



Making a positive difference  
for energy consumers

**Domestic gas and electricity  
suppliers, consumer  
organisations, and other  
interested stakeholders**

Email: [RetailFinancialResilience@ofgem.gov.uk](mailto:RetailFinancialResilience@ofgem.gov.uk)

Date: 14 April 2022

Dear stakeholders,

**Update to December Action Plan: Customer Credit Balances and Renewables Obligation protection**

Since the sharp increases in global gas prices in September 2021, GB has seen 28 supplier failures, affecting almost 4 million customers and causing significant costs to all households. Ofgem has identified a number of reasons behind these failures, which include the energy supply sector not being sufficiently resilient to wholesale price volatility.<sup>1</sup>

On 15 December 2021, Ofgem announced an Action Plan to develop a package of measures to boost financial resilience in the energy retail market.<sup>2</sup> Since then we have taken a number of immediate actions which support financial resilience, including: commenced stress testing with suppliers to better understand market resilience; requested suppliers to provide assurance in relation to their management control frameworks for financial risk; consulted on changes to our Financial Responsibility Principle guidance to ensure suppliers have sufficient control over their material assets<sup>3</sup>; strengthened our ability to intervene at milestone assessments, changes in senior personnel and trade sales<sup>4</sup>; and strengthened financial risk controls and fit and proper person testing in our licence entry checks.<sup>5</sup>

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<sup>1</sup> Other causes include the high prices themselves and inflexibilities caused by the retail price cap, which is being addressed separately by Ofgem.

<sup>2</sup> [Action plan on retail financial resilience \(ofgem.gov.uk\)](#), published 15<sup>th</sup> December 2021

<sup>3</sup> [Update to action plan on retail financial resilience: supplier control over material assets \(ofgem.gov.uk\)](#), published 28 January 2022

<sup>4</sup> [Decision on strengthening milestone assessments and additional reporting requirements \(ofgem.gov.uk\)](#), published 4 February 2022

<sup>5</sup> [Decision on new guidance document for gas or electricity licence applicants \(ofgem.gov.uk\)](#), published 17 March 2022

The package of measures set out in our Action Plan also included work to explore how best to tighten rules around the protection of credit balances and Renewables Obligation (RO) payments.<sup>6</sup> Since then, Ofgem has been engaging with suppliers and consumer groups as we have sought to develop solutions to this issue. We are grateful for the positive and constructive engagement to date, which has informed the development of the policy options summarised in this letter.

Protecting customer money – namely, that held by suppliers in credit balances – is a key outcome of Ofgem's Action Plan on supplier financial resilience. As well as the cost to all consumers from protecting customer credit balances when suppliers fail, the use of customer balances to fund companies' commercial activities has itself contributed to unsustainable business models and the overall systemic risk in the supply sector.

Similarly, under the current RO scheme suppliers are able to use money, collected from customers in order to discharge their obligations under the RO scheme, as free working capital. If the supplier then defaults on their obligation and exits the market, the cost of the resulting mutualisation<sup>7</sup> will ultimately be borne by the consumer. To the extent that legislation is not an expeditious solution, we are considering regulatory solutions to protect RO payments.

Ofgem understands that requiring suppliers to hold specific reserves to protect customer credit balances and RO payments comes at a time when the sector remains under stress, and we are considering appropriate transition arrangements to allow companies to make this adjustment whilst preserving financial stability. The effect on companies' financial position from this and other financial resilience measures will continue to be taken into account as Ofgem considers further updates to the retail price cap.

The purpose of this letter is to recap on the need for intervention in this space, and to outline our emerging thinking around the scope of credit balances and RO payments to be protected, specific approaches and mechanisms that can be used to achieve this and potential transition arrangements, ahead of a statutory consultation later in the spring.

We have been engaging with suppliers and customer groups bi-laterally and via workshops as our thinking has developed. This letter is intended to complement that process and bring our thinking together as we continue to directly engage with stakeholders in parallel. It is

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<sup>6</sup> The Renewables Obligation is a government support scheme for large-scale renewable generation which places an obligation on suppliers to obtain a certain number of Renewables Obligation Certificates (ROCs) in proportion to the amount of electricity they supply to customers. As an alternative, suppliers can make a payment in lieu of ROCs.

<sup>7</sup> "mutualised" is defined at Standard Licence Condition 1 of the Gas and Electricity supply licences.

not intended to be a formal consultation, but we will consider any representations received as we work towards a statutory consultation. Any such representations should be sent by **Tuesday 3 May 2022**.

## **The need for intervention**

Under current market arrangements, suppliers have the ability to accrue and use customer credit balances and RO payments collected from customers as free, and risk-free, working capital. On failure, customer credit balances and payments due under the RO scheme are effectively insured through mutualisation, and so a moral hazard exists as the failed supplier is not exposed to this downside risk. This has allowed suppliers with insufficient capital and poor business models to enter the market and grow unsustainably. Such models do not incentivise good operational performance or good customer service, as suppliers are able to attract new customers based not on their service offering but with non-cost reflective (and ultimately unsustainable) pricing, driving some suppliers to accumulate more and more customers simply to stay afloat.

Suppliers without sufficient capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure. And under present market conditions, the significant costs of failures borne by customers have far exceeded the cost of refunding the credit balances and RO payments of individual suppliers. As such, this moral hazard can give rise to very poor outcomes for consumers and systemic risks to the retail supply market, even in circumstances where the majority of suppliers do not rely on such unsustainable business models.

In order to protect the interests of current and future consumers, we must ensure that suppliers bear the appropriate cost of risk-taking so that they are more resilient to market shocks and that customers are shielded from the impacts of supplier failures as far as possible. Such an approach will require suppliers to use other sources of funding to operate and grow their businesses, which will necessarily have greater levels of oversight and due diligence than customer credit balances. While Ofgem's Financial Responsibility Principle,<sup>8</sup> which was introduced last year, requires that suppliers must have adequate financial arrangements in place to meet costs at risk of being mutualised, it is clear that more specific licence provisions and a greater level of oversight are required to address these risks effectively.

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<sup>8</sup> Standard Licence Condition 4B of the Gas and Electricity supply licences

Our previous consultation in March 2021 identified some possible solutions for protecting 'surplus' credit balances.<sup>9</sup> However, in the context of the current market we do not consider that these solutions go far enough to address the problems we are seeing today. We will issue a statutory consultation later in spring, which will set out our proposed solutions to mitigate the harm to consumers.

## Proposals on customer credit balances

### *Scope of protection*

We are considering introducing a principle that suppliers should not use customer credit balances for working capital at all. This would replace current guidance under the Financial Responsibility Principle that suppliers should not be 'overly reliant' on such credit balances for working capital. We are also considering banning certain 'payment in advance' tariffs (the practice of requiring more than a month's payment from customers before any supply of energy) and strengthening our requirements for more accurate billing by direct debit.

In order to ensure compliance with a prohibition on using customer credit balances for working capital, we are proposing that suppliers hold them (or an equivalent amount) in insolvency-remote vehicles. We are currently considering the scope of such obligations. Options include a requirement to hold (i) total gross credit balances<sup>10</sup> (or a proportion thereof), (ii) gross credit balances net of unbilled consumption<sup>11</sup> or (iii) gross credit balances net of unbilled consumption and gross debit balances.<sup>12</sup>

**Our preference, in order to ensure that a supplier is able to pay its customer credit balances on failure and therefore fix the moral hazard that exists, is option (ii), i.e. that suppliers should protect an amount equal to gross credit balances net of unbilled consumption.** In this way, the methodology would reflect the amount at risk of mutualisation. We do not currently consider that netting this amount off with debit balances will provide an effective solution to this risk given that only credit balances are mutualised whilst debit balances are for the creditors of the failed supplier. However, we acknowledge there are different views across the market on this point and we welcome

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<sup>9</sup> These included requirements to introduce credit balance thresholds at key points during the year and to refund credit balances above £0 at the end of each contract year. See [Supplier Licensing Review: reducing credit balance mutualisation | Ofgem](#), published 17 March 2021

<sup>10</sup> Credit balances occur when a customer has paid more to the supplier than they have consumed and been billed for. Gross credit balances are the sum of all positive balances held by customers of a given supplier.

<sup>11</sup> Gross credit balances net of unbilled consumption reflect where a customer has paid more to the supplier than the value of the energy they have consumed, but not necessarily been billed for. To calculate this, charges for energy consumed (and standing charges) since the last bill was raised are deducted from the credit balance on the customer's account.

<sup>12</sup> Debit balances occur when a customer has paid less to the supplier than they have consumed and been billed for. Gross debit balances are the sum of all negative balances held by customers of a given supplier.

engagement on this, and how other solutions could create an effective solution to this problem.

We recognise that adopting option (ii) is likely to impact on the working capital position of suppliers and we will engage further on the impact of such an approach and on the timelines for implementation (see section on transition below).

### *Ringfencing approaches*

There are two key approaches that we have identified to how suppliers could implement the protection measures:

1. **Using a methodology to calculate the amount protected** – requiring suppliers to set aside or protect a fixed amount using a pre-determined methodology in an insolvency-remote vehicle. The amount to be protected could be calculated on an annual basis, or involve a more dynamic arrangement whereby the amount could be varied on a more frequent basis, e.g. quarterly or even monthly, which would track more closely the seasonality of credit balances. The beneficiary of the protected amount would be customers or the supplier of last resort on behalf of those customers; or
2. **Adopting a 'client account' approach with drawdown rules** – requiring suppliers to collect all existing and future payments receivable from customers into an account held on trust, with drawdown only for specified purposes such as billing/reconciliation. The supplier would be the trustee of the arrangement and the trust would be in favour of the supplier (for legitimate undrawn amounts) and customers. Where the supplier fails, the sums held on trust would be paid to the incoming supplier to be held on trust for the customers. The aim is therefore to ensure that the value of the account would be outside of the insolvent estate of the failed supplier and to minimise customer credit balance mutualisation.<sup>13</sup>

We are engaging with suppliers to assess the deliverability and effectiveness of these approaches or measures that would have equivalent effect, as well as their likely impact on supplier and wider market behaviour and the costs and benefits for consumers. There are challenges and risks to both approaches, such as whether the 'client account' approach would be too operationally complex or insufficiently effective. **On balance, we currently favour using a methodology, based on gross credit balances net of unbilled consumption, to calculate an amount to be protected each month or each quarter.** Our 'strawperson' for this is outlined in the Annex to this letter. We are open to considering either option as well as variations and alternative proposals that will better deliver our

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<sup>13</sup> The aim is that the value of the account will cover the credit balances of the customers transferred to an incoming supplier (generally appointed through the Supplier of Last Resort process) minimising any cost to that supplier for honouring those and therefore minimising mutualisation of that cost.

policy objectives. We understand that suppliers have different business models and ownership structures and will look to engage with all relevant stakeholders with respect to the impact options may have on them.

*Insolvency remote protection mechanism*

We recognise there may be a number of different protection mechanisms available to suppliers. We are open to there being a menu of options for a supplier to choose from. However, in assessing whether protection mechanisms are effective, we will look at criteria including:

- the extent to which the mechanism is insolvency remote, and can survive a supplier falling into financial distress;
- the impact of the measure on effective competition;
- the administrative cost of the mechanism; and
- the supervisory arrangements that would be required to ensure compliance.

Noting that our thinking is likely to develop as we continue to engage with stakeholders and work towards a statutory consultation, including on the question of which mechanism(s) best provides insolvency remote protection, the table below summarises our current views on high level pros and cons for the protection mechanism options we have identified. We have also considered whether insurance might be available, however our current view that it is unlikely to be commercially available and unlikely to remain available during financial distress. We have not therefore included it in the table below.

Protection Mechanism	Pros	Issues
Escrow Account	Quick and simple to establish. Well understood. Can accommodate fluctuating cash amounts.	May impact on supplier working capital and competition. May impact on balance sheet position and credit assessment of supplier. Escrow agent at risk of insolvency. Likely to be more costly than the Trust Account option.
Trust Account	Quick and simple to establish. Can accommodate fluctuating cash amounts.	May impact on supplier working capital and competition. May impact on balance sheet position and credit assessment of supplier. May impact on supplier existing working capital debt facilities.

Letter of Credit	Robust and immune to supplier group financial health. Limited impact on supplier working capital or balance sheet position (save to extent of cash collateral and fees).	Expensive and time-limited so will need replacing. Bank may require additional security if financial health deteriorates. Potentially favours large suppliers, may impact on competition. May not cover fluctuating cash amounts but likely to have a fixed liability limit.
3 <sup>rd</sup> Party Guarantee or Surety	Robust and immune to supplier group financial health. Limited impact on supplier working capital or balance sheet position (save to extent of cash collateral and fees).	Usually time-limited, so will need regular replacement. Can cover liabilities up to a cap. May impact on competition if it favours large suppliers.
Parent Company Guarantee	Simplest, lowest cost protection. Limited / no impact on supplier working capital or balance sheet position. Can cover payment obligation of a fluctuating amount.	Not immune to supplier group financial health. Potentially favours large group suppliers, may impact on competition. May need to restrict to parents with investment grade rating.

### *Transition*

Given the sector remains under stress due to high and volatile wholesale prices, Ofgem understands that requiring suppliers to hold specific reserves to protect customer credit balances and RO payments may require appropriate transition arrangements to allow companies to make this adjustment whilst preserving financial stability. The effect on companies' financial position from this and other financial resilience measures, including potentially other measures suppliers have taken to manage risk, will continue to be taken into account as Ofgem considers further updates to the retail price cap.

**To the extent that any of these proposals result in the need to re-capitalise efficiently run suppliers, we are open to allowing a suitable transition period that aligns with any necessary reform to the price cap.** We will be seeking suppliers' views on transition options and impacts on other aspects of the price cap in order to set an appropriate timeline that allows sufficient time for companies to adapt. We may also consider adopting a staged approach to implementation by incrementally tightening up the scope of protection over a one to two-year period.

## Proposals on Renewables Obligation

Last year we jointly consulted with BEIS on options for addressing the risk of RO payment default on supplier failure. That consultation explored options for increasing the frequency of payments under the RO scheme. To the extent that legislation is not an expeditious solution, we are exploring the introduction of licence conditions that oblige suppliers to protect or ring-fence the payments they receive from customers in respect of their RO payments. In keeping with the outcomes of our Action Plan, we will explore the extent to which firms should protect RO funds in their entirety from the outset, including the trade-offs that presents.

In terms of the **scope** of the protection, we are considering whether all payments should be protected from the start of the obligation period or whether there should be a sliding scale whereby the obligation increases over time. We are engaging with suppliers to understand how they interact with the ROC market in order to develop a suitable forecast methodology, to explore practical questions around timing and calculation, and to ensure that these measures do not negatively interact with the incentives of the scheme.

In terms of the **ringfencing mechanism**, we are considering a similar range of protections as for customer credit balances (escrow accounts, trust accounts, letters of credit and third party guarantees or surety). And in terms of **transition**, to the extent that the RO proposal results in the need to re-capitalise efficiently run suppliers, we are open to allowing a suitable transition period that aligns with any necessary reform to the price cap.

### Next steps

As set out earlier, any representations on the contents of this letter should be submitted to [RetailFinancialResilience@ofgem.gov.uk](mailto:RetailFinancialResilience@ofgem.gov.uk) by **Tuesday 3 May 2022**. We plan to hold a further round of workshops and other engagement towards the end of this month or early next month – following on from earlier workshops held in February/March with domestic suppliers and more recent one-to-one engagement. As noted, we plan to conduct a statutory consultation on ringfencing of customer credit balances and RO payments later in spring. Alongside that statutory consultation we also intend to consult on policy options related to capital adequacy.

We look forward to continuing to engage with you about these matters, ahead of and during the consultation period.



Yours sincerely,

**Cathryn Scott**

Director – Enforcement and Emerging Issues

## **Annex: Proposed approach to protecting customer credit balances**

We are continuing to explore the options around scope, approach and methods of protection and are assessing the costs, benefits and implications of each. We will continue to engage with suppliers and consumer groups on these as our thinking develops. However, below is our current preference or 'strawperson' for protecting customer credit balances, addressing the moral hazard that currently exists and promoting greater financial resilience in the energy supply market.

1. Suppliers should be required to ringfence, in an insolvency remote mechanism, an amount of funds equal to their gross customer credit balances net of unbilled consumption;
2. We currently consider the simplest way of managing this will be using a methodology for suppliers to calculate what that amount should be;
3. We see benefits in a dynamic arrangement whereby the amount is varied monthly or quarterly, in order to take account of the seasonality of customer credit balances and material changes in a supplier's customer base;
4. Suppliers could have a choice of protection mechanisms, from a menu of options that we consider to be effective in accordance with our criteria (e.g. extent to which the mechanism is insolvency remote, impact on effective competition, administrative costs and supervisory arrangements);
5. Suppliers should have regular reporting obligations, with clear accountability for compliance; and

To the extent that this results in the need to re-capitalise efficiently run suppliers, we are open to allowing a suitable transition period that aligns with any necessary reform to the price cap.