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Licensing & Industry Codes
Ofgem
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Dear Lisa and Jeremy,

Supplier Licensing Review

Thank you for the opportunity to comment on this consultation. We welcome Ofgem's review of new supplier entry requirements and ongoing monitoring arrangements, and think it timely in light of the large number of insolvencies over the last two years. These insolvencies cause detriment not only to the customers of the failed suppliers but also the customers of other suppliers who bear the costs of refunding credit balances and mutualisation.

Clearly, insolvencies are a normal part of all competitive markets. Competition between market participants, whether through price, service or innovation requires some level of risk taking – including the risk of insolvency. The objective of the review should be to ensure that markets function efficiently and the impact of insolvencies on consumers and other market participants is proportionate. As far as is practicable, it is important that shareholders and/or business owners bear the costs of insolvency as this in turn will discipline the risk management of the business.

We support Ofgem's proposals for tightening entry criteria and agree that the three categories of information requirement (applicant's resources, applicant's understanding of key customer service-related regulatory obligations and 'fit and proper' checks) are broadly appropriate. It is also correct to change the timing of licensing so that tests are applied closer to market entry and avoid the current problems with 'off the shelf' licensees. Our main suggestion in this context is that Ofgem give further consideration to introducing minimum capital requirements for licensees. We note Ofgem's concerns about deterring innovative business models, but we think that a modest capital requirement could strike an appropriate balance between consumer protection and encouraging innovation.

We also support Ofgem's intention to tighten up its ongoing monitoring of suppliers and its arrangements for managing supplier failure and exit. We believe Ofgem has identified an appropriate range of options for consideration and look forward to further consultation on these matters in due course. In this context we believe there is a strong case for tougher risk-based prudential financial requirements, including a requirement on suppliers to ring-fence or otherwise protect their customers' credit balances in the event of an insolvency.

Finally, we have previously drawn attention to the unduly generous payment arrangements for the Renewables Obligation (RO) which have contributed to the high recent costs of mutualisation. We have suggested to Government that it should undertake a review of the RO payment terms alongside Ofgem's review and were pleased to see that this issue was also highlighted in Martin Cave's speech at Ofgem's Future of Energy Conference.

If you have any comments or queries on any aspect of this response please don't hesitate to contact me.

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive, flowing style.

Richard Sweet
Head of Regulatory Policy

OFGEM SUPPLIER LICENSING REVIEW– SCOTTISHPOWER RESPONSE

We note that Ofgem has not numbered the questions posed within the consultation document. For ease of any cross-referencing in our answers we have numbered the questions within our response.

Section 2: The case for change and our aims

Question 1. Do you agree with the principles we have set out to guide our reforms?

Ofgem is proposing four principles to guide its reforms:

- suppliers should adopt effective risk management and be adequately prepared and resourced for growth;
- suppliers should maintain the capacity and capability to deliver a quality service to their customers, and foster an open/constructive dialogue with Ofgem;
- Ofgem maintains proportionate oversight of suppliers, and effective protections for consumers exist in the event of failure;
- Ofgem’s licensing regime facilitates effective competition and enables innovation.

We agree that all these principles are appropriate to guide Ofgem’s reforms, but suggest that Ofgem should consider an additional principle, which is that where suppliers become insolvent, the associated industry costs (reimbursing credit balances, making good shortfalls in social and environmental programmes, network charges etc.) should be borne as far as reasonably practicable by the shareholders and investors in the company rather than by other suppliers and their customers.

In other words, the reforms should seek to mitigate the “moral hazard” created by a regulatory regime in which:

- suppliers can encourage their customers to pay in advance, safe in the knowledge that their credit balances will be protected by the Supplier of Last Resort (SoLR) regime and without needing to consider the solvency of the supplier;
- suppliers can access credit terms for essential inputs (network services) or industry obligations that do not reflect their individual credit risk and the terms that a commercial counterparty might seek.

As explained further below, this principle would be likely to guide reforms in the direction of requiring that suppliers are adequately capitalised, that relevant payment terms are not unduly generous in relation to a supplier’s credit risk and that suppliers’ customer credit balances are appropriately ring fenced.

Section 4: Entry criteria: policy options

Question 2. Do you agree with our proposal to introduce new tougher entry requirements and increase scrutiny of supply licence applicants?

Yes, we agree with Ofgem's assessment that supplier insolvencies in the last 12 months have demonstrated that current entry requirements and scrutiny of new entrants are insufficient in deterring ill prepared market entrants. It is notable that licensing regimes in a number of other jurisdictions have more stringent entry requirements than the UK – eg see Box 1 below.

Box 1: Licensing requirements in Texas¹

Capital requirements:

Option A

- The supplier or guarantor must have an investment grade credit rating, or
 - have a net worth of greater than \$100m;
 - current(assets to liabilities) ratio of 1.0; and
 - above supported by an affidavit for accuracy from an executive officer

Option B

- The supplier must provide \$1m of shareholder equity;
- The supplier or guarantor must provide an irrevocable letter of credit to the regulator (Texas Public Utilities commission) of \$500k; and
- The supplier is restricted from redistributing shareholder funds if the effect is to reduce above equity to below \$1m.

Protection of customer deposits²

- The supplier must place all customer deposits/advance payments in a segregated escrow account, the account must be provided by a non-affiliate credit provider; **or**
- The supplier or guarantor must provide an irrevocable letter of credit guaranteeing 100% of all outstanding deposits/advance payments at end of each month.

Question 3. Do you agree this can be achieved with increased information requirements and qualitative assessment criteria?

Ofgem has outlined three possible approaches to reforming entry criteria:

- Option 1 – Status quo
- Option 2 – Increased information requirements with qualitative assessment criteria
- Option 3 – Detailed information requirements with financial scrutiny and/or specific capital requirements.

We agree that option 2 would be desirable as a minimum. Supply licence applicants should be required to submit more information than at present, in order to demonstrate the

¹ Public Utility Commission of Texas, REP - Retail Electric Providers Certification and Reporting, <https://www.puc.texas.gov/industry/electric/business/rep/rep.aspx>

² Direct debit type payment methods are not generally used in Texas, with the majority of customers paying on receipt of bill, so it is notable that steps are still taken to protect balances.

robustness and sustainability of their approach to financing their business model, complying with required regulatory obligations and servicing their customers.

We agree with Ofgem that the information component of Option 3 (full business proposals and detailed accounts and projections (eg 5 years)) may be disproportionate and furthermore that Ofgem's ability to scrutinise more detailed information may be limited without specialist expertise.

We do however consider that further consideration should be given to combining Option 2 with the specific capital requirements component of Option 3. We note the challenges cited by Ofgem in setting an effective level of capital requirement but we think it may still be possible to determine a capital requirement that does not pose a barrier to entry whilst being material enough to discipline the conduct of the new licensee. The precedent of Texas (see Box 1 above) may be worth considering in this regard.

Section 5: Entry Criteria: Initial Proposals

Question 4. Do you agree that our proposed assessment criteria for supply licence applications are appropriate?

Yes, we agree that the three assessment criteria proposed by Ofgem for supply licence applications are appropriate:

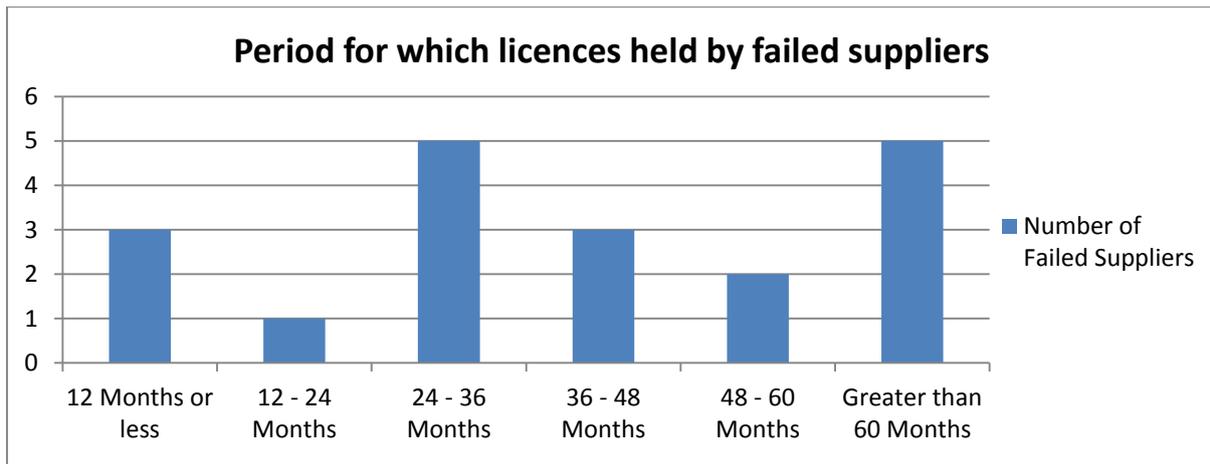
1. The applicant has the appropriate resources for their proposal to enter the market
2. The applicant understands their regulatory obligations and has appropriate plans in place to meet these
3. The applicant is fit and proper to hold a licence

As noted above, we also consider there is merit in including a specific capital related criterion or requirement, as in other jurisdictions.

Question 5. Do you agree that applicants should provide evidence of their ability to fund their activities for the first 12 months, and provide a declaration of adequacy?

We agree that applicants should provide evidence of their ability to fund their activities but we think 12 months is insufficient and think that Ofgem should ask licence applicants to demonstrate their capability to fund their activities for at least 24 months. (We would note that applicants in the Republic of Ireland are required to provide an outline 5 year business plan.)

Historical evidence shows nearly all entrants into the UK energy supply market have been able to sustain themselves for more than 12 months and it is only after this period that suppliers fall into insolvency. The chart below provides a breakdown of all supply licence revocations from November 2016, illustrating the duration the licence was held up to its revocation. Almost all of these revocations are associated with the supplier becoming insolvent. In most instances the supplier went insolvent after the first 12 months and some after the first 24 months. The data from which the chart is derived is set out in Annex 2.



Question 6. Do you agree with the specific information we would generally expect applicants to provide (in Appendix 1)? If not, why/what would you add or change?

We generally agree with the proposed information requirements set out in Appendix 1 but have the following specific comments:

Criterion 1: The applicant has the appropriate resources for their proposal to enter the market

Under operational resources and approach we believe there should be a requirement specifically on the approach to customer service as the business grows. In the context of innovative and disruptive business models it will be important to recognise customer interactions may differ from what is expected from a traditional energy supplier, but it is nonetheless important to have confidence that the quality of service will be maintained at sufficient levels.

The information requirements under criterion 1 should also include details of which individuals will be responsible for key roles, including compliance with regulatory obligations, and the approach to managing and monitoring the activities of any outsourced functions, particularly where these may have a role as a representative of the new supplier.

Criterion 2: The applicant understands their regulatory obligations and has appropriate plans in place to meet these

We think customer switching obligations are an obvious omission from Ofgem’s headings in Appendix 1. It is essential that licence applicants demonstrate their ability to comply with these obligations given the impact on the experience of gained and lost customers and associated suppliers. As part of this assessment, it will be important for applicants to show they will have the necessary IT infrastructure in place.

While Ofgem has included the obligations relating to pre-payment meters and vulnerable customers in the headings in Appendix 1, we believe these to be of particular importance and think that Ofgem must ensure that potential new entrants are provided with relevant requirements in advance by Ofgem, with the applicant expected to provide a response against each obligation, rather than left to the applicant’s discretion to identify in their application as may be the case under Ofgem’s suggested approach.

We note the reference to smart meters. In addition to the smart rollout obligations it is important that applicants are aware of and can demonstrate their approach to meeting the

wider obligations on metering, including obligations on meter reading frequency, and the various guaranteed standards of performance on meter failure and metering appointments.

Criterion 3: Fit and Proper Persons test

We generally agree with the list of 'fit and proper' information requirements in Appendix 1, and that the information should be provided in respect of any named person (or person with significant management responsibility or influence). This should include all directors of the company. In certain circumstances it may also be justified to check whether key personnel (and possibly family members) are also involved in other licensed supply businesses.

Question 7. Do you agree that applicants should provide a narrative in respect of their key customer-related obligations under the licence?

Yes, we agree applicants should provide a narrative with scope for Ofgem to follow up if required with further questions or a direct interview of the named individuals in the application. Applicants should be given a clear steer in Ofgem's guidance that poor quality narrative or lack of it will be interpreted as the applicant's failure to understand the obligations concerned and inability to demonstrate credible plans and resources for compliance. As we have set out in our response to Question 6 above, we think applicants should clearly set out the named individual who is responsible for key roles, and this should include a role related to compliance with customer-related obligations.

Question 8. Do you agree with the areas we would generally expect applicants to cover (in Appendix 1)? If not, why/what would you add?

Yes, we agree with the general areas identified in Appendix 1. We have commented on specific items under each of the proposed criteria in our response to Question 6 above.

Question 9. 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 agree with the general areas for 'fit and proper' questions identified in Appendix 1. We have commented on specific items in our response to Question 6 above.

Section 6: Timing of Licensing: Initial Proposals

Question 10. Do you agree that Ofgem's licensing process should be undertaken closer to proposed market entry?

Yes we agree. First, we think that an application closer to market entry will be more robust and accurate with regards to the underlying business planning assumptions and forecasts. Second and more importantly, this proposal should ensure that any application will be made in conjunction with the senior management of the supply company at the time it starts trading. It is important that individuals who will ultimately assume financial and operational control of the supplier are named in the application and fully involved in all aspects of the process. This proposal should therefore minimise the risk of a new entrant acquiring an "off the shelf" licence and remaining ill-prepared to enter the market.

Question 11. Do you identify any barriers to this approach or any adverse impacts of this change?

No, we only anticipate the benefits identified in our response to Question 10 above.

Section 7 Ongoing Requirements

Question 12. 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?

Financial resilience

Yes, we agree that suppliers should be obliged to report on financial resilience on an ongoing basis. To minimise the regulatory burden, it would make sense for such reporting to be aligned as far as possible with companies' existing statutory reporting requirements. However, there are two key limitations of the current reporting obligations which Ofgem should be aware of in defining any new reporting requirements. In particular:

- Companies are required to file their first accounts with Companies House 21 months after the date they registered with Companies House and file annual accounts 9 months after their financial year end;³ a delay of this magnitude would reduce the value of the information as an early warning indicator of financial difficulty or lack of resilience.
- If a company undertakes other business activities other than licensed energy supply, the accounts may simply provide an aggregate view rather than a segmental view of the supply business. In the absence of a segmental view it may be difficult to compare financial metrics with other supply businesses and form a reasonable view of resilience.

We think Ofgem should consider requiring suppliers to provide financial information on a more frequent and timely basis (eg quarterly or half yearly) and with sufficient segmentation to allow an assessment of resilience. This information should ideally be aligned with (and capable of reconciliation to) the statutory reporting, but would not be made public and would not be subject to an audit requirement. Segmentation should ideally follow similar principles as are used for the existing Consolidated Segmental Statements (CSS) required of larger suppliers under SLC 19A of the current electricity and gas supply licence conditions.

Key information would include cashflow, capital and profitability measures including:

- EBIT
- EBIT to interest payments
- Debt to capital
- Assets to liabilities
- Tangible net worth (tangible assets less intangibles)

There should be a particular focus on short term cashflow resilience, as measured for example by the by the quick ratio (or 'acid test'):

$$\text{Quick ratio} = \frac{\text{Cash and cash equivalent} + \text{marketable securities} + \text{accounts receivable}}{\text{Current liabilities}}$$

³ <https://www.gov.uk/prepare-file-annual-accounts-for-limited-company>

Ofgem should adopt a risk-based approach and exempt suppliers from the requirement if their debt is covered by a major credit rating agency (Moody's, Fitch, Standard & Poor's), since that will already provide a sufficiently robust check of financial resilience. Conversely, we would note that, in our experience, credit assessments from commercial data analytics services may not provide sufficient robustness and should not be regarded as a substitute for a financial reporting requirement.

Ofgem will also need to consider what escalation or mitigation steps are available should the routine financial monitoring reveal that a supplier is financially at risk. Possible options might include:

- More stringent targeted financial reporting requirements (see below).
- Imposition of targeted financial restrictions (see below)

Operational resilience

In terms of operational resilience we think it is important to focus on customer outcomes and therefore the reporting of new licensees should align with key metrics from the existing reporting required of suppliers, including but not limited to the Social Obligations Reporting (SOR), Market Monitoring Reporting (MMR) and complaints reporting. As with financial reporting, suppliers reporting such information under existing obligations should be exempted. The Citizens' Advice Scorecard may also be a useful source of information, reflecting performance under a number of headings including billing, complaints handling and call answering times.

Although the main requirement will be for suppliers to submit information in confidence to Ofgem, we think Ofgem should consider whether there may be any benefit in publishing (or requiring suppliers to publish) certain information categories. Whilst most information regarding financial resilience is likely to be commercially sensitive we see fewer problems with publication of operational data (subject to the usual provision for suppliers to provide representations ahead of any publication where this is not provided for in advance), and consider there could be benefits from the resulting transparency.

Question 13. Do you have any initial views on the potential introduction of targeted or strategic monitoring/requirements on active suppliers?

We think it would be sensible to introduce a targeted and strategic monitoring and requirements framework. Financial distress and ultimately insolvency can develop very quickly, i.e. within weeks or months, and it is therefore important that Ofgem has the ability to reassess a company's financial and operational resources following a key trigger point.

Ofgem identify potential trigger points/events as:

- reaching defined customer number thresholds;
- a significant deviation in growth rates and other metrics from expectations or the original application;
- a change in ownership/control;
- Ofgem identifying significant financial risks, or lack of resilience, as a result of routine financial monitoring.

We agree these are all key points when there is a heightened financial and/or operational risk and it is a timely point for Ofgem to ask companies to resubmit information. We think under the second bullet it should be explicit that this would include where there is a significant deviation from the business strategy within the initial application. This should particularly include situations where a company is undergoing rapid expansion and making substantially increased losses.

Other possible triggers would be:

- New fund raising round (especially if not part of original plans)
- Changes in business practices (eg Direct Debit policy) indicating a need for cash.

Finally, in addition to the above triggers, Ofgem may be able to make use of information it has through its administration of the Renewable Obligation (RO) or other schemes, which may provide early warning of supplier financial distress. Elexon's imbalance collateral is another useful indicator but much closer to real time and more likely to indicate the imminent insolvency of a supplier.

Question 14. Do you have any initial views on the potential introduction of prudential/financial requirements on active suppliers?

We believe prudential/financial requirements are essential to ensure that licensees are adequately capitalised and resourced, reducing the risk that consumers are unduly exposed in the event of financial failure. These could include default requirements (which all suppliers are subject to) and targeted requirements (which would be imposed on specific suppliers on the basis of trigger events or risk metrics).

We believe there is a particularly strong case for protecting customer credit balances, and would encourage Ofgem to consider how best to monitor and enforce any such requirement. This should include consideration of setting a maximum amount of credit per customer that suppliers are allowed to hold (with possible exemption from this rule if the credit balances are held in a protected ring fenced account).

In general, where such requirements are imposed, Ofgem should allow as wide a range of options for discharging them as possible, so that companies can maximise the financial efficiency. For example, options could include:

- Maintenance of a specified capital ratio or amount;
- Provision of a letter of credit or parent company guarantee;
- Lodging a specific amount of cash in an escrow account
- 'Transfer of funds' restrictions.

With regard to the latter point, licensed networks businesses are subject to 'transfer of funds' restrictions on eg dividend payments, and similar restrictions could potentially be considered for suppliers as a last resort if there is a concern that lenders may withdraw funds ahead of an insolvency, leaving customers or other market participants exposed.

Question 15. Do you consider that Ofgem should introduce a new ongoing requirement on suppliers to be 'fit and proper' to hold a licence?

Yes, we understand that Ofgem has in mind that there would be an ongoing 'fit and proper' requirement which means that Ofgem could take action if information came to its attention that a licensee no longer satisfied the test. We agree this would be a more proportionate approach than requiring licensees to proactively confirm their fit and proper status on an ongoing basis.

DATA ON RECENT SUPPLIER EXITS

Supplier		Date licence issued	Date licence revoked	Duration licence held (full months)
GB Energy Supply Limited		29-Oct-15	26-Nov-16	12
Boltland Energy Limited (formerly Utility Point UK Limited)		14-Jul-17	12-Jan-18	5
Future Energy Utilities (Traded as Sirocco Energy Supply Limited)		07-Aug-13	30-Jan-18	53
Future Energy (Supply) Ltd		03-Jul-15	30-Jan-18	30
Flow Energy		08-Apr-11	10-Apr-18	84
Greengem Direct Limited		10-Sep-14	12-Apr-18	43
ENSCO Energy Services Company (UK) Ltd		21-Jan-16	06-Jun-18	28
National Gas and Power Limited		28-Jun-17	25-Jul-18	12
Iresa		01-Jul-14	31-Jul-18	48
GEN4U		04-Feb-16	13-Sep-18	31
Golding Energy Limited (Traded as USIO Energy Supply Limited)		12-Aug-16	15-Oct-18	26
Snowdrop Energy Supply Limited		16-Dec-16	02-Nov-18	22
Callisto Energy Supply Limited (Traded as Extra Energy Supply Limited)	E	22-Aug-12	21-Nov-18	74
	G	12-Jul-13	21-Nov-18	64
Spark Energy	E	16-Jul-07	23-Nov-18	136
	G	18-Oct-06	23-Nov-18	145
Cornflower Energy Supply Limited (Traded as Oneselect Limited)	E	27-Oct-15	10-Dec-18	37
	G	19-Nov-15	10-Dec-18	36
Economy Energy		16-Oct-13	08-Jan-18	50

ScottishPower
January 2019