

OPEN LETTER TO ENERGY SUPPLIERS

Date: 29 October 2021

Dear colleagues

Rising wholesale energy prices and implications for the regulatory framework

The unprecedented and unexpected rise in gas and electricity prices over recent months has put energy markets under severe strain. We have been working with the government, the energy industry, and consumer bodies to manage the situation, protecting consumers during this challenging time.

As this period of uncertainty continues, and the pressure on the sector grows, we are taking steps to protect the short- and long-term interests of consumers, providing greater certainty for investors and strengthening the resilience of the sector. Given the rapidly changing landscape, this letter focuses on how we can use existing licence conditions in the coming weeks and months, but also indicates where we are considering broader reform of regulatory frameworks to reflect the risks that the current situation has revealed.

Set out below are the actions we will take and that we expect suppliers to take, specifically:

- our intention to consult on the price cap methodology to ensure it appropriately reflects the costs, risks and uncertainties facing suppliers;
- our expectation that suppliers must continue to comply with their licence obligations including providing support to their most vulnerable consumers;
- an enhanced approach to monitoring, compliance and enforcement of licence conditions to ensure energy suppliers pursue a sustainable business model, minimising risks to customers and the market as a whole.

We also identify below areas for potential reform, to establish more comprehensive risk management in the sector, such as moving to a more comprehensive prudential regulatory regime, and building a retail market to support the transition to net zero.

Updating the price cap methodology

The unprecedented rise in energy prices this year has changed the perception of risk and uncertainty in this market. In order to protect the interests of consumers, we must ensure that the regulatory frameworks, including the price cap, fully reflect the costs, risks and uncertainties facing the supply companies we regulate.

The price cap methodology includes a range of mechanisms to allow suppliers to recover uncertain costs based on what was considered reasonable at the time. We will consult on whether these existing mechanisms should be adjusted in light of the increased costs and risks facing suppliers. This is in line with the requirements set out in legislation, which require Ofgem to protect consumer interests, and have regard to the need for suppliers to finance their efficient costs,¹ which we believe is essential to retain a competitive retail market that delivers for consumers.

We expect to publish this consultation in November, setting out the options we are considering and our minded-to position. After considering stakeholder responses, we then expect to publish a decision in February 2022. This would allow us to implement any changes in the forthcoming price cap period (from 1 April 2022), if appropriate to do so.

Setting out our regulatory expectations for industry

Our immediate priority is and remains to ensure energy consumers, both domestic and non-domestic, are protected. We recognise that these are challenging circumstances and that energy suppliers are faced with difficult decisions, including commercial ones. To ensure clarity for both suppliers and consumers on what can be expected, we have set out in the annex the expectations we have with regards to compliance with regulatory obligations, including where suppliers are appointed as Supplier of Last Resort (SoLR). If a supplier is concerned it will not be able to meet these obligations, they should contact us at the earliest opportunity.

We will shortly be publishing a letter setting out the steps Ofgem is proposing to take to expedite the process for SoLRs making a Last Resort Supply Payment claim. These steps will facilitate faster payment to suppliers taking on the role of SoLR, and so enable the SoLR process to continue to protect customers.

Responding to the current energy price surge has necessitated a reprioritisation of resources within Ofgem. As a result we are deprioritising certain workstreams. We will publish these,

¹ As set out in Section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018

and any resulting changes to outputs or timelines, on our website in the near future. And we intend to set out our draft forward work programme for 2022/23 as usual by end of December 2021.

Ensuring sustainable and resilient business models

While the recent rise in gas prices is unprecedented, we must plan on the basis that shocks like this could happen again. We intend to respond by 'raising the bar' of what we expect from suppliers with regards to financial risk management: utilising existing licence conditions; reviewing where those licence conditions might need to be strengthened and guidance updated; and considering where new licence conditions may be needed. And we will continue to take robust action against any suppliers that fail to meet licence conditions.

What we've done already to strengthen financial resilience

In 2019 we introduced stronger requirements for new entrants applying for a supply licence, enabling us to check that new entrants are adequately resourced, and fit and proper, to enter the market. The number of new entrants subsequently fell from 35 during 2016-18, to 8 in 2019 and 2 in 2020.

In January this year we introduced new rules to strengthen our regulatory regime, minimising consumers' exposure to financial risks and poor customer service. This includes a Financial Responsibility Principle for suppliers to take action to minimise costs that could be mutualised in the event of supplier failure. We had already taken action against suppliers who were not providing requested financial information.

In addition to the Financial Responsibility Principle, in spring 2021 we consulted on proposals to limit the level of customer credit balances that suppliers could hold, in order to limit mutualised costs in the event of supplier failure. The proposals include a cap on the value of credit balances suppliers can hold onto, as well as an auto-refund mechanism. We believe these changes remain important and intend to publish an update in the new year.

We also carried out early engagement with suppliers to ensure they could pay their Renewables Obligation payments, and have taken enforcement action against suppliers that failed to pay by the statutory deadline. Looking ahead, we are working with government to move away from a single annual Renewables Obligation payment, in order to reduce the risk of significant non-payment. And we monitor changes to direct debit arrangements so we can intervene where we observe poor practices.

Changes going forward

Recognising the increased volatility facing the market, we will:

- use our information gathering powers to an even greater degree to conduct more regular assessments of supplier finances, including audits, and apply increased scrutiny, setting a higher bar for suppliers to demonstrate that they are on a sound financial footing, with appropriate risk management strategies, and that suppliers are adequately resourced for their size and further growth.
- set a firmer expectation on the capital investment that suppliers (both new and existing) should have in place, reflecting the higher risks we are now seeing in the market, updating our existing guidance documents to reflect the increased levels of financial resilience we will be expecting from suppliers.²
- take a more robust approach to assessing suppliers' operational capacity, pricing and hedging strategies and planned investment as they reach the 50,000 and 200,000 domestic customer milestones. Where suppliers cannot demonstrate they meet our assessment criteria we can require independent audits and, where appropriate, will take compliance and enforcement action.
- expect suppliers to regularly demonstrate compliance with the requirement that individuals with significant managerial responsibility or influence in the business are fit and proper to occupy their role. In assessing compliance, we will consider the capacity of individuals to manage market risks and uncertainties, and will take into account whether they have held positions of responsibility or influence in companies that have exited (or the parent/holding companies), leaving behind significant mutualisation costs, and in particular, instances of mismanagement which failed to protect the interests of energy consumers. As well as covering executives and senior managers, this licence condition also extends to any person playing a role in making decisions about a licensee's activities, including consultants and Non-Executive Board members.

As needed, we will amend and/or introduce new licence conditions, ensuring that the tests Ofgem applies and the consequences of not meeting those tests are clear to market participants.

Given that we are reviewing licence conditions, and as a vital step to restoring stability in the sector, in the interests of consumers, we will temporarily pause assessment of applications for new supply licences, by extending the reasonable period of assessment, initially to a period of six months, subject to review.³ And we will continue to revoke unused or dormant supply licences as appropriate.

² [Guidance on the Financial Responsibility Principle \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/financial-responsibility-principle)

³ So that, in the public interest, licence authorisations will not be deemed to be granted in that period.

Managing gas price dynamics:

Energy prices remain volatile and hard to predict. Ofgem, with government, will continue to plan for a wide range of future scenarios, including potential further rises in prices or a sharp fall. Ofgem is aware that although the stark rise in the gas price has caused huge strain on the sector, prices falling rapidly, although welcome, could cause further problems for suppliers. Ofgem will engage with market participants, consumer groups and government to consider whether any additional measures are needed.

Considering the need for longer-term reforms to regulatory arrangements

We believe the steps set out above will make a material difference to reduce the risks facing energy consumers going forward. We also recognise there is a case for wider and deeper changes to ensure that the energy sector is resilient against potential continued global market volatility, and is able to deliver the transition to net zero in consumers interests.

Specifically, we will:

- further develop our regulatory approach to risk in the retail market. This includes exploring a move towards a more prudential approach, recognising that energy suppliers are managing complex financial risks;
- examine how the current design and operation of the price cap might evolve given increased volatility of energy prices, recognising that the future of the price cap is a question for government;
- work with government and across the sector to build a retail market that will support the longer-term transition to net zero, with retailers and other market participants playing an active role to support a smarter, more flexible low carbon system. We recognise the need for continued competition and innovation to deliver optimal outcomes for consumers, and will consider how best to measure the health of the retail market.

These are challenging times, requiring bold action. We welcome continued constructive and collaborative engagement with our stakeholders to ensure we can, together, achieve the shared goal of protecting consumer interests on the road to a net zero energy system.



Jonathan Brearley
Chief Executive

ANNEX – Regulatory expectations

Debt, affordability, vulnerability – Protecting consumers, especially those in vulnerable circumstances, remains our priority. Suppliers must continue to abide by licence conditions governing domestic customer payments, including:

- setting reasonable direct debit amounts based on the most up to date information reasonably available to the supplier, including a domestic customer’s historic and anticipated consumption;
- honouring credit balance refunds in a timely manner, in accordance with the licence conditions;
- take account of domestic customer’s Ability to Pay where they are repaying debt or on a payment plan.

The above applies equally to customers acquired through a SoLR appointment, and where possible we expect SoLRs to honour any existing payment plans.

Tariff offering – We understand the reluctance of suppliers to promote tariffs that are currently loss making, but consumers should nevertheless be able to obtain price cap compliant tariffs in line with suppliers’ licence conditions and obligations.

Customer service – We expect suppliers to continue to ensure customer service arrangements are complete, thorough, fit for purpose and transparent. However, we also acknowledge that where a supplier has been appointed as SoLR it may temporarily face additional and unique pressures on its customer service arrangements, and we will take this into account.

Trade sales – We generally view trade sales as preferable to disorderly market exits, and encourage suppliers wishing to exit to seek such routes. Suppliers must inform us prior to entering into binding trade sale agreements. We expect suppliers to demonstrate to us that any prospective trade sale is in the best interest of affected consumers.

Environmental and social obligation scheme payments – Suppliers must continue to comply with their scheme payments for the current financial year and we will take appropriate enforcement action where suppliers do not comply. In the case of SoLRs, we will work with DWP to ensure the SoLR is provided with Warm Home Discount (WHD) Core Group customer data from the failed supplier. As Core Group rebates are to be included within the Core Group Reconciliation Process, suppliers may not claim costs for these through the SoLR levy. Suppliers should in the first instance use the overspend provisions to accommodate additional broader group rebates for customers. Levy claims will be considered for rebates paid to eligible customers of the failed supplier(s) for the amount above the permitted overspend.