



Making a positive difference
for energy consumers

Gas and electricity suppliers, gas shippers and other interested stakeholders

Email: RetailFinancialResilience@ofgem.gov.uk

Date: 28 January 2022

Dear stakeholders,

Update to action plan on retail financial resilience: supplier control over material assets

In December we published an action plan on retail financial resilience¹. This outlined the 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.

Since the publication of the action plan, we have continued to closely monitor practices in the retail market and to learn lessons from recent supplier failures. Through that process, we have identified certain arrangements where suppliers do not own, control, or have the economic or legal rights to the key assets needed to run their business. We consider this results in consumers and taxpayers bearing an unfair and disproportionate amount of risk of mutualised costs. This is because such arrangements can limit the resources a regulated supplier can rely on to meet its obligations and financial liabilities, increasing the amount consumers or taxpayers may have to contribute following the supplier's failure.

We are therefore proposing to add a further outcome to those in the December action plan and we are setting out the actions we propose to take to deliver this outcome. As an immediate action, we are setting out our expectations around how suppliers should comply with their existing obligations in this area. This includes consulting on changes to the

¹ [Action plan on retail financial resilience | Ofgem](#)

Financial Responsibility Principle (FRP) guidance and publishing additional guidance in relation to the Operational Capability Principle.

As part of this consultation, and in line with our December action plan, we are also consulting on changes to the FRP guidance which aim to provide greater clarity on how suppliers should monitor and manage customer credit balances. This will help to further address another key driver of high mutualised costs which is amplifying the problem of suppliers having insufficient control over their key assets.

We are also continuing to progress the rest of our December action plan, including developing options for an overall framework for retail financial regulation that will help minimise the risk of mutualised costs from supplier failures more widely.

Context and additional outcome for retail financial resilience

Through our monitoring work and recent experience with supplier failures we understand that some energy companies may either have in place, or be considering putting in place, arrangements in which a licenced energy supplier does not own, control or have the economic or legal rights to its material assets. For example, the assets may be solely owned and controlled by a parent company or another company in the same group. These assets can include hedging contracts for energy, employment contracts, IT systems, intellectual property and branding, and other key agreements required for a supplier to serve its customers efficiently and effectively.

We consider this places unfair and disproportionate risk on energy consumers. This is because the arrangement may give a parent or other group company the ability to retain assets that could otherwise have helped offset the contributions from consumers and taxpayers following a supplier's failure. For example, a special administrator may have to pay for the use of existing assets, or invest in new assets, to continue the operation of the supplier. This would increase the overall costs of a special administration regime (SAR) which may ultimately be mutualised and paid by energy consumers. A similar situation could occur through a Supplier of Last Resort (SoLR) process, where an administrator may have to negotiate with a third party for access to key operational assets. Additionally, this type of arrangement could reduce the overall financial amount an administrator can recover to pay a failed suppliers' creditors, minimising the scope for consumers to be repaid for the additional costs claimed by a new supplier through a SoLR process.

We are also concerned about the potential for situations in which direct action is taken prior to a supplier's failure to benefit a parent company or its investors at the expense of

consumers or taxpayers. For example, if steps are taken to liquidate or terminate agreements for key supplier assets (such as a hedging contract), making the supplier insolvent but allowing unregulated parts of the group to retain the value of those assets. We consider this would place unacceptable and unjustified additional costs on consumers as well as other responsible suppliers and market participants.

We think it is imperative that consumers are not unfairly penalised due to arrangements which mean a supplier's key assets cannot be relied on to offset or minimise mutualised costs in the event of a supplier's failure. In our action plan we set out five proposed outcomes we believe are needed to develop an energy supply market in which consumers, energy suppliers and investors can have confidence in going forward. We now propose the following sixth outcome:

- **Control:** suppliers need to have ownership or sufficient control² over all material economic and operating assets used and/or needed to run their business.

We welcome views on this additional outcome. Below we set out the additional actions we propose to take to help achieve this outcome.

Immediate actions

Modification to the Financial Responsibility Principle (FRP) guidance

The FRP is an overarching obligation on suppliers to act in a financially responsible manner and to take steps to bear an appropriate share of their risk. It requires suppliers to take action to minimise the costs that could be mutualised in the event of their failure. This includes costs incurred by a supplier that are capable of being mutualised and met by other market participants via mechanisms in both the SoLR and SAR processes.

We do not consider that arrangements in which licenced suppliers have insufficient ownership or control over the material assets, mechanisms or arrangements they use to meet costs which are at risk of being mutualised are aligned with the FRP. Additionally, any steps to liquidate supplier assets, terminate intra-group agreements or materially alter hedging positions to benefit a parent company or its investors, whilst increasing the burden of mutualised costs on consumers, would not comply with the FRP. This is because the supplier would not be taking appropriate action to minimise mutualisation costs or holding

² Sufficient control means that a regulated supply entity has legally enforceable rights over the material economic and operational assets needed to run 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.

adequate financial arrangements to meet its costs at risk of being mutualised. We propose to update the FRP guidance document to make our expectations on this clear.

The issue of suppliers having insufficient control over their assets is amplified when they accrue unmanageable liabilities. In our December action plan, we noted the urgent need to ensure that customer credit balances are used appropriately by suppliers and we said that we may update the FRP to include clearer guidance on this. We are proposing to introduce this clearer guidance as part of this consultation, given the significant value of customer credit balances and the benefit of introducing coordinated additional guidance on how suppliers should comply with the FRP. We propose to include additional text in the FRP guidance to clarify the requirement that suppliers should not be overly reliant on customer credit balances. This clarifies that we expect a supplier to be able to accurately determine the total amount of sums it holds in customer credit balances at any point in time. We would also expect suppliers to have risk management controls, processes and procedures in place to minimise the risk of these sums being mutualised.

Our proposed changes to the FRP guidance are published on our website alongside this letter. The changes will provide further clarity on how we expect suppliers to minimise mutualisation costs and to comply with the FRP. This will benefit consumers by supporting effective competition between financially responsible suppliers, improving standards across the industry and helping to reduce the risk of cost mutualisation.

We believe issuing this additional guidance is an important step towards achieving our outcomes for retail financial resilience. We recognise that there may be legitimate, beneficial reasons for companies to adopt different operating arrangements and corporate structures and it is not our intention to impose unnecessary costs or restrict effective competition. We encourage suppliers to provide feedback if they believe these changes could have any material cost implications or unintended consequences for existing business models.

Guidance on the Operational Capability Principle

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. We are aware of circumstances where suppliers rely on arrangements with parent companies or third parties to carry out their supply businesses over which they have insufficient control (for example arrangements for their operating assets, equipment, premises, facilities and/or staff needed to maintain

operational capacity). These arrangements, which can be informal or formal, expose the licenced supplier to the risk that its operations may be disrupted or even terminated.

We are proposing to publish additional guidance on the Operational Capability Principle to make it clear that this requirement means suppliers must either own or have sufficient control over all the operations used or needed to run their businesses. A supplier exercises sufficient control when it has legally enforceable rights over the material assets it requires to operate its business and does not rely on, for example, informal intra-group arrangements or the goodwill of third parties.

Our proposed guidance on the Operational Capability Principle is published on our website alongside this letter, in the same document as our guidance for the FRP. As with our proposed FRP guidance changes, we will carefully consider any evidence from suppliers that this additional guidance could have any unintended consequences or undue cost impacts.

We welcome views on our proposed changes to the FRP guidance and the introduction of guidance on the Operational Capability Principle by **18 February**. Subject to any responses and further engagement with stakeholders, we intend to publish a final version of the guidance in early March, at which point the additional guidance for both principles would come into effect.

Ensuring compliance

Where we see poor practice and/or potential risks under these and other relevant areas, we will use our powers to intervene to protect consumers and reduce potential cost mutualisation risk for the rest of the market. If we have concerns, we may decide to undertake detailed compliance monitoring and assessment or move immediately to consider whether enforcement action is appropriate.

Short to medium term actions

Additional licence obligations on asset ownership

In addition to providing guidance on existing obligations, we are considering updating licence requirements to further protect consumers from mutualised cost risk due to suppliers having insufficient control over their assets. This may include, for example:

- Stronger and more specific rules around the control licensed suppliers must have over their material economic and operating assets. This could include options from

the requirement for suppliers to have full legal ownership of all key assets, to obligations that compel licenced supply companies to have intra-group arrangements that mirror arm's length commercial contracts between independent parties.

- Requirements to pre-notify Ofgem of any material changes in asset value or ownership, such as material shifts in hedging positions.

We welcome initial views on the introduction of new and strengthened licence requirements to address the issues outlined in this letter and whether these are the right areas for changes.

Linking with wider actions on cost mutualisation and supplier financial resilience

We believe a coordinated combination of actions is required to fully tackle problems associated with cost mutualisation. The issues around supplier asset control are compounded when suppliers also have the ability and the incentive to build up a large amount of unpaid liabilities. As set out in our December action plan, we intend to further consult on detailed policy options for tackling mutualisation risks associated with suppliers' ability to build up Renewables Obligation (RO) liabilities and consumer credit in Spring 2022 (subject to the outcome of our joint RO consultation with BEIS). Alongside this, we are also undertaking a more holistic review of what is an appropriate level of financial regulation for suppliers in the retail market. We will consider asset ownership and capital requirements further as part of this work.

We recognise that there may be legitimate reasons for energy companies to have different contractual arrangements and corporate structures, for example setting up distinct companies within a group for trading gas and electricity. We intend to work with companies to further discuss these arrangements and to understand the extent to which they can be accommodated whilst achieving our outcomes for supplier financial resilience. This may include looking at intra-group arrangements, agreements or contracts and considering whether any additional requirements are needed to ensure they are equivalent to terms between independent commercial parties.

As part of our wider review of retail financial resilience we also intend to consider whether there are any gaps in our regulatory powers over companies that might limit our ability to protect consumers against the risk of mutualised costs. For example, we may consider whether there should be greater alignment between financial regulations on suppliers and gas shippers.

Longer term actions

Ensuring compatibility with wider insolvency processes

As highlighted in our December action plan, to the extent that we identify limits to what we can achieve through our existing powers, we will work with government to assess whether desirable outcomes can be delivered through legislative change. We intend to consider further existing insolvency rules and processes and how they interact with the energy market SoLR and SAR processes. For example, we will consider whether there may need to be any changes to ensure that all mutualised costs are a liability of failed suppliers. This would further help address existing asymmetric risk in the energy retail market and place greater incentive on companies to act in a financially resilient manner.

Next steps

We welcome views on the proposed outcome and actions in this letter, including the additional guidance we are proposing for the FRP and Operational Capability Principle which is published alongside this letter. Please send your responses to RetailFinancialResilience@ofgem.gov.uk by **18 February 2022**.

We are continuing to progress the rest of our December action plan. We have recently held workshops with suppliers to shape a new stress testing process intended to assess whether suppliers are robust to a range of scenarios, and we will also be reviewing the management control frameworks that suppliers use to set their commercial strategy and identify and manage risk. We also plan to engage with suppliers on policy design for our holistic review of the regulatory framework for retail financial resilience through a series of workshops in February and March.

Yours faithfully,

Cathryn Scott

Director of Enforcement & Emerging Issues