

## Guidance on the Operational Capability and Financial Responsibility principles

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This document provides suppliers with guidance on how they should comply with their obligations under Operational Capability Principle and the Financial Responsibility Principle, as well as information on how the principles are implemented and fit within our existing regulatory framework.

**This version of the guidance is for consultation. We welcome views on our proposed changes by 18 February 2022.**

The document shows the changes we propose to make to the original Financial Responsibility Principle guidance document published on 22 March 2021. Subject to the responses from stakeholders, we intend to publish a final version of this guidance in early March 2022.

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## 1. Introduction

1.1. The Operational Capability Principle (SLC 4A) obligates a supplier to ensure it has and maintains robust internal capability, systems and processes to enable it to efficiently and effectively serve each of its Customers. The Financial Responsibility Principle (SLC 4B1 to 4B3) is an enforceable overarching rule requiring suppliers to take action to minimise the extent of costs to be mutualised in the event of failure. This guidance is relevant for all domestic and non-domestic suppliers.

1.2. Ofgem may update this guidance from time to time following consultation - suppliers are therefore responsible for keeping up to date with the latest version. We remind all suppliers that this guidance does not modify or replace the conditions in the gas and electricity supply licences. Neither is it an exhaustive list of supplier obligations. Suppliers should continue to refer to the conditions outlined in the most recent versions of the gas and electricity supply licences.

### What is the Operational Capability Principle?

1.3. The aim of the Operational Capability Principle is to ensure that suppliers have the appropriate systems and processes to provide a quality service to their customers, meet their regulatory obligations and bear an appropriate share of their risk.

1.4. It is a broad requirement on suppliers to serve customers effectively and have the capability to meet all relevant legislative and regulatory obligations. We are providing additional guidance on how suppliers should comply with this principle in relation to one specific area where we have identified risks to consumers. We are clarifying our expectations on the level of control we expect suppliers to have over the material economic and operational assets they use or need in order to run their businesses. We identified the need for this additional guidance through our work to promote financial resilience in the retail market.<sup>1</sup>

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<sup>1</sup> [Action plan on retail financial resilience | Ofgem](#)

## What is the Financial Responsibility Principle?

~~1.3.1.5.~~ We want to ensure that the costs of a supplier's business are borne by the business itself, rather than being subsidised, on its failure, by its competitors and ultimately by consumers. Features of the retail energy market mean that some supplier costs are at risk of being mutualised upon its failure if they are not managed responsibly while the supplier is trading. Customer credit balances, network charges and environmental and social scheme obligations are examples of this.

~~1.4.1.6.~~ In line with the overarching themes of the [Supplier Licensing Review](#), we want suppliers to bear an appropriate share of their risk, including by adopting responsible financial management approaches to minimise the extent of cost mutualisation in the event of their failure.

~~1.5.1.7.~~ The Financial Responsibility Principle will acts as an over-arching obligation – supporting one of the key aims of the Supplier Licensing Review by ensuring suppliers act in a more financially responsible manner and take steps to bear an appropriate share of their risk. ~~Introducing t~~his new principle allows Ofgem further regulatory powers, along with other tools such as milestone and dynamic assessments, to take enforcement action where we see irresponsible behaviours in the market.

## 2. Implementation

2.1. The Financial Responsibility Principle ~~and the Operational Capability Principle~~ ~~were~~ introduced into the gas and electricity supply licences in early 2021, in line with several other changes being made by Ofgem as part of the Supplier Licensing Review. The ~~introduction of this new~~ principles ~~will~~ allow Ofgem to request further information from a supplier ~~and, if required, take enforcement action~~ to ensure it is acting responsibly ~~financially~~, thus reducing the risk of ~~potential~~ consumer harm and ~~having~~ a negative effect on the GB energy market.

2.2. We are aware of the burden that information requests can have on a supplier. Wherever possible, we will seek to use information that we already gather from other regulatory procedures or tools we already have in place, rather than request new information. This could include, for example, assessing information we gather as part of our general market monitoring<sup>2</sup> or using information gathered via milestone/dynamic assessments, previous information requests, account management engagement, and/or information contained in Consolidated Segmental Statements. We would also expect to request any additional information in a consistent format. We do not expect ~~the introduction of this principle~~ ~~these principles~~ ~~or any updates to this guidance~~ to result in significant burden to a supplier, especially those who regularly provide clear and accurate information to Ofgem, and that are already acting in a financially responsible manner.

2.3. We continue to encourage innovation and appreciate that suppliers' business models will vary. For these reasons, we plan to approach monitoring in a risk-based and proportionate way. Many factors will be taken into consideration, such as size of organisation and customer base/type. Our monitoring approach for non-domestic suppliers will be proportionate to the risk of mutualisation – given that credit balances for non-domestic customers are not recovered through Last Resort Supply Payments, and in any event tend to be proportionately lower than domestic balances.

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<sup>2</sup> "Market monitoring" includes a number of key indicators to assess risk, such as customer service performance, tariff pricing, customer numbers etc.

### 3. Expectation of suppliers

#### **Guidance on the Operational Capability Principle**

3.1. SLC 4A obligates a supplier to ensure it has and maintains robust internal capability, systems and processes to:

(a) efficiently and effectively serve each of its Customers;

(b) efficiently and effectively identify likely risks of consumer harm and to mitigate any such risks; and

(c) comply with relevant legislative and regulatory obligations.

3.2. These rules mean that a licensee must have sufficient control over all of its material economic and operational assets, e.g. premises, facilities, staff and equipment, used or needed to run its supply business.

3.3. The requirement to maintain robust capability, systems and processes means that a regulated supply entity must either own or have sufficient control over all the operations used or needed to run their supply businesses. Sufficient control means that a regulated supply entity has legally enforceable rights over the material assets it requires to operate its business, so that it can rely on those assets legally and enjoy the benefit of them. This means, for example, it does not rely on informal intra-group arrangements or the goodwill of third parties as such arrangements may be able to be terminated at will. Suppliers cannot efficiently and effectively serve their Customers or identify and mitigate risks to those Customers where they have insufficient control over their operational capacity.

#### **Guidance on the Financial Responsibility Principle**

3.1-3.4. The Financial Responsibility Principle requires suppliers to have adequate financial arrangements in place to meet costs at risk of being Mutualised.<sup>3</sup>

3.2-3.5. Without prejudice to the generality of the meaning and application of SLC4B, we would expect a supplier to have, and to be able to provide evidence to us on request that

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<sup>3</sup> “Mutualised” is defined in the Licence as meaning one or more market participants other than the licensee bearing costs incurred by the licensee, which may include Customer Credit Balances and costs incurred by the licensee under government environmental and social schemes, by virtue of regulatory mechanisms.

~~it has, the following in place to demonstrate compliance. Where Ofgem seeks assurances that a supplier is adhering to the Financial Responsibility Principle, we would expect that the supplier would be able to provide evidence that it has:~~

- ~~• plans ~~in place~~ to meet its financial obligations under government schemes by relevant dates and the ability to fulfil those plans;<sup>4</sup>~~
- ~~• effective processes, that are consistent with existing licence requirements,<sup>5</sup> for example setting direct debit levels and for checking and returning customer credit balances;<sup>6</sup>~~
- ~~• sustainable pricing approaches that allow it to cover its costs over time, or if it is pricing below cost that the risk sits with investors and not consumers. We will need to see evidence that suppliers can finance their overall business plans; and~~
- ~~• robust financial governance and decision-making frameworks in place; and~~
- ~~• the ability to meet its financial obligations while not being overly reliant on customer credit balances for its working capital.~~

3.6. We also expect that where a supplier uses a particular asset, mechanism or arrangement to meet its obligations under SLC4B, the supplier should either own that asset, mechanism or arrangement, or have sufficient control over it so that it can rely on it legally and enjoy the benefit of it. For example, if a supplier uses hedging positions to procure energy on the wholesale energy markets to manage and mitigate the risks of insolvency it should either own those hedging positions, or, if those hedging positions are held by a different entity other than the supplier, the supplier should have robust, legally enforceable and clearly defined arrangements in place with the entity that owns the hedging positions that enable the supplier to rely on those hedging positions.

3.7. Furthermore, where a supplier uses a particular asset, mechanism or arrangement to meet its obligations under SLC4B, the supplier should not liquidate, sell or otherwise dispose of that asset, mechanism or arrangement where doing so risks an increase in Mutualised costs. For example, if a supplier uses hedging contracts to procure energy on the wholesale energy markets, it should not liquidate, sell or otherwise dispose of those hedging contracts

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<sup>4</sup> The Financial Responsibility Principle covers both costs that could be mutualised following supplier failure and those that may be mutualised if paid late. For instance any Renewables Obligation buyout fund payments that are not made by the end of October will be mutualised whether or not the supplier has failed.

<sup>5</sup> For example SLC 0 - "The Standards of Conduct", SLC 31F/31I - "Informed tariff and consumption choices", SLC 27.15 - "Setting Direct Debits", and SLC 27.16 - "Refunding customer credit balances on request".

<sup>6</sup> Under Standard Licence Obligations 27.15 and 27.16.



in circumstances where doing so increases the likelihood of consequential Mutualised costs or an increase in those Mutualised costs.

3.8. A supplier must also have the ability to meet its financial obligations while not being overly reliant on customer credit balances for its working capital. We expect a supplier to achieve this by:

- being able to accurately determine the total amount of sums it holds in customer credit balances (the “Credit Balance Amount”) at any point in time;
- having risk management controls, processes and procedures in place to minimise the risk of the Credit Balance Amount being Mutualised. We would expect these to include arrangements for the management of a supplier’s business so that it is predominantly reliant on investor capital and does not put at risk the Credit Balance Amount.

3.8.3.9. We would expect suppliers to be able to demonstrate they are meeting these minimum requirements under the principle. How a supplier does this and the evidence it provides will vary, but we expect suppliers to provide plans and supporting evidence, for example cash flow projections, budgets, guarantees or proof of investments as appropriate. If a supplier is acting in a financially responsible manner this should just require it to report on the arrangements it has in place and provide evidence to substantiate these plans.

3.9.3.10. As highlighted above, we appreciate that there will not be a one-size-fits-all approach to how a supplier should run its business. However, where we see poor practice and potential risk, we would look to use our powers to intervene to protect consumers and reduce potential cost mutualisation for the rest of the GB energy market.

3.10.3.11. If we have concerns regarding the arrangements a supplier has in place, we may seek further engagement, and if appropriate may agree a suitable reporting arrangement. Any additional reporting would be proportionate to the risk of mutualisation and assessed on a case-by-case basis. Where we have concerns about a supplier’s compliance with ~~this~~ these principles, we may decide to undertake a dynamic assessment, request an independent audit, or move immediately to consider whether enforcement action is appropriate.

3.11.3.12. A supplier’s financial circumstances will fluctuate over time. In order to adhere to the Financial Responsibility Principle, we expect all licensees to be open and transparent with us on an ongoing basis. We expect that suppliers should also regularly review and

update their finance and growth plans. Where suppliers identify current or potential future financial difficulties, we strongly encourage suppliers to engage with us early.<sup>7</sup>

3.12.3.13. Our [enforcement guidelines](#) set out the approach we take to enforcing against all licence conditions, including the Financial Responsibility Principle [and Operational Capability Principle](#).

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<sup>7</sup> In accordance with our proposed open and co-operative principle (SLC 5A) we would expect a financially responsible supplier to seek early engagement with us to communicate, and reassure us of, significant changes to its financial position or its approach to financial management.

## 4. Potential further cost mutualisation protections

4.1. The Financial Responsibility Principle and Operational Capability Principle ~~will~~ help to ensure that suppliers adopt sensible practices in managing their costs. In doing so, ~~it~~ they will raise standards among poor performing suppliers without placing an undue burden on suppliers that are already acting in a responsible manner. ~~By itself, w~~ e consider ~~it~~ they will improve our ability to take action to address poor supplier behaviour. However, we are considering whether further requirements are necessary.

4.2. ~~Introducing~~ Providing further guidance on the Financial Responsibility Principle and Operational Capability Principle at this stage will deliver positive changes for consumers in the short term that can be supplemented later should we decide that is warranted. We will review and update this guidance as appropriate, and to align with our wider thinking on ~~more prescriptive measures~~ actions to tackle cost mutualisation risk, including those set out in our December 2021 action plan on retail financial resilience.<sup>8</sup>

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<sup>8</sup> Action plan on retail financial resilience | Ofgem