed regulations. We note that one area of the licence drafting, that require the supplier is open and co-operative with the regulator, is not explicitly covered in any of the questions above. For the avoidance of doubt we fully support this requirement and expect that it should apply to ALL licence holders in the gas and electricity market, and not just suppliers.

Regards

A handwritten signature in black ink, appearing to be "Justin Price".

Justin Price

**Chief Financial Officer**