Supplier Licensing Review

Executive Summary

We strongly welcome Ofgem's proposals with regard to market entry and exit reforms; we only regret that Ofgem has not given this issue greater urgency. For over a year now, stakeholders have been warning of the risks inherent from suppliers operating in the market without due respect for regulatory requirements and with business models that are ill-fitted for operating in the volatile energy supply environment.

A total of 12 suppliers have exited the supply market in 2018 with a further exit in 2019, an unprecedented number of failures. In most cases, the supplier exit has resulted in the Supplier of Last Resort (SoLR) process being invoked. We are still hearing rumours that other suppliers are struggling to stay afloat, particularly given the imminent implementation of the default tariff cap (the cap). These supplier failures exacerbate the risks for everyone; remaining suppliers may have to pick up some of the failed suppliers unpaid bills through mutualisation processes (Renewables Obligation (RO) and Feed-in-Tariff (FIT)) as well as having to pay a share of the costs of an SoLR in taking on a failed supplier's customers and honouring their credit balances through the Last Resort Supply Payment (LRSP).

Over recent years there has been a significant increase in the number of energy suppliers operating in the market; this has been largely due to third party organisations offering off the shelf supply companies, consisting of everything necessary to commence operation, including a supply licence. We therefore welcome Ofgem's proposals to tighten up and change the timing of the market entry regime to ensure that a licence is granted to an operator, not just a shell company, and that the operator has adequate plans to maintain financial resilience and good customer service with the capability to weather some of the volatility inherent in energy supply.

We ask Ofgem, however, to ensure that would-be suppliers can demonstrate a genuine awareness of key customer-service obligations and regulatory requirements; it would be easy for a third party supplier-in-a-box provider to offer policies and documentation to meet the requirements that Ofgem sets out in Criteria 2: Regulatory Obligations.

We have concerns that the ability of SoLRs to claim back significant costs through the industry levy has made trade sales much less attractive. Under a trade sale, the purchaser is likely to have to take on the liabilities of the seller, including unpaid costs such as RO and FIT and credit balances, that the seller may have been using to help keep itself afloat. As was shown from Ovo's appointment as SoLR to Spark Energy, an SoLR can undertake a trade sale for all but a failing supplier's customers and then take advantage of the SoLR rules to pay for many of the costs that would normally be incumbent on a purchaser.

We are also concerned that some suppliers may be offering terms that only relatively wealthy customers can afford, such as paying a year in advance, in return for a lower price. If that supplier fails, the value of such credit is likely to be claimed back through the industry levy, meaning that all customers, including those who are vulnerable, have to experience higher prices so that the failed supplier's customers are not disadvantaged.

We have answered Ofgem's consultation questions below.

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

We agree with the principles Ofgem has set out.

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 agree that new, tougher entry requirements are required to reduce the number of SoLR events seen recently, which cause considerable inconvenience to customers and have the potential to increase prices for all consumers, as remaining suppliers may have to pick up unpaid bills such as RO and FIT and contribute to the industry levy that reimburses an SoLR for at least some of the costs of honouring credit balances.

Ofgem has laid out three options for the entry regime. Option 1 is unacceptable: it is currently too easy to set up an energy supply business through the supplier-in-a-box model. We recognise that forensic examination of financial information (Option 3) is probably disproportionate and would require skills that we do not believe Ofgem currently has. We therefore believe Option 2 is the most appropriate option.

Ofgem could also restrict new entrants to offering prices within a certain percentage of market average. This could deter those who enter the market with unsustainably low prices, often coupled with a requirement for customers to pay in advance, with the intention of growing their business on the back of customer credit.

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

We broadly agree that Ofgem's proposed assessment criteria; however, we believe that 'appropriate' should be defined clearly for greater clarity.

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 believe that evidence should be provided to cover the first 5 years, and that stress testing should be included. We do not believe 12 months is adequate; it would not indicate the plans the applicant had to grow its business whilst maintaining financial resilience. It may be that a supplier can prove financial viability for 12 months even under a stressed wholesale market, but financial planning beyond the first year requires a much more thought through strategy.

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?

Ofgem's proposals appear to be comprehensive and sensible.

We note that Ofgem proposes to require information relating to *"projected volume of energy to be supplied and purchasing strategy"* and *"risk management strategy (plan to mitigate key financial risks and maintain levels of working capital projected under realistic stress scenarios)".* We understand these two points to constitute a proactive approach to manage the commodity risks associated with the purchasing of energy by adopting a sustainable level of risk versus reward. Suppliers can protect against wholesale market price shocks through appropriate hedging strategies, and should be encouraged to avoid leaving it until close to physical delivery to purchase a high proportion of their energy requirements.

We note that Ofgem's proposal is for operators to demonstrate that *"they have satisfied themselves that they have adequate financial and operational resources to undertake their activities …".* Ofgem needs to provide information to indicate how it will satisfy itself that these plans are reasonable, reliable, practicable.

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

We agree that applicants must be able to demonstrate their understanding of regulatory requirements. There is a danger that such narrative could be provided as part of an off the shelf solution, therefore it may be necessary for Ofgem to carry out face to face interviews to ensure an operator is truly knowledgeable in this area.

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

We believe the areas applicants are required to provide information on is comprehensive and are not aware of any additional items that should be included.

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

We agree with the additional 'fit and proper' questions.

Ofgem needs to clarify how it will assess the information it receives and should take reasonable steps to undertake due diligence to ensure the information provided is accurate. It also needs to set out to what extent the information provided would lead to a licence being refused. Company directors of failed supply businesses should not be granted a new supply licence for a given period of time.

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?

We welcome these proposals and believe that the new timings proposed are essential in order to ensure that a licence is granted to the operator of the supply company and not just a company providing off-the-shelf businesses.

Operators could gather the relevant information and present it to Ofgem while the initial market entry requirements are being undertaken in order to minimise the time to get to market. The timing for Ofgem to approve the granting of a licence can therefore be kept relatively low.

The timings proposed do not prevent third parties from offering a supplier-in-a-box: however there is a danger that such businesses could offer off-the-shelf policies, plans and narratives, so that as part of the licence application an operator does not have to fully engage with the relevant requirements. Ofgem needs to mitigate against this. One solution may be a bilateral face-to-face meeting with the operator and a visit to the premises from which it will operate in order to quiz the applicant to ensure they fully understand the documents they have submitted, and not merely 'ticked a box'.

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 is difficult to see how this information would be any different to a normal going concern statement from an auditor.

If Ofgem pursues this proposal, we suggest that any information required should be on a risk-based approach to minimise administrative burden on low risk suppliers; for example, those with acceptable hedging strategies, risk management processes and group management support. For new entrants, this information might be required for at least the first few (possibly five) years of operation.

Where certain trading strategies are employed and in particular market conditions, a going concern can become unviable very quickly; we therefore agree with the use of stress-testing and the need, where appropriate, to cover periods longer than 12 months.

The level of information required should be balanced to minimise the administrative burden on suppliers. If the information will be published in any form, consideration should be given to any impact it may have on financial markets. Any published information should have been audited. We would prefer that the timing of requests should be sufficiently flexible to fit in with the suppliers' accounting cycles in order to minimise administration and cost.

It should only be necessary to request additional information (e.g. an annual viability statement) where a certificate of adequacy is not provided, or is conditional. Such information should include total indebtedness and the age of the oldest unpaid invoices.

There needs to be clarity about the action Ofgem could/would take where information provided indicates that a supplier has resilience issues.

There also needs to be clarity around how white labels will be dealt with; we believe that consideration should be given to the financial resilience of the partner supplier as well as the white label operator.

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

We agree that there are specific times where additional reporting may be useful; however it is not clear what action Ofgem would take in the event that issues were revealed.

We would suggest that relevant times might be where customer numbers are approaching 50k and 250k, where significant additional regulatory requirements come into force. Suppliers approaching these thresholds need to have sufficient plans in place to deliver schemes such as Warm Home Discount and the Energy Company Obligation in order to avoid consumer detriment: these plans need to be shared with Ofgem to evidence the existence of a strategy, resources and financial backing to deliver the additional obligations. Also, where Ofgem finds evidence of non-compliance with regulations as part of an investigation into supplier behaviour, a review should be triggered.

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

We discuss our thoughts on changes to rules around credit balances below.

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

The provision of such information should be on a risk-based approach to minimise the administrative burdens on suppliers who have not previously given any cause for concern.

Comments on exit arrangements

We agree with Ofgem's premises that a failing supplier should take greater responsibility for its share of the costs of failure and look forward to Ofgem's consultation on this later in 2019. In the meantime, we would like to provide some comments on Ofgem's high level processes.

With regard to imposing maximum limits on credit balances, it is important that Ofgem remembers that the expectation is that credit balances are highest at the start of winter and lowest just before summer starts. There may therefore be different limits required for different times of year. Credit balances will also vary according to a customer's consumption level, therefore some allowance should be made for this.

We fully support the restriction of terms that incentivise credit balances. This includes tariffs that require a customer to pay for a month or more in advance.

We agree there should be some restriction on the amount of credit balances that can be used as working capital, and propose that suppliers hold funds in a separate, ring-fenced account.

We have significant concerns about reducing the time to issue final bills and return credit balances; this relies on suppliers having accurate meter reads to calculate the final bill. If a final bill is issued too early, customers may either later be asked to pay back their credit or may need to receive a further credit. Even where homes have smart meters, without the knowledge that a customer has moved on a particular date it can often take considerable time to agree reads between the old and new occupiers.

We fully support the need for improved legislation and/or regulation to lower the burdens on compliant suppliers where there are shortfalls in Government environmental schemes. This year, over £100m of costs is likely to be socialised amongst suppliers and passed on to consumers, which is an untenable industry situation.

We have considered the following options:

1. Increase the frequency of payments for some obligations; in particular, for the Renewable Obligation (RO). Currently the RO bill is due annually, and is the single largest cost item of any third party cost.
2. Require suppliers to guarantee funds prior to payment, either by posting some form of security (bank guarantee/parent company guarantee/collateral etc) or by mandating physical accrual of liabilities in a way that could be checked or audited.
3. Consider the appropriate burden of supplier failures across suppliers and generators. Whilst this is probably not appropriate for smaller generation, it may be appropriate to consider for the RO, where large generation assets may share the burden of industry failures.
4. General taxation for large policy costs.

Our preference would be for the fourth option. However, given that this is unlikely, we believe that a combination of options 1 and 2 would be most appropriate; we demonstrate how this might work below using RO, but it could also be used for other costs.

- Introduce a new, more frequent (e.g. quarterly) RO process: suppliers are required to either prove they have enough Renewable Obligation Certificates (ROCs) to offset their current obligation or pay any difference between their obligation and ROCs available. At this stage the full ROC submission and recycle payment is not required, as it introduces unnecessary complexity and effort.
- Suppliers should provide some security at the start of each quarterly period (or whatever frequency is used) as described in option 2 above. Similar industry processes are in place across a number of other industry costs.
- Ofgem should monitor compliance and could operate a process similar to that used by Elexon for defaults, by publishing details of those who have failed to meet the requirements and holding a dialogue with the failed suppliers with the aim of resolving the issue.
- The full annual RO process would be retained, with ROCs being submitted and the recycle process being implemented. Generators would therefore see a similar process to today.

We would not support running more frequent RO buyout and recycle processes, and generator payments should remain annual.