Making a positive difference
for energy consumers

Gas and electricity suppliers, consumer organisations, and other interested stakeholders

Email:
RetailFinancialResilience@ofgem.gov.uk

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Dear stakeholders,

Decision on proposed guidance on the Operational Capability and Financial Responsibility principles

Earlier this year we consulted on updating existing guidance accompanying the Financial Responsibility Principle (FRP) and on new guidance for the Operational Capability Principle (OCP)[1]. These guidance updates primarily set out what is expected of suppliers, in relation to ownership or control of the material economic and operating assets needed to run their business.

We received 16 responses to our consultation. Having reviewed and considered these responses, we have decided to proceed with the proposed changes, with some amendments to provide further clarity. We believe this will help guide suppliers as to the nature of their existing obligations and ensure that consumers' interests are best served. In this letter, we recap on the rationale behind and content of our proposals; summarise stakeholder views and our responses to them; and set out next steps. Alongside this letter we have published the updated guidance, and in the Annex to this letter we highlight the provisions that we have amended since the consultation.

[1] Update to action plan on retail financial resilience: supplier control over material assets | Ofgem

The rationale behind our proposals

In our consultation we explained how through our monitoring work and recent experience with supplier failures, we identified that some energy companies either had in place, or were 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 stated how 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. We gave examples as to how this results in increased costs to the consumer, whether a supplier failure is managed through the special administration regime (SAR) or Supplier of Last Resort (SoLR) process.

We also noted our concern 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 stated how we consider this would place unacceptable and unjustified additional costs on consumers as well as other responsible suppliers and market participants. We stated how 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.

Summary of our proposals

FRP guidance

The FRP[2] is an overarching obligation on suppliers to act in a financially responsible manner. It requires suppliers to have adequate financial arrangements in place to minimise the costs at risk of being mutualised[3] in the event of their failure. We proposed updating the FRP guidance to clarify that if a supplier uses an asset to meet its obligations under the FRP, it must either own this asset or have sufficient control over it (meaning being able to

[2] The Financial Responsibility Principle is set out in SLC 4B of the Gas and Electricity Supply licence.
[3] "mutualised" is defined at SLC 1 of the Gas and Electricity supply licences.

rely on it legally and enjoy the benefit of it) and should not liquidate, sell or dispose of such an asset if doing so increases the risk and amount of mutualised costs.

The issue of suppliers having insufficient control over their assets is amplified when they accrue unmanageable liabilities, and we therefore also sought to add further clarity in relation to a supplier's use of customer credit balances (CCB). The existing FRP guidance sets out how we expect a supplier not to be overly reliant on customers credit balances for its working capital, and instead to rely predominantly on investor capital. So that suppliers can demonstrate their adherence to this approach where necessary, we included an ancillary point in the guidance clarifying that suppliers need to be able to accurately determine the total amount of CCB they hold at any point in time; and have risk management controls, processes and procedures in place to minimise the risk of the customer credit balance amount being mutualised. We are developing further policy options in relation to the protection of CCBs in addition to this FRP guidance update, and we intend consulting on those policy options in June.

OCP guidance

The OCP[4] places an obligation on 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 proposed creating guidance to clarify that to be compliant with the OCP, suppliers should own or have sufficient control over all material assets required to run their supply business. We stated that suppliers could not efficiently and effectively serve their customers or identify and mitigate risks to those customers where they have insufficient control over their operational capacity. We also recognised in our consultation that where suppliers are part of a broader corporate group, there may be business reasons why some assets are held in a parent or other group company. However, we said that suppliers would not be able to rely on informal intra-group arrangements or the goodwill of third parties as such arrangements can be terminated at will and therefore we proposed that suppliers must have sufficient control (meaning legally enforceable rights) over such assets owned by a parent or other group company.

Stakeholder views and our decision

We received responses to our consultation from 16 stakeholders, including a consumer group, suppliers, gas shippers and industry trade bodies. We also had a series of bilateral discussions during the consultation period. In reaching our decision, we have carefully

[4] The Operational Capability Principle is set out in SLC 4A of the Gas and Electricity Supply licence.

considered all points raised by stakeholders in these responses. We have also considered additional views provided to us in discussions with stakeholders.

Most stakeholders recognise our intent and approve measures to improve resilience across the retail sector. However, some have expressed concern that the suggested changes may not address underlying issues.

We comment on key issues raised by stakeholders concerning the proposed amendments. Our summaries of responses do not represent an exhaustive list of issues raised and we have not commented on issues outside of the scope of our consultation. Non-confidential responses have been published on our website.

Control of assets

Stakeholder views

Several stakeholders have asked for additional information on what we mean by "material assets" and "sufficient control".

Some suppliers who have their assets held at the parent company level have told us that they believe this approach to be the most efficient option for managing assets, with centralised services such as HR and IT offering economies of scale. They believe this ultimately contributes to lower operating costs and customers' bills.

Some suppliers have also noted that reviewing these arrangements would lead to administrative burden and cost, including opportunity costs where resources are diverted away from other tasks during what is already a busy period for suppliers. Some suppliers have told us they have yet to fully assess the legal and fiscal consequences of reviewing and amending arrangements where this is required.

Some stakeholders noted that each company has a different organisational structure, and that a variety of business models are required to drive competition and innovation.

A few suppliers asked how they could retain control over assets such as IT software provided by third parties.

Our response and decision

Material assets, in respect of the OCP, are those relied on by a supplier to run its supply business and meet its obligations with regards to customers. Assets can be considered material depending on specific circumstances; hence we provided a non-exhaustive list

which includes premises, facilities, staff and equipment, to which we are now adding IT systems and brand name to help guide suppliers further.

We provided a definition of sufficient control in the OCP guidance. 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.

It is not our intention to prescribe a single business model, and each supplier remains responsible for its own commercial strategy and structure. Suppliers can continue to choose between direct ownership of assets, and third-party ownership so long as the supplier can exercise sufficient control over them. Material assets can continue to be held at the parent company level, but suppliers must have legally enforceable rights over such assets.

Informal inter-company agreements can be terminated at will and can leave a supplier exposed because of its inability to rely on such arrangements. This is particularly important in a SAR or SoLR situation. We are aware of instances when administrators/SoLRs have struggled to access assets which were essential to run a failed supplier – for example staff and branding – because these were still held by the failed supplier's parent company. Therefore, we believe control over its assets is required for a supplier to meet its obligations under FRP and OCP.

Suppliers whose material assets are held at the parent company level should already have at least informal agreements in place to use these assets. Therefore, putting in place arrangements to ensure that the supplier entity has legally enforceable rights over these assets should not require extensive work. For services provided by third-party commercial entities such as IT software, control can be demonstrated through agreements specifying terms and conditions of use.

Hedging contracts for energy

Stakeholder views

Several suppliers have highlighted that hedging is essential for them to reduce exposure to commodity risks.

Some suppliers have told us that their hedges are held by their parent companies, which tend to have greater expertise and capacity in terms of hedge management. They have noted that parent companies are also more likely to have an investment grade rating, meaning they can secure funds/issue hedges at lower rates.

These suppliers have stated that requiring them to hold hedges would lead to higher financing costs, in part because of their lower investment grade rating. They have also noted that renegotiating hedging contracts now would be particularly detrimental to suppliers given current energy prices, leading to poorer deals and higher costs being passed on to customers.

One supplier has noted that selling hedges should also be allowed when it is in the customers' interest.

Our response and decision

We are not seeking to prevent suppliers' ability to rely on hedges. Indeed, we have noted that for a supplier not to have an appropriately hedged position in the future energy markets could be in contravention of the FRP. Likewise, we are not seeking to prevent suppliers' hedges from being held by their parent companies.

We wish to avoid a situation where suppliers' hedges are held by a third-party, and the supplier is not in control of its own hedging strategy. When hedges are valuable, this can incentivise the hedge's holder to liquidate hedges, leaving the supplier unhedged and increasing the risk of supplier failure.

Therefore, if hedges are owned, managed or controlled by a third-party, the supplier must have back-to-back agreements with the third-party which prevent the third-party from actioning contractual levers to liquidate positions the supplier relies on without the supplier's consent and when this increases the risk of cost mutualisation.

We are not seeking to prevent the sale of a hedge when it is beneficial to consumers provided that the sale of that hedge does not increase the risk and amount of mutualised cost.

Collateral

Stakeholder views

One stakeholder noted that the proposed guidance may create uncertainty around existing contractual rights and therefore have the unintended consequence of restricting access to financing for suppliers. This is because the uncertainty in the proposed drafting around requiring suppliers to retain control of their assets could undermine access to collateral for creditors.

Our response and decision

We are not seeking to restrict access to finance for suppliers. If a supplier's asset is used as collateral, the guidance explains that, to comply with the FRP, we expect the supplier to have sufficient control over that asset so that it can rely on it legally and enjoy the benefit of it. Therefore, we do not expect that the amendments to the guidance should impact on the ability of the supplier, parent or any third-party company to use the asset in question as collateral.

This does not mean that the rights of a counterparty can be undermined. The supplier should control its assets to the extent that contractual terms providing it with control over its asset allow. The counterparty will be able to redeem assets pledged as collateral under the conditions defined in the applicable contractual terms where relevant.

For the avoidance of doubt, we are adding a provision in the guidance explaining that the guidance should not impact the ability of counterparties to redeem suppliers' assets pledged as collateral. However, if these agreements do not directly involve suppliers – for example if the agreement is between the supplier's parent company and a counterparty – they should be complemented by parallel arm's length agreements between the supplier and its parent company.

Customer credit balances

Stakeholder views

Some stakeholders have informed us that CCBs are not accounted for separately from other revenues and that complying with the proposed updates to the guidance would entail a change to their accounting practices.

Some suppliers have questioned whether the obligation would apply to the non-domestic as well as the domestic sector. They have noted that non-domestic customers tend to pay bills monthly based on actual consumption, and that customer credit balances are not prevalent in the non-domestic sector.

Our response and decision

We have seen instances of poor practice by suppliers where CCBs are concerned, and this has resulted in significant mutualised cost. With this in mind we believe it is necessary for suppliers to be able to accurately account for the CCBs they hold and be able to demonstrate that they are not overly reliant on CCBs as working capital at any point in time.

While credit balances are not prevalent in the non-domestic sector, we are aware of instances when non-domestic customers have credit balances. Therefore, we do not believe non-domestic suppliers should be exempted.

Implementation period

Stakeholder views

Several stakeholders have noted that some time would be required to replace informal intra-group agreements with formal contracts. This would entail contributions from multiple teams including legal advisors to draft new contracts, with estimates ranging between three to nine months.

Our response and decision

To comply with the OCP and FRP, we would expect suppliers to already own or have sufficient control over its material economic and operational assets. Therefore, the updated guidance takes effect from the date of publication of this decision and we do not consider that transitional arrangements are necessary for the majority of suppliers. However, noting that some suppliers have told us they will need time to make some changes to their existing arrangements to become compliant, we request suppliers notify us where that is the case and present an action plan that will ensure timely compliance as set out in more detail below.

Next steps

We have published the updated guidance alongside this letter, and this takes effect from the date of publication of this decision. As noted above, we do not consider that transitional arrangements should be necessary for the majority of suppliers. However, as above, noting that some suppliers have told us they will need some time to make changes to become fully compliant, we will work with these suppliers to agree action plans that will ensure timely compliance. Any supplier in this position should contact us via their Account Manager or Retail.Conduct@ofgem.gov.uk to inform of this by Monday 6 June, and present an action plan by Monday 20 June.

As indicated in our original consultation, we are also planning to make licence changes to include more specific rules around the control licensed suppliers must have over their material economic and operating assets. These changes, which we plan to consult on in June, are intended to further clarify the arrangements and protections we expect suppliers to have in place.

Yours sincerely,

Cathryn Scott

Director – Enforcement and Emerging Issues

The Office of Gas and Electricity Markets
10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000
www.ofgem.gov.uk

Annex: Extracts from the finalised Guidance on the Operational Capability Principle and Financial Responsibility principle to show changes since consultation

Drafting amended since our consultation is underlined. We have published the complete finalised guidance separately alongside this letter.

Guidance on the Operational Capability Principle

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, equipment, IT system and brand name, used or needed to run its supply business.

Guidance on the Financial Responsibility Principle

3.8 Without in any way limiting a supplier's obligations under its Licence or this Guidance or otherwise, nothing in this Guidance shall restrict the ability for wholesale sellers (including commodity traders and wholesale suppliers), lenders or other finance providers (or their agents) to a supplier from enforcing, reserving or waiving their rights in accordance with the contractual terms of any hedge, wholesale supply, funding or other financing arrangement entered into with such supplier, including enforcing security over such supplier's assets that secure such supplier's obligations to such wholesale sellers, lenders or other finance providers (or their agents) in such manner as such wholesale sellers, lenders or other finance providers (or their agents) see fit.