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Dear Lisa

Supplier Licensing Consultation

First Utility welcomes the opportunity to respond to this Review, and looks forward to the accompanying consultation on the "Supplier of Last Resort (SoLR)" exit regime.

As one of the first challenger suppliers to enter the domestic market, First Utility is clear that competition has been a positive force for UK consumers, driving down prices, improving customer service and unlocking innovation.

For this reason, we feel strongly that any changes to supplier entry and exit should not provide a barrier to appropriately capitalised and funded suppliers, and that any ongoing monitoring of suppliers should not introduce excessive regulatory oversight of a company's financial position and management.

However, the combination of light touch entry requirements; few solvency checks; and the ability for suppliers to take significant sums of payment upfront - up to a year in some cases - has facilitated irresponsible supplier business models, with the ever-escalating liabilities then underwritten by the consumers of more responsible suppliers.

This moral hazard is further compounded by, first, the exemption of small suppliers from paying the Warm Home Discount, Energy Company Obligation and some Smart costs; and secondly, the mutualisation across industry of those industry schemes all suppliers are required to support, all too easy given the excessively long payment terms (over a year in the case of ROCs).

The current structure effectively means that new suppliers are subsidised either by their customers (via excessive credit balances) or by the industry (via small supplier exemptions and mutalisation). This is a one-way bet for new entrants: if they win, they keep the profits. If they lose, others pay the costs.

With 9 suppliers failing over the past 12 months, at a cost of £200m or more due to lost credit balances and industry scheme mutalisation, we urge Ofgem to:

- **Introduce a new principle explicitly committing to minimising moral hazard.** This should include ensuring regulation is risk-based, with tougher rules to prevent suppliers holding excessive credit balances; consumer obligations the same irrespective of the size of supplier; and the cost to industry of ROC mutualisation minimised through a new requirement for

suppliers to either pay monthly or, if Ofgem feels it is too difficult to change the ROC regulations, to post monthly credit cover sufficient to cover likely annual charges.

- **Require applicants to submit a 3-5 year business plan,** rather than just 12 months as proposed in this consultation. Credible business plans, i.e. those used to secure financing, credit or other forms of support from lenders and investors, would require this longer time frame as funders seek evidence of the potential for sustainable growth.

- **Introduce an initial and ongoing "fit and proper" test** , which should dovetail with the disqualification regime for directors and should also apply to senior management positions. As part of the disqualification regime, 'unfit conduct' should include 'allowing a company to continue trading when it can't pay its debts' (e.g. ROCs, FiTs).

- **Introduce an initial (for new) and annual (for existing suppliers) Certificate of Adequacy**, which should include proper risk management analysis and procedures. Based on this, Ofgem should use pre-determined criteria to identify whether a supplier's risk profile is "high risk" versus "low risk". For low risk suppliers, any monitoring should be appropriately light touch.

- **Consult on specific additional "triggers" for Ongoing Monitoring, such as a referral from Citizens Advice or inability to pay industry schemes.**

- **Consider carefully and clarify the hierarchy of actions taken when suppliers fail the Certificate of Adequacy process or any other Ongoing Monitoring; are referred by Citizens Advice due to poor customer service OR fail to pay into industry schemes.** The current enforcement process is slow, putting customers at risk: we note Economy had three open Investigations when it went into SoLR. Ofgem has been making greater use of Provisional Orders whilst Investigations are ongoing, e.g. suspending a supplier's right to provide services, either completely or in certain respects. Ofgem should set out a more formal "escalation" process, moving from enhanced monitoring through to tougher fines and licence suspension.

- **Introduce fiscal responsibility rules - or ban altogether - practices that promote the build-up of excessive credit balances**. We consider that the most straightforward approach would be to ban practices deemed excessive, for example, preventing suppliers from taking payment more than one month in advance of supply. Alternatively, Ofgem could require suppliers to post an initial bond on entry to the market, or provide a letter of credit to protect excessive balances where a supplier takes payment more than one month in advance of supply. There needs to be real consequences for irresponsible behaviour - either for the consumer, so that the pressure of "buyer beware" can be exerted given the risk they will lose their money, or to the supplier themselves.

- **Any Ofgem proposals on credit balances should apply to new entrants immediately, but with a 12 - 24 month implementation period for existing suppliers.** This will give suppliers time to adjust their tariff mix, credit and financing, risk management and other approaches.

We believe the package of measures proposed above will have an important dual benefit. First, by instituting a system of security cover, domestic consumers as a whole would no longer be liable for the cost of irresponsible behaviour. Secondly, the proposals would have a self regulating effect, as more robust and sustainable business models reduce the chance of failure in the first place.

Below we now answer each question in detail:

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

Yes, we agree with the overarching principles guiding reform as set out in the Consultation, namely:

- 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

- Ofgem should maintain proportionate oversight of suppliers, and effective protections for consumers in the event of failure

- Ofgem's licensing regime facilitates effective competition and enables innovation.

In addition, however, we propose three more guiding principles:

- **All GB customers should be exposed to minimal cost when a supplier fails**, or is in any other way unable to repay customer credit balances / industry schemes, such as e.g. ROCs. This requires
    - Stricter solvency requirements as this consultation sets out

    - Restructuring industry schemes to reduce the risk and cost of of default. ROCs should be paid monthly rather than annually, with a sharper penalty charge for late payments. Where it is not possible to change Government Regulation, Ofgem should look to introduce monthly credit cover to protect industry against mutualisation risk, as is already a protection for networks under many industry codes.

    - Ensuring risky business models provide additional financial protections for consumers, e.g. letters of credit to protect excessive credit balances. We discuss this more below.

- **Moral hazard must be minimised:** Suppliers with much riskier business models (e.g. taking up to a year's payment up front; unsustainably low pricing; and not hedging appropriately) should be banned from taking excessive payment upfront, as this facilitates irrational business models and poses a greater risk (and cost) to the Levy.

- **Suppliers of all sizes must face the same obligations:** Energy is an essential service. And yet a narrative has developed that some suppliers *"due to their size, may face disproportionate costs of complying with the regulations"*[1] and should therefore be exempt from funding the Energy Company Obligation; offering the Warm Home Discount to their vulnerable customers or engaging in the smart rollout on the same basis as other suppliers. We fully support Citizens Advices argument that: *"this exemption significantly distorts competition, acts as a barrier to getting the best deals for low income households, unfairly exempts some households from paying towards the costs of helping the vulnerable and makes the process of deciding if a deal is right more confusing.'*[2]

  In the context of discussions about solvency and sustainable growth, we likewise agree with Citizens Advice that the exemptions provide *"perverse consequences for the growth patterns and long term sustainability of supply businesses. Several [suppliers] have told us that their decisions on when to conduct marketing campaigns have been influenced by whether they would be likely to hit the exemptions threshold. We have even seen examples of suppliers consciously deciding to shrink to try and get back below the exemption threshold...This should concern BEIS, because today's growing small suppliers should be tomorrow's mid-sized suppliers. If the latter see their prospects as being actively undermined by the presence of exemptions, then the sustainability of the market model for entry and growth appears flawed."*

  If Ofgem is serious about supporting sustainable growth, the real distortion and hurdle of the policy cost exemption needs to be proactively tackled.

[1] *Government Response to the Warm Home Discount Scheme 2018/19 Consultation*, BEIS, June 2018, Link
[2] Citizens Advice Response to Warm Home Discount 2018/9 Consultation, Link

2. 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, we support tougher entry requirements, above all related to (i) solvency and (ii) the ring-fencing or reduction of credit balances held by suppliers.

The energy supplier is the hub for delivering an essential and costly service, directly responsible for ensuring that: system costs are settled; wholesale risk is managed on behalf of consumers; consumption is metered; social and environmental obligations are collected and delivered on behalf of government and to also provide a conduit for consumer protection.[3]

The practices of some poorly capitalised suppliers can lead to significant consequences:

- **System costs are left unpaid, or mutalised across the industry, with all consumers paying the price:** Some industry participants (e.g. DNOs) are able to protect their position by demanding deposits from suppliers with poor credit ratings. Suppliers themselves do not have this luxury: our customers must fund the SoLR scheme irrespective of the risk profile of the failed suppliers benefitting. In addition, our customers are the ultimate backstop for missed payments not only relating to ROCs and FiTs but also the Capacity Market and any unpaid network costs. In 2018 alone, consumers will likely be liable for over £200m of industry liabilities, including ROCs and the SoLR regime. And it is the customers of the responsible suppliers which pay this price, as one Telegraph column from October 2016 summarised: *"Customers who have benefited from the cheaper prices offered by an unsustainable start up are then bailed out by those who have already been paying higher prices with a more established supplier."*

- **Irrational and unsustainable below cost pricing** : In H1 2018, a First Utility snapshot revealed that 100 of the cheapest tariffs on the market did not even cover a typical independent supplier's cost base , i.e. the cost of supplying energy to the customer's door. This irrational pricing is not a sustainable business model, with the ultimate cost of this behaviour picked up by GB consumers when the supplier fails.

- **Wholesale risk is ignored rather than mitigated, with customers again paying more:** This not only leads to inevitable supplier failure when wholesale prices rise, as we have seen with the 8 supplier failures in 2018 alone. It also leads to "bill shock" for the customers of these poorly capitalised suppliers. It is notable that all recent supplier failures have been accompanied by 20-30% price / payment increases[4].

- **Customer service suffers as poorly capitalised suppliers fail to invest:** Iresa, Spark and One Select all came bottom of Citizens Advices quarterly customer services survey, with phones left unanswered, incorrect bills sent or bills not sent at all, and customers waiting months to switch or chasing to have their hefty credit balances refunded. Putting in place an adequate and scalable customer services platform; pricing tariffs correctly and hedging requires initial upfront spend which is impossible without adequate capitalisation.

- **The combination of a light touch entry regime, which allows liabilities to be run up, and the overly generous Supplier of Last Resort regime, which allows those liabilities to be written off, means poorly capitalised suppliers are now worth more dead than alive.** Suppliers will have little wish to buy on the open market a company with enforcement actions

[3] Energy UK Response to Ofgem Supplier Hub Open Letter, January 2018, Link

[4] In October 2018, Spark Energy's Move-In Saver saw a sudden increase of £268 (nearly 25%) per year; In January 2018 Iresa hiked Direct Debits by 20% before they failed; and in October 2016 GB Energy increased prices by 30%.

against them, legal challenges, large tax liabilities (above all ROCs and FiTs) and debts (including to their own customers via running up large credit balances)

We therefore agree that solvency checks are essential and further note that energy regulators in other jurisdictions still require proof of solvency:

- **Australia's National Energy Retail Law**[5] requires applicants to prove they have "*the capacity and resources to enter the energy retail market"* and evaluates operational capability; financial resources and the suitability of key staff. In addition, once a licence is awarded, the Australian Energy Market Operator (AEMO) also *"undertakes ongoing prudential assessments of energy retailers to ensure they have sufficient financial capacity to operate in the energy wholesale markets."*

- **In the Republic of Ireland, the CRU (Commission for Regulated Utilities) requires applicants to submit**[6] ***"appropriate financial, managerial or technical resources to ensure that you are able to comply with the terms and conditions that govern the Electricity Supply Licence."*** including 2 years of accounts; where the applicant is being funded by a related or parent company, a letter of guarantee where the applicant has no parent company and no financial history, a statement indicating how the business will be funded and provide proof of funding, and a 5 year Business Plan.

- **In the United States, 12 of the 14 states with competitive energy markets require proof of financial solvency**[7] - usually a bond or Letter of Credit. Several states, including Texas, also require an additional bond to be posted where suppliers take deposits - i.e. payment in advance of supply (usually for those with poor credit scores). We discuss this in more detail later in this consultation.

We agree with Ofgem that solvency checks can be undertaken through increased information requirements and largely qualitative assessment criteria: we recognise that setting a minimum capital requirement would be difficult as this will vary greatly by business model.

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

Yes, it seems reasonable that Ofgem should interrogate how far applicants:

- Understand the costs they will face, both internal and external

- Propose a pricing model that is based on reasonable assumptions, and a plan for realistic growth;

- Have made sufficient provision for human resources – with the necessary capabilities – in the context of their entry and growth plans

- Understand key risks of operating in the market, are aware of the cash flow issues these can cause, and have a plan to mitigate these (inc seasonality, wholesale volatility, churn, bad debt, failure to achieve expected growth, policy and environmental scheme requirements).

As discussed below, however, these should be considered on a 3-5 year basis rather than the initial 12 months proposed.

4. 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

[5] Retailer Authorisation Guidance 2014, Australian Energy Regulator, Link
[6] Electricity Licence Supplier Application Form, Commission for Regulated Utilities, Ireland, Link
[7] Summary of Financial Assurance Requirements by State, State of New York Public Services Commission, April 2018, Link

Yes, we support the requirement for potential suppliers to provide evidence of their ability to fund their activities.

However, the proposed period of 12 months is insufficient. Credible business plans, i.e. those used to secure financing, credit or other forms of support from lenders and investors, are typically 3-5 years, with the first 12 months seen only as the start-up phase. The key factors to be interrogated typically should be:

- Gross Margin assumptions
- Channel strategies
- Assumptions around Cost to Serve
- Understanding of hedging requirements.
- And, how these evolve over the 5 years as the business goes from the initial start-up growth phase into a sustainable and profitable business.

Ofgem should therefore require at least a 3 year business plan from all new entrants, and scrutinise this appropriately. This longer term view is essential to determine the long-term sustainability of an operation.

We recognise that the further out a plan goes provides more uncertainty, and this is an additional reason why Ofgem should require appropriate risk modelling and scenarios as part of the Declaration of Adequacy, combined with ongoing solvency and risk monitoring for suppliers deemed “high risk”

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

Yes, we believe the information in Appendix 1 looks broadly correct although, as stated above, this should set out analysis on a 3-5 year basis rather than just 12 months as currently proposed.

Entry proposal	Corporate structure Business functions and how resourced Outsourced functions Target customer base Expected rate of growth (including geographic focus) Sales & marketing	Timeframe for market entry Pricing, tariffs, products Trading strategy Gross/net profit margin Projected volume of energy to be supplied and purchasing strategy IT systems (billing, CRM) and testing
Source and proof of funds	Financial projections (inc monthly cashflow) with narrative on material assumptions and costs, for min. first year's operation; Risk management strategy (plan to mitigate key financial risks and maintain level of working capital projected under realistic stress scenarios); Signed declaration of financial and operational adequacy for the following 12 months; and Capital structure and working capital arrangements with source and proof of funding for first year, eg: • Cash/liquid assets • Debt finance/letter of credit • Parent company guarantee • Declaration from finance backer • Share capital/shareholder agreement • Grants	

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

Yes, this should form part of the 3-5 year business plan scrutiny proposed above, setting out not only how the applicant plans to meet customer needs initially but also how they plan to scale up as they gain customer numbers and deal with different challenges, e.g. customers who come onto supply through Home Move; customers or customers which pay via Standard Credit / Pay on Receipt of Bill.

Whilst we support such a narrative, it should be a one-off for new applicants rather than an ongoing RFI: licenced suppliers are already required to provide Ofgem and Citizens advice with a wealth of information and we would not support duplication here.

7. Do you agree with the areas we would generally expect applicants to cover (in Appendix 1)?
Yes, we believe the information in Appendix 1 looks broadly correct, although it should also interrogate how the applicant will handle different payment methods, different customer contact methods (we note many new entrants do not support Standard Credit or telephone contact) and scale challenges such as Home Move, as set out above.

Statement of intent covering relevant obligations	• Sales and marketing
	• Billing and credit balances
	• Treating customers fairly
	  ○ How applicant is equipped to service customers
	  ○ Complaints approach
	  ○ Working with Citizens Advice and Ombudsman
	  ○ Managing customers in payment difficult
	• Compliance reporting
		• Vulnerability
		  ○ Identification and treatment of vulnerable customers
		• Retail price protections
		  ○ Safeguard tariff
		  ○ Default tariff cap
		• Smart metering
		• PPM
		• Government schemes

8. Do you agree that we should ask additional 'fit and proper' questions as part of the application process

Yes, we support additional "fit and proper" questions, which should dovetail with the disqualification regime for directors and should also apply to senior management positions.

It should ban senior management who have previously held Director positions in suppliers falling into SoLR.

We also believe a 12 month ban is too short given the high cost to the industry, and would propose 3 years instead.

There should, however, be a clause for an applicant to appeal this ban where the SoLR was the result of regulatory changes which fundamentally undermined their business, or other external circumstances that have caused the failure.

Fit and proper (new requirements)	In respect of any named person (or person with significant management responsibility or influence): • Refusal/revocation/restriction/termination/disciplinary by any other body • Bankruptcy • Insolvency / Debt judgements / CCJ • Previously triggered a SoLR event (including SoLR event which happened within 12 months of a named person's involvement with that company) • Compliance/enforcement history • Adverse findings in civil proceedings

9. 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. The "supplier in a box" is a useful innovation which allows suppliers to more easily enter the market, and also meet their obligations as a market participant, e.g. through off the shelf billing and settlement systems.

However, ease of entry has undoubtedly lead to unprepared suppliers entering the market-place. In addition, even a robust understanding of industry systems does not provide evidence a supplier is committed to good customer service and has a plan for growth which does not rest on unsustainable hedging strategies.

Ofgem should conduct a full business plan assessment of new entrants rather than relying on the managed accession to industry Codes as proof a supplier is appropriately managed and resourced.

10. 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?

Yes, we support an annual Certificate of Adequacy, with declarations that the supply business is a going concern and has sufficient financial and operational resources to meet its forecast growth/business activities for the next 12 months, with an updated/evaluated three year risk management strategy, including plans for sustainable growth and 'severe but plausible' stress-testing,

Ofgem will need to consider carefully the next steps if a supplier is not financially and/or operationally resilient. There are a number of options that could be considered:

- A form of enhanced monitoring and reporting by Ofgem (or a third party);
- Requirements around an enhanced risk management approach;
- The ability to suspend their right to provide services, either completely or in certain respects, e.g. not being able to take on more customers if their risk management policies indicate a failure of longer term planning for coverage of tariffs offered to the market.

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

As well as an annual Certificate of Adequacy, we agree that Ofgem should consider targeted or strategic monitoring/requirements on active suppliers should certain triggers be met.

Ofgem should trial a number of responses to determine efficacy vs burden on suppliers, e.g. procuring third party analytics vs requesting information via RFIs

We would support Ofgem using pre-determined criteria to identify whether a supplier's risk profile "high risk" or "low risk". For suppliers identified as high-risk, Ofgem should undertake more detailed monitoring. For low risk suppliers, any monitoring should be appropriately light touch. We would not support Ofgem categorising suppliers according to their size to determine the appropriate level of ongoing monitoring. In its next consultation we would like to see Ofgem propose metrics that it might use to determine a supplier's risk profile.

12. Do you have any initial views on the potential introduction of prudential/financial requirements on active suppliers? (e.g. credit balances)

Yes, new rules must be urgently introduced to more appropriately protect credit balances, given the increasingly risky and costly behaviour of some market participants.

Fixed Direct Debits perform an important function, smoothing the cost of energy payments across the year to avoid consumers facing sudden price spikes over winter. This means that customers typically build up credit during summer which might peak at just over £100[8]. If any supplier went bankrupt in the summer months, it would always be likely that significant credit balances could be lost.

However, several suppliers are abusing this function, taking payment far in advance of bill or even of supply in order to fund their working capital: an inherently risky and unfair procedure with the costs then spread across industry if and when they fail - a clear case of moral hazard.

[8] Ofgem Safety Net Protects Consumers' Cash, 26 October 2018, Ofgem Press Release, Link

We note that more than 94% of Octopus's successful £13.8m claim for Iresa was related to lost credit balances (including working capital). Likewise, 90% of Co-Op Energy's successful £14.04m claim for GB Energy was connected to credit balances.

We further note that, in Germany, the energy supplier Teldafax took significant cash payments upfront from customers with the result that, when it collapsed in June 2011, it owed €500 million ($560 million), one of Germany's largest ever corporate bankruptcies, including significant credit balances to 700,000 customers (which, in Germany, the customers had to fund themselves)[9]. There is nothing in currently UK regulation to prevent a similar scenario here.

Given the combination of cost to consumers and moral hazard posed by this practice, Ofgem should ban suppliers from taking more than a month payment in advance unless adequate security is posted against those balances.

We propose below a risk-based approach; Ofgem should monitor how far suppliers are meeting these criteria on a regular basis.

Any Ofgem proposals on credit balances should apply to new entrants immediately, but with a 12 - 24 month implementation period for existing suppliers. This will give suppliers time to adjust their tariff mix, credit and financing, risk management and other approaches.

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

Yes, we agree the "fit and proper" requirements should be an ongoing requirement.

[9] Managers back in court in Teldafax insolvency case, DW.com, 26 January 2011, Link