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Industry Codes and Licensing
Ofgem
9 Millbank
London
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23 January 2019

By email: licensing@ofgem.gov.uk

Dear Lisa and Jeremy,

RE: Supplier licensing review

We welcome the opportunity to comment upon Ofgem's review of licensing process, the timing of which has assumed greater importance in current market circumstances. Nine energy suppliers have failed over the last twelve months. These failures are estimated to have resulted in a conservative estimate of over £100million¹ being redistributed across the remaining energy suppliers, who will have to pass this cost through to consumers. The current regime therefore does not strike a balance between enabling new entry and limiting the scope for harm to competition and consumers.

The key contributing factors to these instances of supplier failure have been the combination of:

- A. A 'light-touch' entry and ongoing monitoring process;
- B. The incentives within the current regulatory regime, specifically the mutualisation of costs, that enable new entrants to operate unviable commercial models with little consideration of the risks or consequences of failure that would otherwise arise for new entrants in many other consumer markets; and
- C. Under capitalisation relative to the risks an energy supplier is likely to face.

The mutualisation of costs has had a significant negative impact on consumers, and damages competition by adversely impacting consumer confidence and the finances of solvent suppliers. This mutualisation principle has been extended to many important elements of the regulatory scheme, notably in the Supplier of Last Resort process, the Renewables Obligation (RO), Feed-in Tariff (FiT) and the Capacity Market Payments regulations.

Most of the recently failed suppliers, and especially those whose failure led to a large mutualisation of costs, were simply offering unsustainably low tariffs. This is not an innovative business strategy, nor does their participation in the market help facilitate sustainable competition.

We identified the mutualisation of costs risk, specifically customers' credit balances being used to fund unsustainably low tariffs, to Ofgem in December 2016². To the extent that the

¹ Based on Ofgem information requests provided when seeking to appoint a supplier of last resort. And the £58.6m Renewables Obligation shortfall: <https://www.theguardian.com/money/2018/dec/16/questions-over-energy-firms-58m-debt-to-renewables-obligation-scheme>

² Letter to Rob Salter-Church after the failure of GB Energy.

mutualisation principle remains a feature of the regulatory landscape, it should be common ground that its application going forwards must be a rarity.

Accordingly, whilst we agree it may not be possible for supplier failures to be prevented altogether, Ofgem must do all it can to implement a stronger licensing process to limit the scope for the level of supplier failure and corresponding mutualisation of costs witnessed in the past 2 years.

We agree with many of Ofgem's proposals on stronger licence conditions, implementing a more robust market entry process and managing market exit better. Specifically, we agree that Ofgem's broad policy option 3 on market entry requirements: 'Detailed information requirements with financial scrutiny and specific capital requirements' should be adopted. Of Ofgem's three options it is the most likely to be effective in protecting consumers. We do not consider that it would act as an undue barrier to entry.

However, in many cases Ofgem's proposals should go further to meet what we consider to be the two key aims of the supplier licensing review:

1. Implementing a rigorous **market entry and ongoing monitoring** process that prevents unsustainable business models entering the market or emerging after market entry; and
2. Addressing the moral hazard created by the current **mutualisation processes**, which give suppliers an incentive to act irresponsibly as there are materially less negative consequences to the supplier of accruing large amounts of debt and exiting the market, relative to what would happen to suppliers in other markets.

The implementation of the following proposals would ensure that the above objectives are realised:

- A new licence condition requiring each licensee to prevent mutualisation of its debts if it fails.
 - The onus will be on supply licensees to demonstrate adherence to this condition, for example by:
 - Ringfencing credit balances in an Escrow account;
 - Having sufficient secured finances in place to cover their current and future debts;
 - Having a parent company guarantee in place;
 - Having a 'living will' in place that sets out how the company would be wound down in an orderly fashion, should it fail. The living will should include details of the steps that would be taken to avoid mutualisation of costs; or
 - Appointing an intermediary to cover the credit and mutualisation risk -- and if so, having such funds in place to cover any intermediary fees.
 - Suppliers would be required to have secured financing arrangements in place to meet likely scenarios that could place additional costs on a supply business -- including spikes in commodity costs and a colder than average winter.
 - Licensees should be required to report to Ofgem on a regular or targeted basis on how they are complying with the above licence condition. The reporting should reveal whether, and the extent to which, customer credit balances and cash required to cover Government policy obligations, are

- being used to finance risk and operational costs, and whether the licensee could refund customers' credit balances if called upon.
- Ofgem should focus on those licensees which are most likely to risk their debts being mutualised. Therefore, if the reporting to demonstrate compliance with the licence condition is targeted rather than regular, it should be automatically triggered by risk criteria including:
 - low or below-cost tariffs,
 - rapid customer growth,
 - unexpected increases in Direct Debits,
 - requiring customers to pay for energy in advance,
 - customer service problems, particularly those where customers struggle to get their credit balances refunded,
 - balance sheets and / or profit and loss accounts that suggest the supplier would be at risk if e.g. commodity prices were to suddenly increase; or
 - an inability to refund customer credit balances if called upon.
 - Ofgem to work with BEIS to ensure the requirement to prevent mutualisation of costs also applies to Government policy costs, such as the Renewables Obligation (RO).
 - Only awarding a supply licence to a person(s) who intends to operate the supplier and not to 'off the shelf' supply companies that set up supply companies with the aim of then selling them on at a profit.
 - Disqualification for certain individuals from being granted a supply licence for many years, specifically if they have a track record of having operated suppliers irresponsibly and unsustainably in the past.

We consider that our proposals are in the interests of energy consumers. Our proposals should ensure that:

- There is limited scope for the extent and types of supplier failure in 2018 to recur in future;
- End consumers, consequently, do not pick up the substantial mutualised costs associated with supplier failures;
- Supply licence applicants that do not have robust business plans will not be granted a supplier licence, these business plans should include how suppliers would manage in stress situations e.g. commodity price spikes and a cold winter;
- Suppliers will be less able to accrue large debts and exit the market without consequence;
- There will be less negative impact on the initiatives suppliers have been mandated to implement, e.g. the smart metering roll-out and the energy company obligation (ECO); and
- There is sustainable competition with the ability for genuinely innovative and well-designed commercial models to emerge (as opposed to the types of new entrants and unsustainable commercial models that we have analysed in more detail in Appendix 2).

Ofgem is consulting on market entry in this consultation, and supplier monitoring and market exit in subsequent consultations. However, as is clear from the above, all three areas are closely linked and solutions need to be designed holistically to cover all three elements of

the licensing review. Therefore, we have covered all three areas in our response, though we may refine our views as Ofgem's process develops.

We encourage Ofgem to set up an industry workshop to discuss the potential reform options for market entry, supplier monitoring and market exit.

Our answers to the specific questions in the consultation are appended to this letter.

In a second appendix we look at recent supplier failures that have resulted in the mutualisation of costs, and whether their failure may have been foreseeable and avoidable. Our analysis reveals that these entrants pursued commercial strategies that were not viable even in the short term and that any perceived enhancement to competition was fleeting and clearly offset by the adverse impact of failures on consumers.

If you have any questions, please contact Tabish Khan in the first instance on 07789 575 665 or Tabish.khan@centrica.com.

Yours sincerely

Tim Dewhurst
Head of Regulatory Affairs
Centrica

Appendix 1: Consultation questions

In this appendix we set out our thoughts on addressing the aims of the supplier licensing reviews and answer the questions posed by Ofgem in the supplier licensing review consultation.

Centrica considers the two key aims of the supplier licensing review are:

1. Implementing a rigorous market entry process that prevents unsustainable business models entering the market; and
2. Preventing a significant mutualisation of costs across other suppliers and ultimately consumers.

A rigorous market entry process

As Ofgem has noted, companies have emerged more recently that will create a fully accredited and licensed supplier entity before selling the company as an ‘off the shelf’ supply business. This is a product that has resulted in under prepared individuals being able to operate a supply company without the resources in place to manage its growth.

Under prepared individuals running a supplier business can result in:

- Poor customer service;
- Significant mutualisation of costs across the supplier community;
- Decreased consumer confidence in the energy market; and
- A negative impact on competition

We support a far more rigorous market entry process being implemented, based on Ofgem’s option 3: ‘Detailed information requirements with financial scrutiny and specific capital requirements’.

It is important that extra market entry checks should also lead to more thorough ongoing monitoring of new suppliers. As flagged in Appendix 2, most supplier failures occur among suppliers that have been in the market less than five years.

Preventing mutualisation of costs

A key question for the supplier licensing review is whether the costs of a failed supplier should be mutualised across the wider industry. Our view is that it should not, and we have seen no evidence to suggest mutualisation in energy or other sectors is beneficial to consumers and competition.

Mutualisation introduces a moral hazard as it can incentivise suppliers to act irresponsibly as there are materially less negative consequences to the supplier of accruing large amounts of debt and exiting the market relative to suppliers in other markets.

This risk of detriment is why we are proposing a licence condition requiring suppliers to *prevent mutualisation of its debts in the event of failure*.

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The onus would be on supply licensees to demonstrate adherence to this condition, and it should be sufficiently flexible so suppliers can meet it through different means, by either

- Ringfencing credit balances in an Escrow account;
- Having sufficient secured finances in place to cover their current and future debts;
- Having a parent company guarantee in place;
- Having a 'living will' in place that sets out how the company would be wound down in an orderly fashion, should it fail. The living will should include details of the steps that would be taken to avoid mutualisation of costs; or
- Appointing an intermediary to cover the credit and mutualisation risk -- and if so, having such funds in place to cover any intermediary fees.

Licensees should be required to report to Ofgem on a regular or targeted basis to Ofgem how they are complying with the licence condition. The reporting should reveal whether and the extent to which customer credit balances and cash required to cover Government policy obligations, are being used to finance risk and operational costs, and whether the licensee could refund customers' credit balances if called upon.

Ofgem should focus on those licensees which are most likely to risk their debts being mutualised. Therefore, if the reporting to demonstrate compliance with the licence condition is targeted rather than regular, it should be automatically be triggered by risk criteria such as:

- low or below-cost tariffs,
- rapid customer growth,
- unexpected increases in Direct Debits,
- requiring customers to pay for energy in advance,
- customer service problems, particularly those where customers struggle to get their credit balances refunded, or
- an inability to refund customer credit balances if called upon.

In Appendix 2 we have set out previous supplier failures and the 'warning signs' that were evident before they failed. With our proposed licence conditions in place the cost of these supplier failures may have been reduced and Ofgem may have been able to act more swiftly to lessen the risks of mutualisation of costs.

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

We agree that the current arrangements are not fit for purpose.

Centrica considers there to be sufficient protections in place for customers of a failed supplier, through the supplier of last resort (SoLR) process. But we consider that there are insufficient protections for all consumers, which face unacceptable risks of paying the mutualised costs of failed suppliers.

We agree with Ofgem's principles that suppliers should adopt effective risk management and be prepared to meet their supplier obligations from market entry onwards.

Competition and innovation should be facilitated and we agree this means there may be an occasional supplier that fails when trying out a new business model. However, most supplier failures we've seen over the past twelve months have mostly been suppliers that were not particularly innovative in their approach.

Most suppliers, and especially those whose failure led to a large mutualisation of costs, were simply offering unsustainably low tariffs. This is not an innovative business strategy, nor does their participation in the market help facilitate sustainable competition.

Indeed, as we have seen with the supplier failures in 2018, allowing many suppliers to enter the market without adequate controls at entry, or ongoing monitoring can lead to a large cost being redistributed across other consumers through the SoLR levy.

Mutualising costs across all market participants is also likely to act as barrier to entry itself. Potential new entrants may be discouraged from entering the market if they are likely to pick up substantial costs from other suppliers failing.

When evaluating its proposals, Ofgem should conduct analysis to determine whether the supplier failures over the last few years could have been prevented if Ofgem's consultation proposals were in place, i.e. would these suppliers have been granted a licence under the new proposals?

If the recently failed suppliers would still have acceded under Ofgem's new proposals, then Ofgem's proposals for market entry need to be more rigorous than currently proposed.

The test of whether any new proposals are effective will be whether they discourage unsustainable or high-risk business models from entering the market.

Within Ofgem's supplier licensing review Ofgem has not used evidence from the specific supplier failures in the energy sector nor described arrangements in other sectors to support its proposals. Whilst Ofgem states that it has considered such evidence, we encourage Ofgem to set out how supplier failures are avoided and handled in other sectors including finance, telecoms and travel. Including what measures are in place to:

- Prevent accession by companies that are not fit and proper to operate.
- Assure the regulator that an acceding company is financially viable. Ensure companies have finances in place to cover their existing and future liabilities.
- Ensure company failure is handled appropriately – both in terms of how the costs are managed for the failed supplier's outstanding debts, and the costs of other companies having to take on their customers.

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?

Yes, tougher entry requirements are needed before the award of a supply licence.

No, we do not consider increased information requirements and qualitative assessment goes far enough. 'Option 3 Detailed information' would be more effective. Ofgem should implement option 3.

Tougher entry requirements

The criteria for the award of a supplier licence by Ofgem has always been extremely light touch, and largely a 'tick box' exercise.

The current licence application and market entry process for a supplier is largely designed to ensure an applicant meets all the functional requirements of energy supply, e.g. sending data flows to industry systems and agreeing to follow the rules set out in the energy supply licence.

There is nothing in the current licence application and market entry process to ensure that suppliers must have funds in place so that its debts aren't mutualised across the wider energy supplier community should it fail. We believe this should be reviewed.

Once the new supplier entry requirements are in place, it's unclear whether Ofgem will be assessing new entrants or a certified third party. We believe that a certified third party may be better placed to audit a company's application. Any entry assessment must be rigorous if it is to be effective.

Our proposal of a licence condition requiring suppliers to *prevent mutualisation of debts in the event of supplier failure* should be the enforceable condition that Ofgem uses to conduct this assessment at market entry.

Policy options

Our views on the three options set out by Ofgem are:

- **Option 1 – status quo:** We agree with Ofgem that this option isn't appropriate for today's energy supply market.
- **Option 2 – information requirement and qualitative assessment:** Option 2 is an improvement upon the status quo. A more active role for Ofgem in scrutinising new entrants is welcomed. However, we do not consider it goes far enough and is inferior to option 3.
- **Option 3 – detailed information requirements with financial scrutiny:** Ofgem should implement option 3. It is unclear why Ofgem is not willing to ask for a full business proposal and financial projections from new entrants. Particularly given that most suppliers would have to provide their business proposal and financial projections to potential investors, and should therefore have them to hand. Given this, we do not believe such an approach would be disproportionate, nor would it act as a barrier to entry. It would also be effective in allowing Ofgem to see if the new entrant's forecasts are realistic. Ofgem could appoint a third party to assess business proposals, if Ofgem doesn't have this expertise in house. Furthermore, Ofgem could

seek assurances from the supplier's equity providers as to their willingness to inject more capital into the business if required.

Option 3 further proposes a minimum capital requirement (MCR). An MCR could prevent the costs of supplier failure being redistributed across the wider energy industry. We are proposing the option of a licence condition requiring suppliers to *prevent mutualisation of debts in the event of supplier failure*. Evidence of minimum capital in place could be used by a supplier to demonstrate adherence to our proposed licence condition. We do not agree with Ofgem's view that placing an amount of capital in place would act as an undue barrier to entry. A proportionate amount of capital could protect consumers from redistributed costs. Given an MCR is considered good practice in other industries such as insurance, it's unclear why Ofgem doesn't think an MCR is appropriate for the energy sector. We consider further methods for preventing mutualisation of costs in our section on credit balances.

We strongly suggest Ofgem reconsiders option 3. Given the costs across the industry in the last year alone are conservatively estimated to be more than £100m, this is a serious issue that requires Ofgem to obtain as much information as it can from a licence applicant. We have set out some significant supplier failures in Appendix 2 and Ofgem must take steps to prevent such significant mutualisation of costs from happening again.

Under Ofgem's preferred option 2 a person(s) who is knowledgeable of the energy sector but financially irresponsible would still be able to enter the market, accrue a significant debt and exit the market without consequence. This person could demonstrate a high level of competence in understanding how an energy supply business functions, and still run an unsustainable business model.

A combination of option 3 and our proposed licence condition should prevent such an individual from setting up a supply business.

We propose that Ofgem provides mocked up examples of licence applications that would pass Ofgem's entry requirements under options 1, 2 and 3. This would make the problem Ofgem is trying to solve more tangible and help determine the correct market entry requirements that need to be put in place.

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

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?

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?

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

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

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

Centrica agrees with the three assessment criteria set out by Ofgem in section 5 of Ofgem’s consultation. As all the above questions are grouped within the same chapter we have answered them together, setting out our additional thoughts within each of Ofgem’s three criteria.

Criteria 1: Resources

Questions for new entrants

As part of the application process suppliers should be asked a series of questions that set out they will handle stress events. This should include:

- What is your forecast growth in customer numbers?
 - What will you do if you gain customers slower or faster than expected?
 - How will you scale up your customer service in line with your growth projections?
- What actions will you take if there is an increase in costs? E.g. changes in wholesale costs or weather variances.
- How much collateral will you put in place with the various industry players that require collateral?
 - If collateral requirements were to increase, how would you raise the extra capital?
- What plans do you have in place to meet the supplier obligations that come into effect once you exceed certain customer thresholds?

The questions above are all likely to be encountered by a new entrant. The applicant’s answers to these questions should allow Ofgem to determine whether the applicant is ready to manage the challenges that come with being a licensed energy supplier.

Ofgem should use the answers provided as part of its ongoing monitoring of new entrants. Ofgem should place the onus on suppliers to notify Ofgem if any of their answers were to change significantly as they grow in customer numbers.

Furthermore, Ofgem should proactively monitor new suppliers and request more information if they have doubts as to the supplier’s sustainability.

Unsustainable growth

New suppliers may have a growth plan in place but we have seen some entrants over the last few years gain many more customers than was originally expected due to pricing tariffs at unsustainably low levels. This can lead to poor customer service and a lack of sufficient

available capital to avoid the mutualisation of costs should the supplier fail, as customer numbers increase faster than the supplier is resourced for.

Poor customer service is demonstrated by data from Citizens Advice Scotland³ that shows 46% of help sought by vulnerable customers was due to dealings with small and medium suppliers, who only make up 20% of the market.

Iresa and Extra Energy both saw significant customer growth when they had the cheapest tariff on the market, or one of the cheapest tariffs. Both suppliers subsequently failed, suggesting their tariffs were unsustainably low. A more rigorous assessment of their business plans at market entry may have allowed Ofgem to spot this, and could have prevented the mutualisation of millions of pounds worth of debt across the wider industry.

Linked to their cheap tariffs, both Iresa and Extra were known for poor customer service. Delivering high quality customer service costs money. When suppliers offer deep discount tariffs at unsustainably low rates, customer service often suffers. Ofgem has previously acknowledged that very low tariffs can lead to a decrease in quality of service⁴.

Financial projections and business plans

Submitting financial projections as part of the application process is a welcome proposal from Ofgem. We would add that this should be caveated with a requirement for suppliers to provide updated projections to Ofgem at regular intervals and to notify Ofgem if the projections change significantly.

Ofgem should ask all energy suppliers to provide a business plan as part of the market entry process. Ofgem is well placed to determine if there are elements of the business plan that do not look sustainable – i.e. unrealistic growth figures or profitability per customer. Given most supply companies will have business plans to hand, it should be easy for new entrants to hand over business plans to Ofgem as part of Ofgem's due diligence.

If Ofgem doesn't feel best placed to assess business plans then it can appoint a third party to carry out this assessment, at the cost of the new entrant. The costs of using a third party would only benefit the licence applicant and therefore the applicant should be required to cover the costs.

Costs and risks

We agree with the principle of Ofgem's proposal that applicants should provide evidence of their ability to fund their activities for the first 12 months, and for subsequent 12 months if Ofgem has seen any activities in the first year of operation that suggest the company is struggling financially – e.g. multiple instances of late payment of industry charges.

³ When energy suppliers go bust, it hurts everyone: <https://wearecitizensadvice.org.uk/when-energy-suppliers-go-bust-it-costs-everyone-235a26d716bd>

⁴ Default tariff cap - Impact Assessment: https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_11_-_final_impact_assessment.pdf

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Some suppliers can start relatively stable and then grow unsustainably, as we saw with Extra Energy who Ofgem only took enforcement action against after they had been operating for two years. Only monitoring the first 12 months of activity would not capture such supplier behaviour.

Further to our proposed licence condition Ofgem could ask for profit and loss accounts, and balance sheets annually. These are items that all companies should be producing and therefore should be easy for all energy suppliers to share with the regulator.

We agree with Ofgem's proposals that applicants should have to satisfy Ofgem that they understand the costs and risks of operating as a supplier, and have a realistic pricing and growth plan.

We agree with the areas, set out by Ofgem in Appendix 1 of its consultation, that supplier licence applicants should have to provide.

Criteria 2: Regulatory obligations

We note that some of the supplier failures towards the latter half of 2018 were linked to the inability to pay their forecastable renewables obligation (RO) annual charges. Given the stress this places on smaller supplier's finances and the cost now redistributed across industry it would be prudent to change how these charges are collected.

Ofgem should co-ordinate with BEIS to ensure there is a flexible payment plan that works for all suppliers, whereby suppliers either:

- Demonstrate that they have sufficient secured capital to pay the charges in longer instalments; or
- Pay RO charges monthly.

Ofgem's consultation states that applicants for a supply licence had to provide details on how they would comply with licence conditions. However, this requirement was removed as part of the supply licence review in 2007. Ofgem should provide the rationale for why these requirements were removed to ensure that any new requirements implemented as part of this review aren't also removed in the future.

It is important that any reforms implemented are permanent. Our concern is that while the recent spate of supplier failures will result in a stricter licence application process. In the future after several years of very few supplier failures they will be repealed, thus exposing the market to the risk of multiple suppliers failing once again. It is important to recognise that any reforms brought about soon may in the longer-term future come to be viewed as a barrier to entry at a time when supplier failure is less likely.

We agree that licence applicants should provide a narrative in respect of their key customer-related obligations under the licence. Ofgem should monitor new suppliers to ensure they adhere to their initial narrative.

We agree with the areas Ofgem generally expect applicants to cover, as set out in Appendix 1 of the Ofgem consultation.

Criteria 3: Fit and proper

We strongly support Ofgem's proposed additional analysis of companies for the previous track records of their directors, specifically if they have been involved in previous failed entities that have redistributed costs across the rest of the industry.

In the energy industry there have been several instances of a company folding as it was unable to pay its debts, with the same directors setting up another company shortly after – a practice often referred to as 'Phoenixing'. There is evidence that the managing director of the recently failed Extra Energy has set up a new entity⁵.

Ofgem should place additional scrutiny on any Phoenix entities before they are granted a supply licence, and be ready to refuse an application if Ofgem deems the risk of poor customer service and mutualised costs to be too high. Ofgem should disqualify individuals from establishing energy supply companies, for many years, if they have a track record of operating poorly managed and unsustainable suppliers.

Centrica agrees that Ofgem should ask additional 'fit and proper' questions as part of the application process, and as part of ongoing requirements for the supplier.

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 Ofgem's licensing process should be undertaken closer to proposed market entry.

As Ofgem has noted, companies have emerged more recently that will create a fully accredited and licensed supplier entity before selling the company as an 'off the shelf' supply business. This is a product that has resulted in under prepared individuals being able to operate a supply company without the resources in place to manage its growth.

We propose any person(s) running an energy company must have personally been through the qualification process to become an accredited supplier. Any purchase of an 'off the shelf' supply business should automatically require the new owners to go through the code administrator qualification processes again to ensure the new owner is able to operate the supply business competently. Only once the person(s) who plan to run the energy company are in place, and have been through the qualification process, should a licence be awarded.

Our understanding of Ofgem's proposal is that it would prevent an 'off the shelf' company receiving a licence that it could then sell on to another person or entity. We further believe it would also prevent a company qualifying as a supplier and then remaining dormant for many

⁵ The Telegraph: <https://www.telegraph.co.uk/business/2018/12/15/boss-collapsed-energy-supplier-returns-market-new-brand/>

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years before gaining customers. We would appreciate confirmation from Ofgem that our understanding on this is correct.

We fully support Ofgem's new market entry timelines and agree any elongation of entry timeframe will not be an undue burden for market entry, especially as it significantly decreases the risk of poor customer experiences.

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?

It's unclear what additional benefit there is from scrutinising companies where Ofgem has received no signals that they are struggling financially. We do not support cyclical reporting. We prefer a targeted approach as set out in our next answer.

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

We fully support targeted monitoring as both the most efficient use of Ofgem's monitoring resources. Ofgem should focus on those licensees that are which are most likely to risk their debts being mutualised. Targeted monitoring, including automatically requiring a supplier to report to Ofgem demonstrate compliance with the licence condition should be triggered by risk criteria such as:

- Low or below-cost tariffs, in conjunction with rapid customer growth;
- Unexpected increases in Direct Debits;
- Customer service problems, particularly those where customers struggle to get their credit balances refunded;
- Non-payment of industry charge invoice;
- Entering credit default with the likes of ELEXON;
- Failure to cooperate with Ofgem and respond to queries, including non-provision of data demonstrating adherence to our proposed licence condition requiring suppliers to prevent mutualisation of debts in the event of supplier failure;
- Balance sheets and / or profit and loss accounts that suggest the supplier would be at risk if e.g. commodity prices were to suddenly increase; or
- Enforcement investigations and actions taken by Ofgem with respect to the supplier.

Using the above, Ofgem should be able to identify the firms that require additional scrutiny and target its monitoring accordingly.

We support a milestone assessment when a supplier reaches a customer threshold. While certain supplier obligations only take effect at 250,000 accounts, there may need to be graded assessments at other thresholds – say every 50,000 customers.

A supplier with just under 250,000 accounts is still able to generate a large debt that may be picked up by industry, so it's important that there are gated thresholds for targeted monitoring before suppliers reach the 250,000 accounts threshold.

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

Prudential reporting should be an added tool that Ofgem may use as part of its targeted monitoring option.

Under our proposed licence condition, on a supplier would be required to report to Ofgem on whether and the extent to which their customers' credit balances could be refunded if called upon and over what time frame, and demonstrate their ability to cover Government policy costs. The content of these reports should signal to Ofgem which suppliers pose the greatest risk of failure and mutualisation of costs.

Where Ofgem raises concerns with a supplier's operating model, the supplier should be required to submit revised plans for how it will address Ofgem's concerns. If Ofgem still deems the risk of failure high then it should be ready to stop the supplier gaining customers and force it to return outstanding customer credit balances.

The financial services industry uses certain reports to determine the financial health of companies, and Ofgem could seek to mimic best practice from the finance industry where appropriate.

Similar reporting also exists for communication firms under Ofcom's remit. Companies are required to have in place sufficient funds for any liabilities they incur⁶. This is another case of good practice that Ofgem could co-opt.

Credit Balances

We are proposing the option of a licence condition requiring each licensee *to prevent mutualisation of its debts if it fails*.

The onus would be on supply licensees to demonstrate adherence to this condition, and it should be sufficiently flexible so suppliers can meet it through different means, by either

- Ringfencing credit balances in an Escrow account;
- Having sufficient secured finances in place to cover their current and future debts;
- Having a parent company guarantee in place;
- Having a 'living will' in place that sets out how the company would be wound down in an orderly fashion, should it fail. The living will should include details of the steps that would be taken to avoid mutualisation of costs; or
- Appointing an intermediary to cover the credit and mutualisation risk -- and if so, having such funds in place to cover any intermediary fees.

Licensees should be required to report to Ofgem on a regular or targeted basis to Ofgem how they are complying with the licence condition. The reporting should reveal whether and the extent to which customer credit balances and cash required to cover Government policy

⁶ Ofcom – funds for liabilities: <https://www.ofcom.org.uk/phones-telecoms-and-internet/information-for-industry/policy/electronic-comm-code/funds-for-liabilities>

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obligations, are being used to finance risk and operational costs, and whether the licensee could refund customers' credit balances if called upon.

Ofgem should focus on those licensees which are most likely to risk their debts being mutualised. Therefore, if the reporting to demonstrate compliance with the licence condition is targeted rather than regular, it should be automatically triggered by risk criteria including:

- low or below-cost tariffs,
- rapid customer growth,
- unexpected increases in Direct Debits,
- requiring customers to pay for energy in advance,
- customer service problems, particularly those where customers struggle to get their credit balances refunded,
- Balance sheets and / or profit and loss accounts that suggest the supplier would be at risk if e.g. commodity prices were to suddenly increase; or
- an inability to refund customer credit balances if called upon.

Targeted monitoring linked to thresholds that automatically lead to an investigation by Ofgem, e.g. what percentage of credit balances could a supplier refund to customers if called upon and how long would it take or a failure to provide the data to meet our proposed licence condition above.

We have seen examples from Eversmart and Outfox the Market recently asking customers to pay 12 and six months up front respectively so that customers may earn interest on their positive balances. Ofgem should prevent such propositions if the company is highly dependent on this customer investment to continue operating as a licensed supplier, i.e. is using customer's money for financing risk and operational costs.

A supplier offering such products should be required to demonstrate it can cover the costs, or a large portion of the costs, of customer's credit balances.

A wider point is that offering interest on a credit balance is more akin to a financial product offered by a bank. Therefore, Ofgem should investigate whether mirroring financial regulations is a better fit for monitoring 'pay up front' products.

In Appendix 2 we have set out examples of recent supplier failures and the main cause for the mutualisation of costs is outstanding credit balances. Therefore, mutualisation of costs is the priority to address as part of the supplier licensing review.

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

We support the principle of a 'fit and proper' licence condition to prevent suppliers engaging in activities that may potentially harm consumers and the wider industry. If there is considerable risk of harm to consumers then Ofgem should be ready to act to protect customers. Moving swiftly if there is a chance of imminent supplier failure.

In its future planned consultation on supplier monitoring, Ofgem should set out the types of enforcement actions Ofgem could take to reduce the chance of a supplier failure and the mutualisation of costs brought about by a failing supplier.

As highlighted in appendix 2 some suppliers that have now ceased trading were under investigation by Ofgem at the point of failure. In the case of Extra Energy, the investigation was launched in 2016 and no action had been taken by the time they ceased trading in 2018. A 'fit and proper' licence condition must be designed to allow Ofgem to act more quickly than it is able to today.

However, we have concerns over a broad new licence condition that could be enforced more widely across all supplier activities than the current policy intent. Any new fit and proper condition must be explicit in stating that it has been introduced to prevent supplier activities related to a failing supplier.

Appendix 2: Failed suppliers

This appendix sets out the suppliers who have failed over the last few years up to the end of 2018. Whether there were any signs of difficulties before the SoLR process was enacted and whether the failure and the mutualisation of costs could have been avoided. As the impact of a supplier failure is relative to size, suppliers with 10,000 customers or less have been excluded:

GB Energy

Established: 2014

Date of failure: November 2016

Size: 160,000 customers.

Cost of claim through SoLR levy: Co-op was appointed SoLR and claimed up to £14m, of which £11m were credit balances. This equates to an average of each customer being £81 in credit.

Signs of difficulties: Gained many customers when they were the cheapest tariff on the market. Given the subsequent failure it points to the fact that either the tariff offered and / or the number of customers gained was unsustainable.

Iresa Energy

Established: 2016

Date of failure: July 2018

Size: 91,000 customers

Cost of claim through SoLR levy: Octopus was appointed SoLR and claimed up to £13.8m, made up of £11.5m of credit balances. This equates to an average of each customer being £126 in credit.

Signs of difficulties: Enforcement action raised in February 2018 for multiple licence breaches relating to billing, customer service and vulnerable customers. No action taken and case closed once they ceased trading.

Spark Energy

Established: 2007

Date of failure: November 2018

Size: 290,000 customers.

Signs of difficulties: There have been multiple instances of defaulting on industry invoices going back nearly a decade, suggesting they had ongoing financial difficulties.

Spark was investigated before 2015 for breach of multiple supply licence conditions including fraudulently transferring customers away, objecting to customer transfers without sufficient grounds and delaying refunds to customers. The investigation was closed in 2015 with a total redress of £250,000 paid by Spark.

Spark was third from bottom of the latest Citizens Advice supplier ratings with 2.1 out of 5 stars.

Extra Energy

Established: 2014.

Date of failure: November 2018

Size: 190,000 customers.

Signs of difficulties: Investigation opened in July 2016 into multiple supply licence breaches including conditions relating to billing, switching and customer service. The investigation was closed once they ceased trading, without any action having been taken.

OneSelect

Established: 2016

Date of failure: December 2018

Size: 36,000 customers.

Signs of difficulties: OneSelect was bottom of the latest Citizens Advice ratings for energy suppliers, being awarded 1.3 out of 5 stars.

Conclusion

In many of the above examples – especially among the larger entries, there was a significant amount of time between the ‘warning signs’ of a struggling supplier, and the supplier ceasing trading. Warning signs have and may include:

- Poor customer service ratings and a disproportionately high number of complaints per customer – identified by impartial third bodies such as Citizens Advice and the Energy Ombudsman.
- Offering the cheapest tariff on the market for a set amount of time.
- Asking customers for several months’ worth of payment in advance.
- Instances of defaulting on industry invoices.
- Enforcement investigations and actions taken by Ofgem with respect to the supplier.
- Entering credit default with the likes of ELEXON
- Expressing an unwillingness to refund customer credit balances upon
- Sudden increases in customer’s direct debits (DD) suggesting the supplier needs an urgent capital injection to stay afloat, with no commensurate price increase to justify the DD increase.

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- Not refunding credit balances to both existing and former customers, or refunding at a slower rate than the industry average.

The above signs do not necessarily mean a supplier is in financial trouble. However, they are signs that should be used by Ofgem to increase its monitoring of that supplier. Especially if a supplier meets more than one of the above criteria. Ofgem should implement automatic thresholds that result in targeted monitoring based on the above criteria.

It's also clear that most failed suppliers had not been operating for long, except for Spark energy. Thus, suggesting any proposed monitoring by Ofgem would be best targeted at new suppliers – those that have been in operation for less than five years.

Of the suppliers that failed only the costs of GB Energy and Iresa Energy's failures have been made public. Ofgem should publish figures on the other suppliers to indicate:

- How much these suppliers owed in terms of outstanding credit balances?
- What was the average customer owed in credit balances. And therefore, what cost was mutualised across other suppliers?
 - Assessing the average level of credit balances could act as a strong indicator of whether a supplier is in financial difficulties?

After the first 'warning sign', the following actions could have been taken to prevent the costs of supplier failure rising:

- Preventing the supplier from gaining more customers until financial stability has been proven.
- Asking the supplier for financial and growth forecasts to determine whether a supplier is likely to fail.
- Requiring the supplier to refund customer's credit balances, thus reducing the cost of mutualising its debts when it did fail.

Centrica considers that having both Ofgem's and our proposed changes in place would have prevented many of these failures by:

- Preventing these companies from gaining a licence if they presented an unsustainable business model,
- Strict monitoring preventing new suppliers from growing too fast or using customer's money to finance their risk, or
- Limiting mutualisation of costs, if the supplier passed the two tests above and then subsequently failed.