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Call for Input

Action plan on retail financial resilience

Summary

Following on from the open letter from our CEO, Jonathan Brearley, to suppliers in October[1] we set out below a plan outlining actions we propose to take immediately and in the short to medium term to strengthen the financial resilience of suppliers, to ensure that risks are not passed on inappropriately to consumers.

Ofgem had been strengthening its approach in this area, for example introducing higher standards for new entrants in 2019 and new licence obligations on operational capability, financial responsibility and ongoing fit and proper requirements earlier this year. However, we need to go further and faster. The scale of recent supplier failures has highlighted the vital importance of suppliers having sustainable and resilient business models to manage financial risk. Suppliers are accountable for managing risks in their businesses and we have witnessed practices that fall short of the minimum standard necessary to protect consumers. As the regulator, we want to support suppliers in developing robust risk management frameworks to manage these types of risks, and also to stamp out bad practice when we see it.

Scope

The immediate focus of our work is on domestic supply. We recognise there is a need to ensure financial resilience for non-domestic supply, and many of the proposed actions may

[1] https://www.ofgem.gov.uk/sites/default/files/2021-10/20211028%20-%20JB%20open%20letter%20to%20suppliers_0.pdf

apply to non-domestic suppliers. We will consider where we need to make specific adjustments to reflect the different market and risks.

The recent failures have also highlighted the key relationships between gas shippers and suppliers, and the importance of how wholesale market facing risks are managed between them. We will be looking at this as part of our work, from the perspective of how we regulate the financial resilience of the supplier but also potentially how we regulate gas shippers.

Outcomes and approach

Our objective for this programme of work is to create a market where energy suppliers are financially resilient, so that risks are not inappropriately passed to consumers. In order to develop an energy supply market in which consumers, energy suppliers and investors can have confidence going forward, we have developed the following draft key outcomes. We welcome views on these draft outcomes, which we intend to finalise in January.

- **Robust minimum standards:** Regulation provides robust minimum standards, to ensure commercial risk is well managed. For example, suppliers need to be adequately hedged or hold sufficient capital to manage a wide range of market scenarios. Within this, suppliers are responsible for their own commercial strategy but must have a robust management control framework in place to support it and manage their risks;
- **Protecting customer money:** suppliers should not pass inappropriate risk to consumers, e.g. through use of customer monies or levy payments to fund wider business activity. Socialisation of losses when suppliers fail must be minimised (in line with firms in the broader economy);
- **Accountability:** there should be minimum requirements for staff in significant leadership or executive roles and board members, e.g. fit and proper person test and capability requirements, and appropriate board governance;
- **Proportionality:** we should regulate as necessary, and no more than needed. The regulatory burden of data exchange should be minimised through use of data and digitalisation techniques, for data provision and monitoring;

- **Transition:** Any regime must be designed to enable a sustainable, innovative and competitive market, to promote our transition to net zero.

To achieve these outcomes, we will utilise our existing regulatory tools and powers wherever possible. Where these are not sufficient, we will identify and implement new regulations. To be clear, we do not expect to be able to deliver all these outcomes immediately. However, we want to act swiftly to implement our action plan so we can deliver a financially resilient market as soon as possible for the benefit of consumers. To the extent that we identify limits to what we can achieve through our existing powers, we will work with BEIS to assess whether desirable outcomes can be delivered through legislative change.

In developing this programme, we will work closely with suppliers as well as consumer groups and others to develop an effective monitoring and compliance regime and design new licence conditions. We have already commenced bilateral engagements, however, key stakeholder engagement in the coming months will include:

- Provide any feedback on our draft outcomes by 17th January. Do this by email to RetailFinancialResilience@ofgem.gov.uk
- Discussion with domestic suppliers through Energy UK on stress testing design to be scheduled for mid-January
- Roundtable with consumer groups to be scheduled for early January
- Workshops in the New Year on a wider review of the regulatory framework for supplier resilience – further details to follow.

In the following sections we set out the details of our action plan together with a high-level timeline for these activities.

Ofgem action plan:

1. We have already started to refine and enhance the **monitoring data** we request from suppliers – and will continue to do so throughout January and on an iterative basis going forward. Our vision is to digitalise this to make it as efficient as possible in order to minimise regulatory burdens;
2. We will be launching a programme of **stress testing assessments** with suppliers from January - to assess whether suppliers are robust to a range of scenarios;
3. We will require suppliers to undertake a self-assessment of their **management control framework** and provide Board assurance to Ofgem of appropriate management of risks;
4. Where we identify concerns as a result of our monitoring, stress testing or supplier self-assessments, we will work with suppliers to develop and support improvement plans over a suitable transition period to address these concerns and in cases where there is high risk to consumers we will also consider **compliance and enforcement action.** If necessary, we will provide additional guidance on the **Financial Responsibility Principle** (SLC 4B) and the **Operational Capability** condition (SLC 4A);
5. Early next year, we will consider options for **protecting customer credit balances** such as clearer guidance around ring-fencing, pending the development of a regulatory framework for supplier financial resilience;
6. We are issuing a statutory consultation alongside this letter on measures to manage risks associated with **new customer acquisitions and growth**;
7. We are reviewing whether further guidance or regulatory change is needed on **fit and proper** in our licence application process and/or licence, and potentially wider measures associated with board **accountability and governance;**
8. Accompanying this letter is a decision to **extend the new supply application assessment period;**
9. We will consult on detailed **policy options tackling mutualisation risks** associated with RO payments and credit balances in Spring 2022 (subject to the conclusions of our joint consultation with BEIS on supplier default under the RO);

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10. We will carry out workshops with suppliers to “co-design” a **stronger regulatory framework for supplier financial resilience** in early 2022 – and consult on new financial based licence requirements in Spring 2022.

Details of action plan

Immediate actions

Recent events have shown that Ofgem needs to have a more comprehensive understanding of the financial position of individual suppliers and the wider retail market in order to protect consumers effectively. We will use our existing tools more intensively to identify and address concerns around financial resilience and we will use the information we gain through this process to examine the case for expanding our regulatory toolkit to mitigate the risks of potential future shocks.

1. Enhanced monitoring and data

We already receive data from suppliers and other parties relevant to supplier and retail market resilience[2]. We are reviewing, refining and consolidating the information that we collect and, where necessary, will expand the scope of this reporting from suppliers. This will be an ongoing and iterative process. We expect suppliers to be responsive and engaged in this process and provide prompt, robust and accurate information to us. Failure to respond fully or accurately to these requests will be met with robust enforcement action.

Areas of enhanced reporting going forward are likely to include information that will demonstrate supplier financial and operational preparedness to provide and secure supply for new and existing customers and strategies for risk management, including approaches to

[2] Other parties may include network companies and code bodies from whom we collect regular data related to the retail sector

hedging, customer credit balances, pricing, volume management and policy costs such as social and environmental schemes.

To oversee the market efficiently, in the longer term we need a more sophisticated approach to collecting and managing data. Our vision is to consolidate and improve how we collect this data and digitalising collection and analysis to reduce burden on suppliers, Ofgem and other parties. We will take an iterative approach to achieving this, learning lessons and adapting as needed and will provide more information to suppliers on this project in Spring 2022.

2. Stress testing

We will be launching a new stress testing process in January. The purpose of this is to assess whether suppliers are robust to a range of scenarios, whether through capital cover or risk management.

We envisage these initial stress tests would take the form of a number of 'what if' scenarios – trying to keep these as targeted and simple as possible. These scenarios are likely to include price volatility, differing levels of customer bad debt and significant acquisitions or loss of customers, for example testing supplier's resilience to a cold winter, price decline and/or churn. In terms of process, we will provide suppliers with a request for information and guidance as necessary. We will then undertake the stress testing on the data provided, test our results with the supplier and adjust our findings as appropriate. As with enhanced monitoring, we will take robust enforcement action against suppliers who fail to cooperate with this process, or fail to provide accurate data.

We will be engaging with suppliers through Energy UK in January to clarify and help shape content of these initial stress tests, after which we will issue requests for relevant information from suppliers. We anticipate this being the start of a series of stress testing exercises. As with enhanced monitoring, we will be learning lessons and adapting the design of these stress tests over time. We plan to take a risk-based approach, and with that in mind are prioritising engagement with domestic suppliers. We will consider in the New Year the best approach to engagement with non-domestic suppliers on appropriateness of, and approach to, any stress testing.

We will share the results of the stress tests with individual suppliers and discuss with them whether follow-up actions are required to further test or to strengthen their financial resilience. Our primary aim will be to encourage and support suppliers in developing their own robust management control frameworks, and therefore where issues are raised we will identify a suitable improvement plan for a supplier to rectify these issues. However, if this is not agreed or followed and we consider a supplier is in breach of an obligation such as the Financial Responsibility Principle (FRP) or Operational Capability condition, we will consider further action – as set out below.

3. Management Control Framework

We expect suppliers to have a robust management control framework in place to support delivery of their commercial strategy and management of their risks. We will launch in early 2022 a self-assessment exercise to be undertaken by suppliers and will request Board assurance to Ofgem that risks are appropriately managed. As part of this self-assessment, we will expect the suppliers to demonstrate their management control framework is sufficiently robust, including by reference to their governance, policies, processes, controls and management information used to manage and monitor commercial risks. Where appropriate we will use this information (alongside information from our enhanced monitoring and stress tests) to identify a sensible transition for a supplier to improve their management control framework, which will deliver good business outcomes.

4. Financial Responsibility and Operational Capability obligations

In January of this year, we introduced the FRP (SLC 4B), which is an enforceable rule requiring suppliers to manage responsibly costs that could be mutualised, to take appropriate action to minimise such costs and at all times to have adequate financial arrangements in place to meet such costs.

In March of this year, we issued Guidance to clarify how the FRP will be implemented. The Guidance states we may seek evidence from suppliers to demonstrate:

- plans are in place to meet financial obligations under government schemes such as the Renewables Obligation;
- there are effective processes, consistent with existing licence requirements, to, for example, set direct debit levels appropriately and for checking and returning customer credit balances;
- there are sustainable pricing approaches that allow suppliers to cover costs over time, or, where pricing below cost, that the risk sits with investors and not consumers;
- evidence overall that business plans are adequately financed;
- robust financial governance and decision-making frameworks are in place; and
- the ability to meet financial obligations while not being overly reliant on customer credit balances for working capital.

We introduced the Operational Capability condition (SLC 4A) at the same time as the FRP. The Operational Capability condition requires suppliers to maintain robust internal capability, systems and processes to enable them to serve their own customers, comply with their regulatory and legislative obligations and efficiently and effectively identify likely risk of consumer harm and mitigate that harm. Under this condition, suppliers are required to have robust financial and risk management processes in place, such that they are able to meet the requirements of the FRP and other relevant obligations.

As part of our enhanced monitoring, stress testing activities and supplier self-assessments, we will evaluate whether suppliers are meeting these minimum requirements set out in the licence conditions and FRP Guidance. Where we see poor practice and potential risks to consumers, we will not hesitate to use our powers to protect consumers and to reduce potential mutualisation costs. If monitoring, stress testing or supplier self-assessments reveal concerns, action could include, for example, requiring a compliance audit under SLC 5B to examine in greater detail the financial arrangements the company has in place, or we may ask the supplier to develop an improvement plan designed to strengthen their resilience, setting a clear timetable for actions over a suitable transition period. Where significant risks emerge, or where improvement plan actions are not met, we will take swift enforcement action, including under the FRP and Operational Capability rules.

The steps that need to be taken to comply with these licence conditions will vary depending on the individual circumstances of a supplier and the nature of the market in which it operates. We expect a supplier to be able to meet the challenges of a changing market; to operate and adapt its business models in a sound and prudent manner; and to have sufficient financial and non-financial resources available to it to meet its costs at risk of being mutualised. This may include, for example, ensuring the supplier has sufficient capital, provisions against liabilities, holdings of or access to cash and other liquid assets, human resources and effective means by which to manage risks.

For example, a supplier that has inadequate arrangements in place such as not having an appropriately hedged position in the future energy markets and/or insufficient financial assets to absorb price shocks may be in contravention of the FRP. Such contravention may result in quick follow-up compliance or enforcement action.

In addition to following up on the results of monitoring and stress testing with individual suppliers, we expect these activities will also provide useful data to inform whether and how the FRP Guidance should be updated, to further clarify what measures need to be taken by suppliers to comply with the FRP.

5. Credit balances

There is an urgent need to ensure that customer credit balances are used appropriately. Given the supplier failures over the last few months, we will review options for protecting customer credit balances and will be engaging with suppliers on this early in the New Year. For example we will consider protections such as ring-fencing, unless and until suppliers can demonstrate that they have sufficient capital or assets to protect these balances in other ways, and we may update the FRP to include clearer guidance.

Earlier this year we consulted on a range of options on credit balance protections[3]. In this consultation we presented two proposals:

- Autorefunding of credit balances - to complement existing rules on accurate direct debits (which we also consulted on strengthening);
- Thresholds on balances, requiring suppliers to protect credit balances at an aggregate level.

We will consider further the effectiveness of autorefund and thresholds on balances as part of our wider review of financial regulation of the retail energy sector (see the proposals below on short to medium term actions).

6. Managing new customer acquisitions and growth

Alongside this open letter, we have published a Statutory Consultation on targeted measures to strengthen our requirements on suppliers with regards to financial risk management, focusing in particular on mitigating the risks associated with customer acquisition and growth. It is important that suppliers are able to grow and acquire new customers, but they must do so sustainably. This Statutory Consultation will consult on:

- temporarily pausing customer onboarding once suppliers reach the 50,000 and 200,000 domestic customer milestones until such time as we have completed any necessary milestone assessment and the supplier has had sufficient time to complete any necessary actions;
- introducing more flexibility into the milestones assessment framework to allow for new milestones to be added and/or for the existing thresholds to be adjusted if necessary in future; and
- strengthening requirements that we are notified of any significant commercial or personnel changes to allow us to carry out an assessment of its impacts on consumers.

[3] https://www.ofgem.gov.uk/publications/supplier-licensing-review-reducing-credit-balance-mutualisation

7. Governance and Accountability

To complement financial resilience policies, we are also exploring whether to further enhance the regulatory framework for supplier governance and accountability. Those in positions of significant managerial responsibility or influence, including those in executive and non-executive leadership positions, within licensed suppliers must be fit and proper and have the relevant capability to occupy their role and must be accountable for their actions.

We already have a fit and proper test for licence applicants, and an ongoing requirement on suppliers to ensure those with significant managerial responsibility or influence are fit and proper. We remind suppliers of their existing obligation to notify Ofgem key changes as listed under SLC 19AA - including changes in staff where the person has significant managerial responsibility or influence, and any trade sale or purchase. Suppliers are further obligated to have and maintain robust processes to ensure that any person holding significant managerial responsibility or influence is fit and proper to occupy that role, as defined in SLC 4C.

We are reviewing whether further guidance or amendments to these rules is appropriate, or if further regulations associated with governance and accountability are required.

8. Extension of the new supply application assessment period

Alongside this letter we have published a decision[4] to extend the six month pause, announced in the October letter, by a further three months. The assessment window is now nine months, alongside continuing to refrain from applying the autogrant mechanism (deemed authorisation) until further notice.

The reason for this is that the work we are carrying out will help us to develop a new enduring financial resilience regulatory framework. Once in place, we will use this framework to assess both new entrants and current suppliers, to ensure they are sufficiently robust. In the

[4] https://www.ofgem.gov.uk/publications/supply-licence-applications-reasons-decision-amend-time-period-assessment-and-remove-tacit-authorisation

meantime, we consider it is important to continue to 'pause' our assessment of new applications to protect the retail market and consumers.

Given our Principal Objective to act in the interests of existing and future consumers, and in light of the current market uncertainty, we consider the removal of tacit authorisation, and extension of the assessment period is a necessary and proportionate course of action, justified by overriding reasons of public interest.

Short to Medium term

We have already consulted extensively with stakeholders on policy options related to financial resilience and cost mutualisation. In our Supplier Licensing Review decision in 2020[5] we introduced the Financial Responsibility Principle (see above section) and set expectations that further intervention was likely to be needed. This year, we have consulted on reducing credit balance mutualisation[6] and – jointly with the Department for Business, Energy and Industrial Strategy (BEIS) – addressing supplier payment default under the Renewables Obligations (RO)[7]. Recent further supplier failures provide timely evidence that there are direct and indirect costs to the energy market beyond credit balances and RO payment defaults. Over the next few months, we will also review options for more comprehensive financial requirements on suppliers.

9. Mutualisation – credit balances and Renewables Obligation (RO) payments

As part of the Supplier Licensing Review, we consulted on proposals for prescriptive rules to reduce the scale of credit balances at risk of mutualisation in the event of supplier failure. We first considered prescriptive rules aimed at minimising the mutualisation of credit balances and government scheme costs (particularly the RO) in October 2019. We subsequently decided to

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[5]https://www.ofgem.gov.uk/publications/decision-supplier-licensing-review-ongoing-requirements-and-exit-arrangements
[6] https://www.ofgem.gov.uk/publications/supplier-licensing-review-reducing-credit-balance-mutualisation
[7]https://www.ofgem.gov.uk/publications/consultation-addressing-supplier-payment-default-under-renewables-obligationro

split out consideration of changes to the RO, to enable us to work with BEIS on the range of potential options for RO reform, while progressing our work on credit balance protections in parallel.

Our joint consultation with BEIS on supplier default under the RO closed on 9 November, and we are currently considering the responses and our next steps. One of the proposed options is an Ofgem-led solution that would be implemented through the electricity supply licence. In the event we conclude with BEIS that this is the right option for consumers, we plan to expedite the process to implement a solution. Additionally, if a licence solution is taken forward, we think it would be sensible to consider the implementation details holistically with our work on credit balances as the risks around cost mutualisation have strong parallels.

Subject to the outcome of our consultation on supplier default under the RO with BEIS, we will further consult on detailed policy options tackling mutualisation risks associated with RO payments and credit balances in Spring 2022.

10. Wider review of the regulatory framework for supplier financial resilience

Recent behaviours we have seen in the market, and associated supplier failures, have highlighted that costs to consumers and the market can materialise from multiple sources (beyond just credit and RO balances). Therefore, we are undertaking a more holistic review of what is an appropriate level of financial regulation for suppliers in the retail market, designed to deliver the outcomes we set out at the start of this letter.

We will consider a wide range of options, drawing on lessons from regulatory regimes in the UK and around the world.

We will ensure policy development complements ongoing work on credit balances and RO mutualisation, and plan to engage with suppliers on policy design through a series of workshops early in the New Year and consult in Spring 2022.

Longer term

We are acting quickly to respond to the most immediate needs of the current market and will continue to build a robust financial resilience framework, making further licence changes where necessary. To the extent that we identify limits to what we can achieve through our existing powers, we will work with BEIS to assess whether desirable outcomes can be delivered through legislative change. We are mindful of the importance of creating an enduring framework to deliver a resilient retail market, while delivering value to consumers and enabling delivery of Net Zero commitments.

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Retail financial resilience – high level timeline

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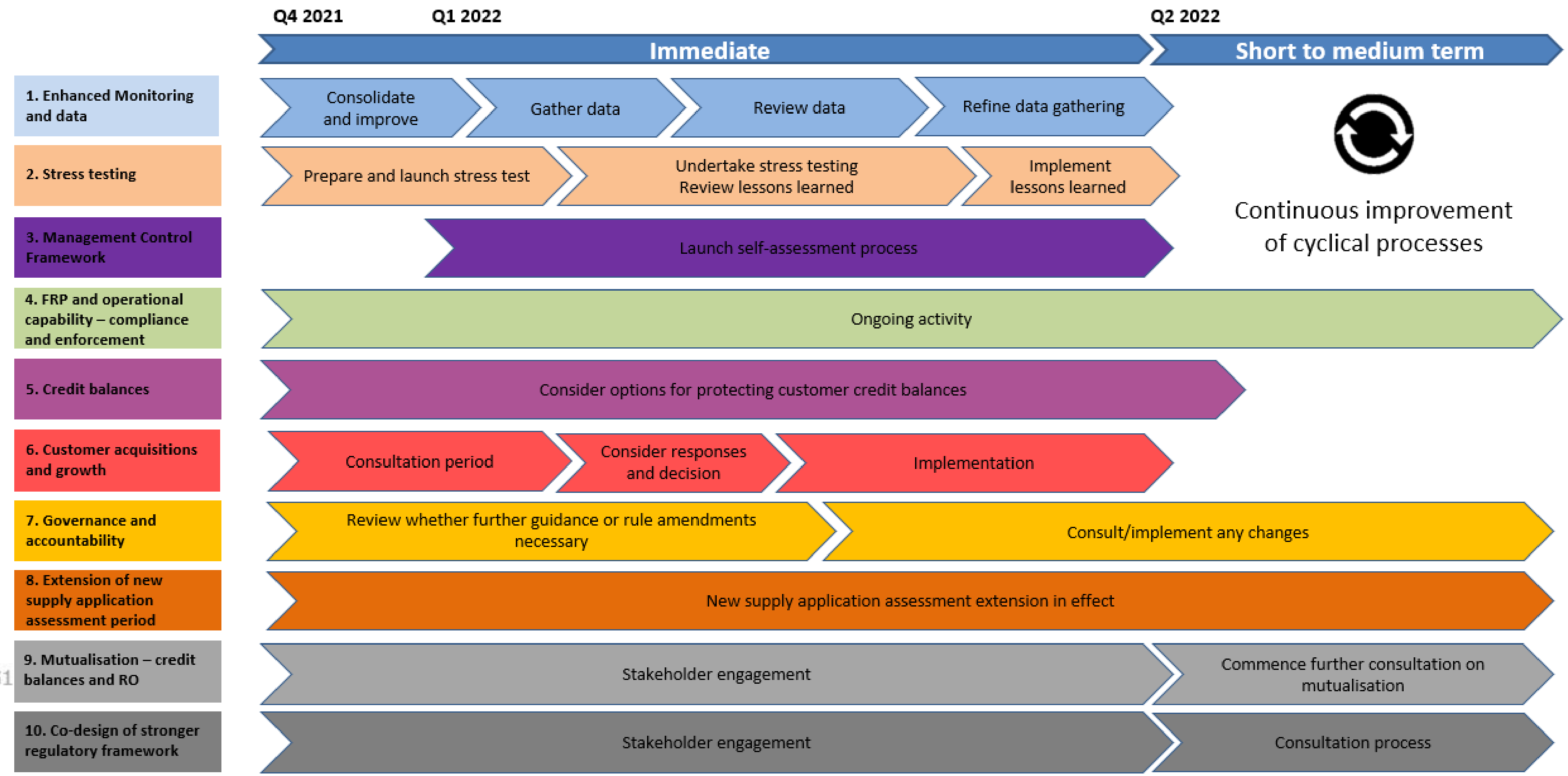

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