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# **Review of Ofgem's regulation of the energy supply market**

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## Contents

<b>Foreword</b>	<b>1</b>
<b>Executive summary</b>	<b>2</b>
<b>1 Introduction</b>	<b>14</b>
<b>2 Ofgem's approach to regulation of the energy supply market</b>	<b>17</b>
2.1 Context for Ofgem's regulation of the energy market	17
2.2 The supplier lifecycle	19
2.3 Entry arrangements	20
2.4 Ongoing requirements	23
2.5 Exit arrangements	26
2.6 Corporate governance, assurance, and other constraints on companies' behaviour	29
2.7 The price cap	35
2.8 Conclusion	41
<b>3 The root causes and costs of supplier failure</b>	<b>43</b>
3.1 Context of entry and exit	46
3.2 Analysis of companies' ability to absorb shocks	47
3.3 Business models and evidence of 'systemic' risk	58
3.4 Conclusion	64
<b>4 Assessment of Ofgem's role in recent supplier failure</b>	<b>66</b>
4.1 Approach to regulating the market	66
4.2 Mitigating the costs of failure through a different regulatory approach	67
4.3 Regulatory precedents	70
4.4 Approach to monitoring the market	71
4.5 Findings on the cultural and operational drivers of Ofgem's decision-making	73
<b>5 Recommendations and lessons learnt</b>	<b>81</b>
<b>A1 Ofgem market review terms of reference</b>	<b>86</b>

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<b>A2</b>	<b>Ofgem's historical and policy environment</b>	<b>88</b>
<b>A2.1</b>	<b>Ofgem's statutory duties</b>	<b>88</b>
<b>A2.2</b>	<b>Historical market context</b>	<b>89</b>
<b>A2.3</b>	<b>Policy context</b>	<b>95</b>
<b>A3</b>	<b>The Supplier Licensing Review</b>	<b>98</b>
<b>A3.1</b>	<b>Ofgem's assessment of policy options at the Supplier Licensing Review</b>	<b>98</b>
<b>A3.2</b>	<b>Measures introduced in the ongoing arrangements and exit requirements section of the Supplier Licensing Review</b>	<b>100</b>
<b>A4</b>	<b>Renewables Obligation and industry levies</b>	<b>102</b>
<b>A4.1</b>	<b>The Renewables Obligation</b>	<b>102</b>
<b>A4.2</b>	<b>Other industry levies and policy costs</b>	<b>102</b>
<b>A5</b>	<b>Additional data on financial resilience</b>	<b>104</b>
<b>A5.1</b>	<b>Current ratio during the pandemic period</b>	<b>104</b>
<b>A5.2</b>	<b>Customer credit balance for small suppliers during the pandemic period</b>	<b>104</b>
<b>A5.3</b>	<b>Deferred income as a percentage of total assets</b>	<b>104</b>
<b>A5.4</b>	<b>Correlation between customer growth rates and total equity for failed companies in our sample</b>	<b>105</b>
<b>A5.5</b>	<b>Profitability for small suppliers</b>	<b>107</b>
<b>A6</b>	<b>Supplier hedging arrangements</b>	<b>108</b>

## Figures and tables

Box 1.1	Oxera recommendations	12
Figure 2.1	✂	19
Figure 2.2	Entry and exit of domestic suppliers	23
Box 2.1	✂	32
Box 2.2	Auditors' statement case study 2: Avro	32
Figure 2.3	Composition of the price cap for dual fuel (£/year)	37
Figure 2.4	Evolution of the Default Tariff Cap (dashed line) compared with cheaper tariffs and the direct fuel price component (£/year)	38
Figure 2.5	Direct fuel component of the price cap, on a daily basis and based on rolling six-month averages (£/year)	39
Table 3.1	SoLR levies for failures since September 2021 and companies covered in our sample (bold)	45
Figure 3.1	Number of suppliers over time	46
Figure 3.2	SoLR levy claims from September 2021 (£)	47
Figure 3.3	✂	48
Figure 3.4	✂	48
Figure 3.5	✂	48
Figure 3.6	✂	49
Figure 3.7	✂	49

Figure 3.8	✂	49
Table 3.2	Deferred income as percentage of current assets for the period FY2015–20 and as percentage of forecast current assets for selected months	50
Figure 3.9	Equity balances for small suppliers, FY 2016–20	51
Figure 3.10	Equity balances for medium suppliers, FY 2015–20	51
Figure 3.11	Equity balances for large non-legacy suppliers, FY 2016–20	52
Figure 3.12	Equity balances for large legacy suppliers, FY 2015–20	52
Figure 3.13	✂	53
Figure 3.14	Pre-tax domestic supply margins of the large legacy suppliers, combined electricity and gas, 2009–20	54
Figure 3.15	Profitability for large and medium non-legacy suppliers, combined electricity and gas 2015–21	55
Table 3.3	Overview of the failed companies in Oxera's sample	57
Figure 3.16	Seasonal trends in customer credit balances (dark green), with minimum (light green) and average (mid green)	59
Figure 3.17	New entry into the supply market (bars, left axis) against wholesale spot prices (line, right axis)	60
Figure 3.18	Market share of fast-growing companies (left axis) and wholesale costs (dashed line, right axis)	61
Figure 3.19	Wholesale spot prices (line) against supplier failures (bars)	62
Figure 4.1	✂	73
Box 4.1	Chronology of decision-making on measures to reduce cost mutualisation as part of the Supplier Licensing Review	77
Figure 5.1	Regulatory policy options to reduce the risk and cost of future supplier failures	81
Figure A2.1	Electricity supply market share (domestic), 2004–21	91
Figure A2.2	Gas supply market share (domestic), 2005–21	92
Figure A2.3	Rate of switching in the electricity and gas supply markets	93
Figure A2.4	Failed domestic suppliers per year from 2010	94
Figure A2.5	Daily electricity and gas spot prices (£/MWh, pence/therm)	95
Table A3.1	Ofgem's assessment of broad policy options in the 2018 Supplier Licensing Review on entry arrangements	99
Figure A5.1	✂	104
Figure A5.2	✂	104
Figure A5.3	✂	104
Figure A5.4	✂	104
Figure A5.5	✂	104
Figure A5.6	Customer growth rates (dashed line, left axis) and total equity (right axis) for Utility Point	105
Figure A5.7	Customer growth rates (dashed line, left axis) and total equity (right axis) for Pure Planet	105
Figure A5.8	Customer growth rates (dashed line, left axis) and total equity (right axis) for PFP Energy	106

Figure A5.9	Customer growth rates (dashed line, left axis) and total equity (right axis) for People's Energy	106
Figure A5.10	Profitability for small suppliers, combined electricity and gas 2015–21	107
Box A6.1	Disclosed information on hedging arrangements	108
Figure A6.1	✂	109
Table A6.1	Hedging arrangements for failed suppliers	110
Table A6.2	✂	111

## **Foreword**

The Ofgem Board is ultimately accountable for the regulatory regime for energy, and this requires us to have an objective and clear line of sight into critical areas of the organisation's governance and performance. Given the volume of recent supplier failures in the UK retail energy market, the Board commissioned an Independent Review to analyse the root causes of, and learn any lessons from, these failures, with a view to shaping better regulation in the future.

We have acted on behalf of the Board to oversee the appointment of independent consultants and to ensure that the review addressed the key points set out in the terms of reference. This Independent Review has been delivered at pace, reflecting the priority which the Ofgem Board places on its findings. The competitive tender was released in December 2021, Oxera was appointed in January, and we received the final report in May 2022.

The Board fully accepts the findings of this Independent Review. We are now focused on ensuring that action is taken to learn lessons and strengthen the regulatory regime going forward, building on work already in hand.

Myriam Madden

Christine Farnish

(Ofgem Non-Executive Board Members)

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## Executive summary

### Introduction

Over the course of 2021, global gas prices rose to unprecedented levels. Over autumn and winter 2021/22, this has pushed around 30 suppliers (as of 31 March 2022) to insolvency, with a combined market share at the point of failure of more than 10% (around 4m customers). Customers have been transferred to new suppliers or, in the case of Bulb, to a court-appointed Special Administrator. The costs associated with the customer transfers that have resulted from these failures are significant, and are or will be borne by consumers.

As regulator of the energy supply market in Great Britain (GB), Ofgem has commissioned Oxera to carry out an independent 'lessons learnt' review of its role in the recent supplier failures in the UK retail energy market. We assess Ofgem's role in recent supplier failures through:

- the system of licensing and other requirements that it places on energy suppliers. These, collectively, shape the structure of the market;
- its ongoing monitoring of the market, which helps it to determine an appropriate regulatory policy direction.

At the outset, we note that our review is grounded in the statutory duties of Ofgem.<sup>1</sup> Ofgem's principal objective across all aspects of its regulation of electricity and gas markets is:

to **protect the interests of existing and future consumers** in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems.<sup>2</sup> [emphasis added]

In addition, it has relevant secondary duties to promote effective competition where this best protects the interests of consumers;<sup>3</sup> to have regard to the need to secure that licence-holders are able to finance<sup>4</sup> the activities that are the subject of obligations on them; and to have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>5</sup>

### Approach to the lessons learnt review

It is important to note the scope and approach of this lessons learnt review. We aim to avoid focusing unduly on 'fixing' specific regulatory mechanisms that may have contributed to recent supplier failures. This would lead to a disproportionate focus on specific historical problems, distracting from creating a robust and flexible approach to regulation that is targeted at the problems of tomorrow. In other words, the lessons to learn are about how to drive better

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<sup>1</sup> Where relevant, we also consider Ofgem's duties in light of primary legislation—e.g. the introduction of the retail price cap in 2018.

<sup>2</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.3, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>3</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.4, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>. Ofgem (2013), 'Our powers and duties', 19 July, para. 1.5, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>4</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.6, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>5</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.7, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.



regulation (i.e. regulation that protects the interests of consumers more effectively).

### **Ofgem's approach to regulating the energy supply market**

From this perspective, the incidence of supplier failure that has been observed since autumn 2021 is not a failure of the regulatory regime per se. Indeed, we note a number of regulatory documents and board papers that state that it was never Ofgem's intent to have a zero supplier failure regime. Instead, the regulatory regime should be judged on whether the regulatory policy positions taken and implemented by Ofgem in the retail market over time have been supported by robust evidence that they were in the consumer interest. We observe that Ofgem's regulatory approach to the retail market has been to promote competition wherever possible, through encouraging entry of new suppliers and lowering barriers to entry. We explore the market and policy context that has driven this approach below.

We identify three salient historical characteristics of the market that have provided important context for this policy position. They are: i) the persistent dominance of the 'big six' large legacy suppliers; ii) few instances of supplier failure, up to 2017; iii) relatively stable wholesale prices from 2010 to the end of 2020 that provided a benign backdrop against which the current price volatility has proved to be unprecedented.

Against this understanding of the market context, we note important features of the policy context. First, we note that, as well as complying with statutory duties and primary legislation (e.g. in relation to the retail price cap), Ofgem acts with regard to policy direction from the Department for Business, Energy & Industrial Strategy (BEIS) and its predecessors, as set out in its statutory duties.<sup>6</sup> This has both direct and indirect effects on the discharge of Ofgem's duties. The direct effects drive how Ofgem designs specific regulatory interventions, such as environmental levies that need to be recovered as part of retail tariffs. The indirect effects are also potentially important—and it is not always possible to disentangle Ofgem's regulatory philosophy from the direction of policy set by BEIS. For example, Ofgem's emphasis on the promotion of competition as a means of protecting consumers, and incentivising innovation to deliver the energy transition, is aligned with the corresponding focus of BEIS.<sup>7</sup>

Second, the findings of the detailed Energy Market Investigation assessing the sector since liberalisation, which was undertaken by the Competition and Markets Authority (CMA) in 2014–16, played an important role in informing the perceived sources of market failure in the energy retail market. In particular, the CMA identified a £1.4bn per annum consumer detriment from high prices in energy retail markets. In interviews, several stakeholders have referenced this headline as having substantiated the policy and regulatory focus on competition as a means of reducing consumer detriment in the retail market. Moreover, the CMA's citation of harm to consumers from 'poor quality of service' and 'restrictions on innovation' has underpinned the regulatory focus on delivering competition and higher rates of switching as a means of incentivising higher quality standards and rates of innovation in the industry.<sup>8</sup>

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<sup>6</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.9, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>7</sup> For example, see Department for Business, Energy & Industrial Strategy (2021), 'Energy Retail Market Strategy for the 2020s. Helping consumers on their net zero journey', July, pp. 4–5.

<sup>8</sup> Competition and Markets Authority (2016), 'Energy market investigation: Final report', 24 June, p. 48.

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Against this market and policy context, we assess how Ofgem has approached the regulation of the sector over time. Considering the overall package of incentives that a licensee will have faced across its lifecycle, we find that Ofgem's approach to regulating the market created the opportunity for suppliers to enter the market and grow to a considerable scale while committing minimal levels of their own equity capital. This was justified largely on the grounds of increasing the degree of competition in the market, and created the opportunity for prospective suppliers to enter the market on the basis of a 'free bet'. By pursuing a high-risk/high-reward business model, such suppliers would benefit from any upside, while being able to exit at no or minimal cost if the downside materialised.<sup>9</sup>

This regulatory approach does not seem to have been justified by an evidence-based assessment of trade-offs or a detailed understanding of the supplier business models and supplier incentives that arose as a consequence of Ofgem's regulatory approach. In the pursuit of higher levels of competition, Ofgem did not seek evidence on trade-offs on an ongoing basis (e.g. between competition and financial resilience). Nor did Ofgem sufficiently test whether the economic incentives at the point of entry and exit were aligned with the protection of the consumer interest, through promoting effective competition. For example, Ofgem did not fully analyse systemic risks that might arise, and test how the probabilistic costs of failure would rise as new players with low levels of financial resilience acquired growing market shares, especially after 2015.

In the absence of detailed proactive regulation and/or monitoring, this left Ofgem reliant on industry codes and companies' governance arrangements—in particular, directors' financial statements and auditors' statements—to foster financial resilience. A sample of publicly available audit statements from suppliers shows that these did not provide sufficient independent assurance to obviate any need for Ofgem to undertake its own monitoring and scrutiny of energy suppliers.<sup>10</sup>

In parallel, the Domestic Gas and Electricity (Tariff Cap) Act 2018<sup>11</sup> created a duty for Ofgem to design and implement a price cap for customers on a standard variable tariff (SVT)—a customer segment constituting around 60% market share. Noting the inconsistency with what is otherwise a largely procompetitive approach to regulation, we identify some concerns with the implementation of the price cap, which had the scope to introduce competitive distortions, in the context of rising wholesale prices. These include the following.

- It was Ofgem's explicit intent in calibrating the price cap that it should be 'a tough cap that ensures loyal consumers pay a fair price that reflects efficient costs'.<sup>12</sup> To the extent that the price cap was calibrated to deliver stretching levels of cost efficiency, it may have left suppliers with insufficient headroom to deal with shocks.

<sup>9</sup> We also identify a potential loophole around the transfer of financial derivatives to group/parent companies, which is being remediated, through a combination of legislation introducing a Public Interest Business Protection Tax (which is intended to be temporary) introduced by government and new regulation by Ofgem.

<sup>10</sup> This assessment does not relate to the audit processes as a whole. Rather, this references information contained within the audit statements as published in companies' annual reports, and whether this information could be considered a reasonable substitute for Ofgem carrying out its own regulatory assurance of supplier financial resilience.

<sup>11</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, accessed on 4 February 2022 at:

[https://www.legislation.gov.uk/ukpga/2018/21/pdfs/ukpga\\_20180021\\_en.pdf](https://www.legislation.gov.uk/ukpga/2018/21/pdfs/ukpga_20180021_en.pdf).

<sup>12</sup> Ofgem (2019), 'Our strategic narrative for 2019–23', July, p. 14.

- In the event that wholesale prices rise above the wholesale cost allowance provided for in the Default Tariff Cap, the cap effectively acts as a ceiling, preventing tariffs from increasing and preventing suppliers from being able to fully recover wholesale costs for new or unhedged customers until the price cap is reset.
- The periodicity of the price cap, which is revised every six months, exposes suppliers to this gap between spot energy prices and the fixed remuneration for wholesale costs within the fixed cap, for a significant period of time.
- The interaction of the price cap methodology as implemented by Ofgem and the SoLR regime leads to the gap between the maximum price and the (higher) wholesale price being mutualised through future customer bills.

We have identified a number of factors that have contributed to the root causes and costs of the extensive supplier failures in the market in 2021.

### **Business models of energy suppliers**

In the first instance, to distil lessons about the causes of supplier failure, we have gathered evidence from stakeholders and undertaken quantitative analysis to identify two business models that were pursued to varying degrees by some fast-growing non-legacy suppliers.<sup>13</sup> While these models were never identified in the following terms by Ofgem or by companies, we find that they have certain common features that characterised the business models of many of the suppliers that grew strongly in the period up to the 2021 failures. Specifically, these models are as follows.

- A **growth** model, under which businesses relied on receiving customer balances before delivering services, used these prepayments to fund the ongoing costs of the business and to act as a buffer against any short-term shocks, and relied on growth in customer balances as a result of a growth in the customer base to keep ahead of future liabilities.
- A **timing** model, under which suppliers undercut hedged rivals by entering at favourable moments in the market, entering into long-term supply agreements with customers based on prevailing low spot rates, and reducing costs by reducing the coverage or duration of hedging arrangements.

In both cases, it seems plausible from our assessment that these models were followed by some suppliers, given the incentives that they faced due to the regulatory regime. We also find that the empirical evidence provides some support for the pursuit of these models—in particular, the growth model. The use of these business models should not be seen as mutually exclusive, and several challenger supplier business models may have represented a hybrid of the two. Collectively, these models exposed suppliers to supply or demand shocks and thereby contributed to market instability.

We have considered the implications of a conglomerate business model in energy retail (i.e. the provision of joint services, such as integrated energy and telephony services). We note that, to the extent that a conglomerate business model, or a vertically integrated business model, leads to higher or lower resilience of the energy supply licence-holder, this would be of interest to Ofgem in its future monitoring of the resilience of the sector. It may be

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<sup>13</sup> The description of these business models does not represent a taxonomy of all supplier business models in the retail market.

appropriate for Ofgem to require financial reporting of energy retail activities on a stand-alone basis, even for smaller suppliers (as we understand is currently the case for larger suppliers).

### Implications for systemic risk

In terms of the causes of, and costs associated with, recent supplier failures, suppliers that followed such business models are likely to have faced high exposure to shocks such as the recent wholesale price volatility. In the round, we can make the following observations across these financial models, to the extent that they were present in the market:

- they reduced the financial resilience of the sector relative to more sustainable long-term business models;
- they created an environment in which a large shock to the wholesale price would lead to *correlated* failure of multiple suppliers, increasing with the size and persistence of the wholesale price shock;
- in combination with the price cap and the SoLR safety net, the larger the shock to the wholesale price, the greater the mutualised costs per customer that need to be recovered through future SoLR levies—i.e. there is a positive *correlation* between the risk of failure and the cost of failure.

### Assessment of the financial resilience of suppliers

Consistent with our understanding of supplier business models, we have identified that a number of suppliers<sup>14</sup> that would go on to fail shared many of the following financial and operational characteristics: (i) negative equity balances in the years leading up to their failure; (ii) poor liquidity (current ratios and low levels of working capital); (iii) over-reliance on their customer credit balances to finance their operations; and (iv) either unhedged, or not substantively (i.e. more than 50% over nine months or more) hedged, positions.

These factors limited suppliers' ability to absorb shocks amid demand uncertainties and rapid and sustained increases in wholesale energy prices. Moreover, it should be noted that negative equity balances lower the opportunity cost of exit, where investors can walk away from net liabilities and the potential losses of customer credit balances due to the mutualisation of costs as part of the SoLR process.

Through the combination of the systemic risks set out above, the market that had emerged by 2020/21 did not prove resilient in the face of an unprecedented rise in wholesale energy prices. This was exacerbated by:

- a lag in the pass-through of wholesale fuel costs in retail energy prices—in particular, a six-month price cap based on allowed wholesale prices that have been far below prevailing spot prices from September 2021 onwards, and a SoLR process that has mutualised this cost differential across future bill payers in the event of supplier failure;
- the ability of owners of energy supply companies to extract in-the-money financial derivatives (or other assets), and then declare the supplier insolvent;

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<sup>14</sup> The sample of failed suppliers chosen corresponds to £1.5bn of SoLR levy claims, accounting for 82% of all SoLR claims made between September 2021 and December 2021. It covers around 60% of customers affected by supplier failures.

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- low levels of financial resilience caused by some suppliers' pursuit of riskier business models.

The consequence has been a high mutualised cost for GB bill payers, at the point of exit, via the SoLR claims process. The majority of this cost to date (up to 22 December 2021) has been due to the 'wholesale' cost—the gap between the Default Tariff Cap and the wholesale price of energy that it costs to take on the customers of insolvent suppliers.

Next we turn to a number of the lessons that our review identifies that Ofgem can take forward in how it approaches the regulation of energy supply—in relation to both specific policies and its broader framework for making and implementing decisions on policy.

### **Assessment of Ofgem's role and its effectiveness in regulating the market**

To remediate the risk of supplier failures that subsequently occurred, there were several regulatory options that could have mitigated either the risks of failure, the costs of failure, or both.

These are:

- requiring a substantial commitment of shareholder equity prior to market entry, with sufficient monitoring of dividends to ensure that suppliers retained 'skin in the game' and had something to lose on market exit, to reduce moral hazard;
- setting and monitoring minimum levels of capital adequacy, in line with growth in suppliers' customer books, on an ongoing basis;
- requiring and verifying third-party or parent company guarantees that protected prepaid customer balances—or otherwise limiting the use of prepaid customer balances as working capital;
- requiring third-party or parent company guarantees that protected Renewables Obligation (RO) sums—or influencing government to require more frequent settling of these balances;
- being assured, through credible information received from suppliers and ongoing stress-testing, that suppliers' arrangements to mitigate demand- and supply-side shocks were fit for purpose;
- requiring a higher degree of assurance from directors of a supplier in relation to its business model, how its cash flow position has evolved, and how risks are managed (including hedging policies);
- requiring the company's auditor to write a report to the regulator annually on their assessment of solvency and any risks to it.

Another key measure already being implemented by Ofgem is requiring suppliers to have ownership or control over the assets that they need to run and operate their business, including hedges.

Individually, or as a collective package, these measures would have led to a sector in which (i) all suppliers were capitalised to better absorb shocks to supply or demand/bad debt; and (ii) by requiring suppliers to have 'skin in the game', they would have been better incentivised to pursue more sustainable

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business models and avoid costly failure (in terms of losing shareholder capital).

However, such changes would also have raised barriers to entry and required a number of players that had already entered the market to either substantially change their business model or exit the market. Switching rates—which had been highlighted in the CMA's Energy Market Investigation as a key mechanism to improve market outcomes—would probably have decreased if a market with fewer, more financially resilient players had priced at higher levels (reflecting their higher costs).

It is important that Ofgem does not reactively swing from one end of the competition-resilience spectrum to the other. Rather, Ofgem should determine the retail market that it considers will best meet its statutory objectives—in particular, its primary duty to protect the consumer interest, and priorities in the future policy environment (e.g. net zero), and accordingly assess the characteristics of suppliers that would be desirable in such a market. Its future approach to regulation should then enable the relevant business models of such suppliers and preclude alternatives. In so doing, Ofgem will need to explicitly consider the role of competition in a sustainable, long-run steady state.

### **Assessment of costs of failure**

Up to December 2021, £1.8bn of SoLR levy claims were approved by Ofgem, and these are being recovered from consumers over the period April 2022–September 2022. Forecasts by Ofgem submitted in response to the 'Energy pricing and the future of the Energy Market' Inquiry held by the Business, Energy and Industrial Strategy Committee forecast total claims (including, and not incremental to, the £1.8bn) of £2.2bn–£2.4bn.<sup>15</sup> Many of the headlines on the costs of recent supplier failures conflate the SoLR levy claims (i.e. the £68 average increase in the April 2022 Default Tariff Cap) with the cost to the consumer of supplier failures that could have been avoided if Ofgem had taken a different approach to regulating the market. This is unlikely to be accurate.

Developing a robust quantification of the proportion of costs that might have been avoided if specific measures had been taken, and what the optimal bundles of such measures would be, falls outside the scope of this review. Such an analysis would require the financial resilience of the sector to be modelled under a number of plausible regulatory counterfactuals. It would also require all relevant costs to have been realised, which is not currently the case. However, from our review of evidence to date, we identify the following sources of costs that could have been avoided (although not necessarily in full)<sup>16</sup> had Ofgem adopted a different approach to regulation:

- the economic value of assets lost to customers through insolvency proceedings;
- the economic value of assets lost to customers where these were transferred outside of the regulatory ring-fence prior to a supplier failure—in

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<sup>15</sup> Business, Energy and Industrial Strategy Committee (2022), 'Ofgem written evidence: Call for Evidence on energy pricing and the future of the Energy Market', 11 March, para. 49, accessed on 8 April 2022 at: <https://committees.parliament.uk/writtenevidence/107169/html/>.

<sup>16</sup> Measures to foster a more financially resilient market may have reduced the degree of competitive pressure in the market, and led to customers paying higher prices in the years leading up to the recent supplier failures in 2021.

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particular, financial derivatives such as commodity price hedging instruments;

- the value of prepaid customer credit balances held by a supplier at the point of failure;
- the value of unmet RO payments at the point of failure;
- costs associated with the transfer of customers from one supplier to another through the SoLR process;
- costs from the Special Administration Regime (SAR) process (as yet unknown<sup>17</sup>).

We note that these cannot be directly related to the figures currently in the public domain on the level of mutualised cost. The publicly available figures are:

- the £1.8bn in SoLR levy claims made since September 2021—split into wholesale (93.4%), customer credit balance (3.6%), working capital (2.6%), and onboarding and migration;
- the £1.7bn loan facility currently available to the administrators of Bulb under the SAR regime;
- any future SoLR claims or extension of additional lines of credit to companies under the SAR regime.

The cost to taxpayers or bill payers of loan facilities made available from the SAR process will not be known until the point of divestment, and therefore it is not possible to estimate a direct cost at this point in time. The same holds for bill payers/taxpayers in the event of additional SoLR levy claims or the extension of additional lines of credit to companies under the SAR regime.

This leaves the £1.8bn in SoLR levy claims made from September 2021. Of these, the following components of SoLR levy claims can be considered as direct costs borne by customers that could have been avoided, had Ofgem regulated the market differently:

- SoLR levy claims for customer credit balances (£66m)—customer balances collected by the failed supplier that need to be covered by the new suppliers;
- SoLR levy claims for working capital (£48m)—financing or opportunity costs incurred by the appointed SoLR through the time lag between incurring other costs and being recompensed through the SoLR levy;
- SoLR levy claims for onboarding and migration (£6m)—costs to transfer customers to the new supplier.

The remaining £1.7bn in SoLR levy claims corresponds to wholesale claims—the gap between the Default Tariff Cap and the wholesale price of energy that it costs to take on the customers of insolvent suppliers. Our assessment is that, while some of these costs could have been avoided through a different

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<sup>17</sup> The cost to the taxpayers and/or bill payers will not be known until the divestment of Bulb is undertaken.

approach to regulating the market, a proportion of wholesale claims represent a transfer of costs among customers.<sup>18</sup>

This is not to say that wholesale claims should not be considered as costs arising from Ofgem's regulatory approach—it is likely that a different approach to regulation could have averted some of the market entry and subsequent failures that led to these costs. However, it is unlikely that this £1.7bn gap could have been costlessly eliminated from the consumers' perspective. Policies that reduced the magnitude of wholesale cost claims—such as more stringent financial regulation, more frequent updating of the price cap or allowing a greater headroom allowance within the price cap—could have reduced consumer welfare prior to 2021 through higher price levels.<sup>19</sup>

It is important to note that, even if a proportion of mutualised costs can be characterised as transfers between groups of consumers, rather than costs that could have been avoided through a different approach to regulation, an unplanned transfer that imposes unexpected costs on some customers and creates uncertainty is likely to represent a detriment to consumers.

### **Assessment of Ofgem's role and effectiveness in monitoring the market**

We have reviewed how Ofgem's approach to monitoring the market has evolved over time, as shown by a) information flows between suppliers and Ofgem; b) collaboration between operational teams within Ofgem (e.g. the Retail team, the Retail Compliance and Monitoring team, and the Regulatory Finance team); and c) information flows between the operational teams and the senior leadership team as well as the board.

We identify three key messages from our review of how Ofgem's approach to monitoring the market has developed.

- First, the level of monitoring of financial resilience carried out by Ofgem prior to 2020 was reactive, and limited to monitoring suppliers that had already exhibited signs of financial distress.
- Second, related to the above, at the time when the Supplier Licensing Review was undertaken in 2018, Ofgem had a limited available evidence base to make trade-offs between accessing the benefits of competition and maintaining financial resilience in the sector.
- Third, when it became apparent that the sector was likely to enter a period of financial distress, Ofgem was able to rapidly introduce a Request for Information (RFI) of the data that it would require to assess supplier financial resilience (in early 2020), and use this data to carry out relevant analyses to support its monitoring of the market (from September 2021).<sup>20</sup> By this time, the sector was experiencing a rising number of exits.

Overall, Ofgem's approach to assessing financial resilience in the sector has been reactive rather than proactive. Ofgem did identify risks to the sector that could have been addressed with earlier intervention, but in some cases was slow to design new policies. For example, according to board papers, Ofgem's

<sup>18</sup> Specifically, there are likely to have been transfers of costs from customers of failed suppliers to the total customer base (via mutualisation) and over time, i.e. from customers in October 2021–March 2022 to customers in April 2022–September 2022.

<sup>19</sup> For reference, in its Energy Market Investigation the CMA estimated the customer detriment arising from adverse effects on competition at £1.4bn p.a. over the period 2012–15. CMA (2016), 'Energy market investigation: final report', 24 June, p. 633.

<sup>20</sup> Ofgem faced a number of compliance issues in relation to its data requests from some suppliers—for example, suppliers not fully responding on a timely basis (see appendix A6).



Supplier Licensing Review—which would encompass considerations of financial resilience—was delayed over the period 2016–17, and consultation began in late 2018.

### **The effectiveness of Ofgem's approach to regulatory policy**

As we note above in relation to the perspective of our review, our objective is not to focus on specifying a particular regulatory approach that solves the problems of yesterday. Instead, we aim to provide Ofgem with recommendations for how to strengthen the effectiveness of its regime.

Maintaining a 'lessons learnt' perspective to this review, the strength of a regulatory regime is in calibrating the desired incentives for market participants, to achieve intended outcomes while minimising the risk and costs of unintended outcomes. In the case of the present supplier failures, the challenge was that it was part of the regulatory philosophy—reinforced by the policy environment—that low barriers to entry, which led to a high number of market participants, would protect existing and future consumers' interests. Specifically, it was intended that a high degree of switching would deliver in the consumers' interests by increasing choice and incentivising the delivery of efficiency and innovation. However, the weakness of the regime was that:

- there was no ex ante framework for defining and measuring consumer outcomes. We note that there are many elements that could constitute consumer interest—including intergenerational interest. These include the following: quality of service; convenience; availability of choice; delivery of net zero objectives in the economy; value for money; stability and predictability in tariffs; and protection of credit balances;
- there was no evidence of quantitative impact analysis being undertaken to inform policy choices at the time of significant regime changes (e.g. the 2018 Supplier Licensing Review) to test the extent to which the intended outcomes of increased efficiency, innovation and better quality of service (among others) had been achieved without raising negative consequences, such as risks to customer credit balances to date;
- there was no subsequent ongoing market monitoring with the view that the costs and benefits of a regulatory regime are dynamic. For example, the benefits of competition may accrue more than proportionately with early entrants in a highly concentrated market and then taper off as competition increases to unsustainable levels (e.g. with a high number of loss-making firms). Taking a dynamic view in monitoring market outcomes is therefore important in understanding how the benefits of competition, and the risks as well as costs of supplier failure, evolve over time.<sup>21</sup>

### **Recommendations**

Moving beyond specific regulatory interventions to minimise the impact of recent supplier failures, we can draw a broader set of lessons learnt and recommendations from an assessment of the causes of recent supplier failures, as set out in Box 1.1.

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<sup>21</sup> An understanding of the market context informs an important distinction between the risks of failure and the costs of failure, as we examine in this report. In relation to the risks of failure, Ofgem's minimal experience of supplier failures prior to 2018 supported a perception that the probability of supplier failure—and concurrent failures of a large number of suppliers—was low. As regards the costs of failure, we understand from conversations with Ofgem stakeholders that the hypothetical failure that Ofgem anticipated was of small player(s) with small customer books, such that low costs of failure were anticipated.

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### Box 1.1 Oxera recommendations

1. The determination of the **consumer interest**—of both existing and future consumers—is key. Where policy trade-offs are to be made, they should be guided by an explicit weighing up of the expected costs and benefits to consumers along dimensions of consumer interest that are defined ex ante.
2. The definition of the criteria and the expected characteristics of **effective competition** is valuable, to provide a framework against which to assess whether intended outcomes are being achieved on an ongoing basis. Analysis of effective competition should consider whether the market can sustain the number of market players in the longer term, e.g. by examining ongoing profitability. It is important to emphasise that, in so doing, the intention is not to switch the focus to a zero supplier failure regime, but rather to understanding the risks of failure ex ante. Another feature of effective competition that Ofgem should consider is the extent to which competition delivered innovative business models that are in the consumer interest—with a specific focus on furthering the net zero objectives set by the government.
3. In terms of the process that is adopted for decision- and policymaking going forward, it is important that the identification and selection of options is then guided by these ex ante frameworks. Specifically, it is important that the qualitative and quantitative criteria that are decided on for the delivery of the consumer interest and effective competition are then used to make **evidence-based policy trade-offs**, including in the competition-resilience spectrum. In developing the evidence to make these trade-offs, Ofgem should consider how it can most effectively use data and digitalisation to support them.
4. The nature of this evidence base needs to be understood as drawing on **cross-disciplinary skills** in Ofgem. A combination of skills from the energy retail industry, economic and financial analysts, and regulatory expertise is needed to understand the *demand side*—i.e. knowledge of industry retail business models, incentives, and financial and operational performance—as well as the *supply side*—i.e. wholesale price movements and supply chains. This may necessitate overcoming **horizontal frictions in information flows** that have taken the form of divisional silos between different teams at Ofgem.
5. Furthermore, we identify some evidence of **vertical frictions in information flows** within Ofgem. In practice, it is not feasible for members of the board to have the same in-depth knowledge as the operational and management teams; notwithstanding this, the board needs access to timely information that drives decisions by the operational and management teams. Therefore, vertical information flows need to effectively prioritise critical information to facilitate the board's understanding of strategic policy choices and its subsequent decision-making. This implies a complex and iterative process of refining information flows between the teams and the board: the board needs to ensure that the framework for prioritisation is clear below it, while the Executive Committee (ExCo) and the directorships need to ensure that critical information is being made available to the board on a timely basis. This means that the board needs to be clear in asking for information, but that teams also need to be agile in selecting and prioritising those sources of information that allow for critical understanding of choices, and allow challenge by the board. The board also needs to ensure that there are appropriate processes in place for important documents to be discussed in board meetings.
6. It has been raised by many stakeholders that the agility and responsiveness of Ofgem in dealing with the recent supplier failures has been exemplary at all levels of the organisation (i.e. the GEMA, CEO, and team management levels) in 'crisis mode' analysis and communications. However, there have been some concerns around **timely information exchange in a business-as-usual environment**. Ofgem could consider undertaking an internal review of business-

as-usual stakeholder relationship and communication processes across Ofgem, BEIS, and other government departments.

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## 1 Introduction

Over the course of 2021, global gas prices have risen to unprecedented levels. This has resulted in a significant and persistent increase in the wholesale price of gas and electricity faced by bill payers in Great Britain (GB) over the period from September 2021 to the time of writing (March 2022). As customers have been protected in the short term from price rises by the Default Tariff Cap or existing long-term agreements, energy suppliers with exposure to current wholesale prices have faced a substantial and growing shortfall between costs and revenues.

Over autumn and winter 2021/22, this has pushed around 30 suppliers (as of 31 March 2022) to insolvency, with a combined market share at the point of failure of more than 10% (around 4m customers). Customers have been transferred to new suppliers or, in the case of Bulb, to a court-appointed Special Administrator. If they have been transferred to a standard variable tariff (SVT) from a more favourable fixed-term contract offered by their failed supplier, customers have also faced a bill increase—notwithstanding that the extent of this increase has been mitigated by the Default Tariff Cap. The historical costs associated with these customer transfers up to December 2021 are accruing as mutualised costs to customers through Supplier of Last Resort (SoLR) levy costs over the period April–September 2022, and any further costs will be borne by future consumers.<sup>22</sup>

As regulator of the energy supply market in GB, Ofgem has commissioned Oxera to carry out an independent review of its role in the recent supplier failures in the UK retail energy market. We assess Ofgem's role in recent supplier failures through the system of licensing and other requirements that it places on energy suppliers, and its ongoing monitoring of the market. Our terms of reference for this review are set out in appendix A1, and can be summarised as follows:

- to investigate the causes of recent UK energy supplier failures in the context of how the energy market has been designed, how it is regulated, and how it functions;
- to assess the ongoing information and evidence base that the energy regulator set in place to facilitate its risk-based decision-making approach to regulating the retail market;
- to investigate the extent to which customer interests were protected effectively by how Ofgem responded to information that was, or could have been, available to it;
- to distil lessons learnt and outcomes-focused recommendations from this review.

To undertake this review, we consider Ofgem's statutory duties, the policy environment within which Ofgem has operated, the characteristics of the retail market that it has regulated, and the overall architecture of the supply market that it has designed. We consider developments in the retail market since the introduction of competition in 1990, but put a particular focus on the period since the Competition and Markets Authority's (CMA) detailed Energy Market Investigation was completed in 2016.

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<sup>22</sup> The level of SoLR levy claims up to December 2021 has led to a £68 average increase per customer for the next Default Tariff Cap period (April 2022–September 2022).

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Having established this context, we then seek to isolate the root causes of recent supplier failures, based on a review of board papers, industry and Ofgem representations and decisions, and quantitative analysis. We relate the root causes identified to the approach that Ofgem took in regulating the retail market. We assess the extent to which Ofgem's approach was consistent with its primary duty to protect the interests of existing and future consumers, and alternative approaches to regulating the sector that might have better promoted this duty.

As part of this review we have examined the following sources of evidence, among others:

- interviews with relevant stakeholders from Ofgem, government and industry;
- supplier licences;
- the Supplier Licensing Review;
- board papers and minutes over the period 2015–21;
- strategy documents written by government and Ofgem;
- precedent from other regulated sectors and markets, based on stakeholder interviews as well as regulatory consultations and decisions;
- the CMA's findings from the Energy Market Investigation;
- the primary legislation introduced by government to implement the SVT cap (later the Default Tariff Cap);
- quantitative analysis of suppliers' financial performance as well as analysis of retail market data—this is based on both public domain information such as financial statements, and several confidential datasets that have been made available for our review by Ofgem.

As context for our review of lessons learnt from suppliers' failures, we note that the gross transfers involved in mutualisation and taxpayer funding are large.<sup>23</sup> However, it is important to note that these values are unlikely to represent the net negative impact on consumers taken as a whole. A proportion of these sums are transfers between customers and over time (e.g. a lag in the pass-through of wholesale costs).

Accordingly, the aim of this report is not to present a comprehensive and fully quantified analysis of the additional costs that have resulted from the recent supplier failures, or of the benefits that might have accrued to customers in earlier years as a result of the market entry of the suppliers that have now failed. Rather, this report seeks to answer the question of why the market evolved as it did, and whether Ofgem understood how the market was developing as well as the implications of those developments on protecting the interests of consumers.

Our review is structured as follows.

- Section 2 sets out the key building blocks of Ofgem's approach to regulation of the energy supply market. Specifically, we discuss the following items in turn. We start with the policy context that will have influenced Ofgem's approach to regulation (section 2.1). Next, we introduce the supplier lifecycle (section 2.2), so as to focus on how regulation evolves from the

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<sup>23</sup> £1.8bn and £1.7bn respectively as of 31 March 2022.

point of entry (section 2.3), to ongoing arrangements (section 2.4), and at the point of exit (section 2.5). We then look at the role of corporate governance and audits (section 2.6), before turning to the role of the price cap within the regulation of retail suppliers (section 2.7).

- Section 3 focuses on the root causes and costs of supplier failure. Section 3.1 begins with a brief overview of the levels of market entry and exit. Section 3.2 assesses the financial resilience of the suppliers, with a focus on liquidity and working capital levels (section 3.2.1), the level of equity balances and dividends (section 3.2.2), levels of profitability margins (section 3.2.3), and hedging arrangements (section 3.2.4). A summary is provided in section 3.2.5 on the financial resilience of suppliers in the round. Based on insights from stakeholder interviews and the evidence on financial metrics of different suppliers, section 3.3 then describes two unsustainable business models that (some) failed suppliers may have followed.<sup>24</sup>
- Section 4 assesses Ofgem's role in supplier failures and the effectiveness with which it regulated the energy supply market, in the context of its statutory duty to promote the interests of current and future consumers. This includes the extent to which Ofgem adequately considered relevant trade-offs in making decisions on regulatory design, and the quality of the analysis that it undertook, and conclusions that it drew.
- Section 5 distils lessons learnt from the experience of recent supplier failures, and draws recommendations for Ofgem to consider in how it approaches the regulation of the sector going forward.

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<sup>24</sup> In the version of this report that has been made publicly available, we have redacted information that could be prejudicial to companies operating in the market at the time of publication. This includes, for example, confidential data that has been submitted in response to an Ofgem data request or non-public market data. These redactions are indicated with > symbols throughout the text and do not alter the findings of the report.

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## **2 Ofgem's approach to regulation of the energy supply market**

In this section, we first summarise the relevant features of the environment that have shaped Ofgem's approach to the energy supply market (section 2.1). We set these out in more detail in appendix A2. Next, we outline the key building blocks of Ofgem's approach to regulation of the energy supply market. These are important in understanding the root causes of supplier failure, to which we turn in the next section (section 3). We start by introducing the supplier lifecycle (section 2.2), so as to focus on how regulation evolves from the point of entry (section 2.3), through ongoing arrangements (section 2.4), and at the point of exit (section 2.5). We then look at the role of corporate governance arrangements as a check on company behaviour (section 2.6), and the role of the price cap within the regulation of retail suppliers (section 2.7).

Additional relevant material is set out in the appendices to this report—in particular:

- Ofgem's relevant statutory duties (appendix A2.1);
- the market context that Ofgem operates within (appendix A2.2);
- the broader policy context for Ofgem's regulation of the energy supply market—including direction from government as well as the influence of the 2016 CMA Energy Market Investigation (appendix A2.3);
- detail around the policy options that Ofgem considered for the Supplier Licensing Review (appendix A3);
- other features of the regulatory approach that are important in understanding the context for the causes and costs of supplier failure—specifically, the mechanisms for recovering environmental subsidies (appendix A4).

### **2.1 Context for Ofgem's regulation of the energy market**

A number of key features of the statutory duties, market, and policy environment have shaped Ofgem's approach to the regulation of the energy supply market. We outline these in detail in appendix A2 and summarise them here.

First, we review the statutory duties and powers that dictate how Ofgem determines its strategy, sets policy priorities, and makes decisions about how to regulate the market. Ofgem's principal objective across all of its regulation of electricity and gas markets is to protect the interests of existing and future consumers. In addition, Ofgem has two secondary duties that are relevant to its regulation of the supplier market, which are to promote effective competition and to have regard to the need to secure that licence-holders are able to finance their licensed activities. Accordingly, for this review we focus on the primary consumer interest duty, and consider the financial resilience of the sector—and market confidence as a whole—as one of several factors that affect how Ofgem meets this primary objective.

Second, we identify three salient historical characteristics of the market that have provided important context for many of the decisions that have been taken by Ofgem over the past decade. They are: i) the persistent dominance of the 'big six' large legacy suppliers, whose collective market share in both gas and electricity markets did not drop below 90% until 2015, did not drop below

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80% until 2017, and remains at around 60% as of December 2021; ii) few instances of supplier failure, up to 2017; iii) relatively stable wholesale prices that from 2010 to the end of 2020 fluctuated between £32/MWh and £61/MWh for electricity (excluding the 5% most extreme days), and between £0.24/therm and £0.68/therm for gas (excluding the 5% most extreme days). By comparison, in the second half of 2021, wholesale prices fluctuated between £91/MWh and £375/MWh for electricity (excluding the 5% most extreme days), and between £0.86/therm and £3.16/therm for gas (excluding the 5% most extreme days).

Third, as well as complying with statutory duties and primary legislation (e.g. in relation to the retail price cap), Ofgem acts with regard to policy direction from government, especially the Department for Business, Energy & Industrial Strategy (BEIS) and its predecessors. In carrying out its functions, 'the Authority must also have regard to: [...] certain statutory guidance on social and environmental matters issued by the Secretary of State.'<sup>25</sup> Government policy has both direct and indirect effects on the discharge of Ofgem's duties. The direct effects drive how Ofgem designs specific regulatory interventions, such as environmental levies that need to be recovered as part of retail tariffs.

The indirect effects are also potentially significant. For example, the emphasis on the promotion of competition as a means of protecting consumers and incentivising innovation to deliver the energy transition (e.g. see Ofgem's Strategic Narrative 2019–23)<sup>26</sup> is aligned with the corresponding focus of BEIS (e.g. see Energy Retail Market Strategy for the 2020s).<sup>27</sup> Furthermore, the findings of the Energy Market Investigation by the CMA in 2014–16 highlighted the importance of reducing the dominance of the legacy players and addressing any harm to consumers from 'poor quality of service' and 'restrictions on innovation'.

In this context, we draw an important distinction between the perceived risks and costs of failure.

- **Risks of failure.** Ofgem's minimal experience of supplier failures prior to 2018 supported a perception that the probability of supplier failure—and concurrent failures of a large number of suppliers—was low.
- **Costs of failure.** The historical market share data shows that new entrants had a small share of the market up to 2015. We understand from conversations with Ofgem stakeholders that the hypothetical failure that Ofgem anticipated was of small player(s) with small customer books. Moreover, the early experiences of the functioning of the SoLR regime provided reassurance that the orderly transition of customers from failed suppliers to alternative suppliers could be achieved smoothly, and with low costs to customers.

As we now move on to assessing Ofgem's approach to regulation of the retail energy sector, it is important to note the perspective with which this lessons learnt review is undertaken. We are not seeking to 'fix' specific features of the duties (which are, in any case, primary legislation), the market or policy environment, or specific regulatory mechanisms that may have contributed to the recent supplier failures. To do so would risk hindsight bias, and would also risk fixing the problems of yesterday, rather than creating a regulatory regime

<sup>25</sup> Ofgem (2022), 'Our powers and duties', accessed on 30 March 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>26</sup> Ofgem (2019), 'Our strategic narrative for 2019 – 23', July, pp. 14–15.

<sup>27</sup> Department for Business, Energy & Industrial Strategy (2021), 'Energy Retail Market Strategy for the 2020s. Helping consumers on their net zero journey', July, pp. 4–5.

that is targeted at better monitoring, identifying and resolving the problems of tomorrow—ideally before they lead to costly outcomes for existing and future consumers.

Instead, the lessons to learn are about how to drive better regulation (i.e. regulation that protects the interests of consumers more effectively). This means that the various elements of consumer interest, including intergenerational interest, need to be defined *ex ante*. These include the following:

- quality of service;
- convenience;
- availability of choice;
- delivery of net zero objectives in the economy;
- value for money;
- stability and predictability in tariffs;
- protection of credit balances.

## 2.2 The supplier lifecycle

We structure our assessment of Ofgem's regulation of the energy supply market across the different stages of the lifecycle of a (failed) supplier in the market—from regulation of entry, through ongoing arrangements, and lastly to the regulation of suppliers from financial distress through to exit arrangements. Ofgem sets regulations that affect suppliers at each stage of this lifecycle.

To illustrate, Figure 2.1 below sets out the evolution of Bulb from market entry in September 2015 to insolvency and entry to the Special Administration Regime (SAR) in November 2021. Specifically:

- on market entry in September 2015, Bulb had to meet the **entry requirements** set by Ofgem to receive a licence—including complying with any industry testing processes;
- once approved, Bulb was subject to the conditions of its **licence and any ongoing requirements**—this would have included any milestone assessments, had they been introduced at this point;<sup>28</sup>
- at the point of insolvency, Ofgem either directly allocates an exiting supplier's customer book to another supplier—through the SoLR process—or, if the supplier is too large (as was the case with Bulb), appoints a temporary special administrator through the SAR regime.

Figure 2.1 ✂

✂

Source: ✂

In the next three sub-sections, we address in turn:

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<sup>28</sup> Outside of ongoing regulatory requirements, Ofgem has access to powers to request information on an ongoing basis to monitor the levels of supplier resilience in the market. We assess Ofgem's use of such powers to gather information in section 5.

- regulation at the point of entry;
- ongoing requirements of the licence and other forms of regulation;
- regulation to govern exit arrangements.

In each section, we first set out how regulation has evolved, from arrangements at liberalisation, through reforms introduced from 2003 to 2018—such as the 2016–17 changes to the SoLR process (the introduction of the ‘safety net’)—to the 2018–20 Supplier Licensing Review, and subsequent developments over the period 2020 onwards. Next, we summarise the economic incentives that this placed on suppliers. We conclude with an assessment of how this relates back to the statutory duties of Ofgem, with specific reference to its primary duty to protect the interests of consumers.

## 2.3 Entry arrangements

### Pre-2018 licensing arrangements

Ofgem's 2018 Supplier Licensing Review consultation on entry arrangements sets out a clear narrative of the evolution of the requirements placed on licence applicants, as follows.<sup>29</sup>

- From market liberalisation to 2003, entrants were required to disclose substantial amounts of information—including business plans and financial statements—and comply with a number of specified licence conditions. This was in part to manage uncertainty around the regulation of newly liberalised markets.
- Following the establishment of a more mature retail market, from 2003 Ofgem largely removed financial and business plan information requirements, streamlining the licence application process.<sup>30</sup>
- In 2010, Ofgem carried out its last substantial review prior to the 2018 Supplier Licensing Review. The primary change was to shift to a risk-based, three-tiered application process. It is notable that, at this point, Ofgem continued to permit intermediaries to acquire licences for sale or rental to future suppliers—the ‘supplier in a box’ model—noting that:

The process is not designed to restrict or limit market entry or restrict parties involved in supporting **market entry** but it is our intention to limit speculative licence applications.<sup>31</sup> [emphasis added]

From board papers,<sup>32</sup> we understand that Ofgem's Supplier Licensing Review, which would encompass considerations of financial resilience, was delayed over the period 2016–17, and that consultation commenced in late 2018.<sup>33</sup> This followed the first year of multiple supplier failures instigated by severe weather (the ‘Beast from the East’) in winter 2018. We turn to this review next.

### The 2018 Supplier Licensing Review

In its 2018 Supplier Licensing Review entry arrangements consultation, Ofgem set out its overall case for change across the three stages of the supplier

<sup>29</sup> Ofgem (2018), ‘Consultation – Supplier Licensing Review (Entry Requirements)’, 21 November.

<sup>30</sup> Ofgem (2002), ‘Review of the Licensing Application Regulations Consultation document’, September.

<sup>31</sup> Ofgem (2010), ‘Gas and electricity licences - Changes to the Application Regulations and Revocation Schedules of future licences’, 3 September, p. 9, para. 2.29.

<sup>32</sup> Ofgem (2017), ‘Our approach to supplier licensing, monitoring and engagement: board paper for 13 July 2017’, 6 July, paper number A17-82, p. 1.

<sup>33</sup> Ofgem (2018), ‘Energy supplier compliance and enforcement: progress and issues: board paper for 15 March 2018’, 9 March, paper number A18-7, p. 4.

lifecycle. The motivation and context for the review, set out at the time by Ofgem, was:

- the need to manage a much larger number of players (growing from 27 domestic suppliers in December 2014 to 73 domestic suppliers by June 2018);
- a greater proportion of customer book value being held by non-legacy suppliers (more than 24% of market share by 2018);
- greater customer engagement and switching levels, indicating improved competition in the market;
- instances of poor customer service from non-legacy suppliers;
- a growing number of supplier failures that had to be managed through the SoLR process.<sup>34</sup>

Given this context, the key aim of Ofgem's Supplier Licensing Review was to raise standards around financial resilience and customer service by strengthening the regulatory regime. The Review highlighted the need to protect consumers against suppliers' financial instability and poor customer service, while ensuring that arrangements did not create undue barriers to innovation and competition.<sup>35</sup> As an overall set of strategic aims for the Supplier Licensing Review, we note that this approach is broadly aligned with relevant statutory objectives for the retail market.

Ofgem considered three broad policy options for potential reform in the sector. These ranged from the status quo (lightest-touch) option, to a more interventionist approach that would place capital requirements on suppliers. We summarise these in detail in appendix A3. On the basis of its assessment and with support from the majority of stakeholders, Ofgem selected a middle option, in which it would seek to introduce a number of requirements for prospective entrants to disclose more data to inform Ofgem's decision to approve a licence.

A paper summarising this was tabled and discussed at GEMA's meeting on 27 February 2019, at which the proposed recommendations were agreed. These were published in Ofgem's April 2019 decision paper on entry requirements, to come into effect in June 2019.<sup>36</sup> Overall, although Ofgem did not introduce capital requirements, the changes to the entry process represented a substantial tightening—taking the scrutiny of entrants back to levels not seen since 2003.

We note that, in coming to this position, Ofgem's assessment of trade-offs was mostly qualitative in nature. Furthermore, based on our review of the available internal and external papers, Ofgem does not seem to have used a clear framework for comparing different options for intervention. Such a framework might have included:

- an assessment of what business models and market dynamics would best protect the consumer interest;
- an evaluation of how this differed from observed behaviour in the market, on the basis of empirical evidence and the incentives facing suppliers;

<sup>34</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, pp. 13–14.

<sup>35</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, p. 14.

<sup>36</sup> Ofgem (2019), 'Supplier Licensing Review: Final proposals on new entry requirements', 11 April.

- an analysis of the costs and benefits of specific interventions in the market to effect improvements to how the market functioned.

We outline proposals for such an 'effective competition' framework as part of our recommendations in section 5.

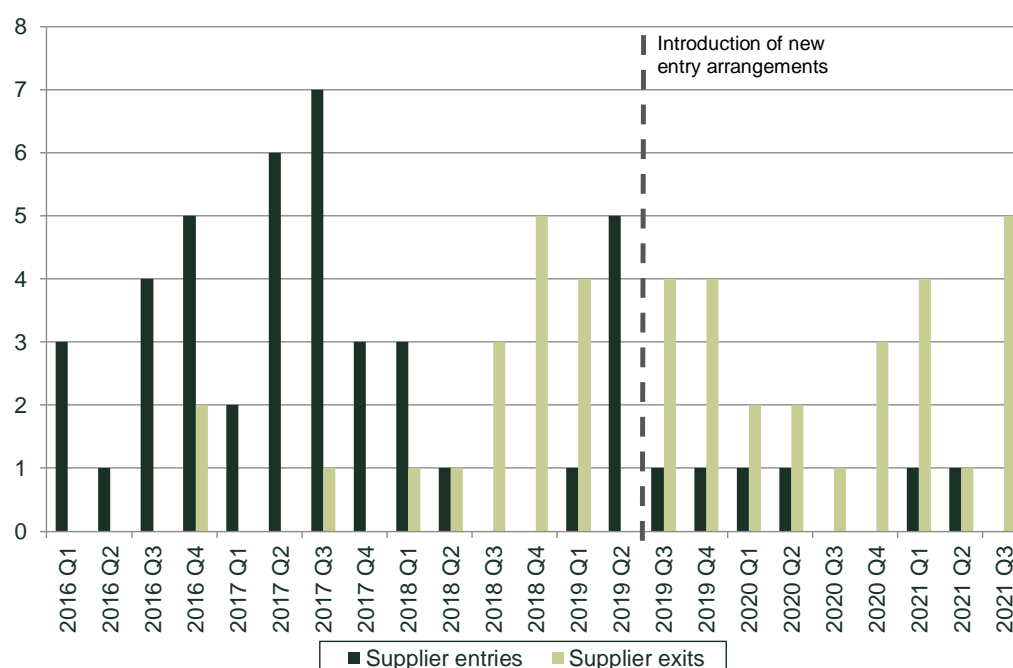
### **Implications of the 2018 Supplier Licensing Review**

Given the substantial change in the entry process in 2018, it is useful to segment the incentives that prospective entrants faced before and after the introduction of new entry requirements in June 2019.

Prior to the introduction of the new entry arrangements as part of the Supplier Licensing Review in June 2019, players in the market were able to enter without needing to provide a robust business model or demonstrate that they possessed sufficient financial reserves or adequate levels of total or working capital. In combination with the ability to enter the market through 'supplier in a box' models, this meant that entry into the market as a new supplier was low-cost.

Of course, whether suppliers were incentivised to enter would be driven by their economic incentives and perception of prospective profitability (see section 3.3 on business models), and would be potentially constrained by the ongoing regulatory requirements that they would face (see section 2.4). However, there was little to prevent any player that identified an opportunity in the market from entering. This has been supported by feedback in a range of stakeholder interviews, including with current and past Ofgem staff as well as suppliers.

Following the introduction of new entry arrangements, it appears that new entry was significantly deterred, with no more than one new entrant in each subsequent quarter, as shown in the chart below. This is also borne out by our understanding from stakeholders in the Retail team at the time—that the number of applications dropped dramatically, the proportion of applications that failed Ofgem's criteria rose considerably, and none of the suppliers that had a supply licence granted after June 2019 have failed to date.

**Figure 2.2 Entry and exit of domestic suppliers**

Source: Ofgem (2022), 'Supplier entries and exits in the domestic energy retail market (GB)', accessed on 23 February 2022 at: <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/retail-market-indicators>.

However, we note that regulating market entry arrangements would affect only new suppliers that sought to enter the market. It would not remediate any concerns about the resilience or quality of service provided by the existing suppliers—in a market that had already expanded to over 60 suppliers.

Moreover, even if it had been applied before any players entered the market, a stricter entry arrangements regime would tend to play only a temporary role in securing financial resilience.<sup>37</sup> As noted in Ofgem's entry arrangements consultation:

Our proposed new entry requirements will mitigate the risks of poor outcomes for consumers, and bolster our ability to monitor new entrants, by requiring details of an applicant's plans and resources for at least their initial 12 months' operation. However, checks undertaken at entry will be 'point in time' assessments; there are limitations to the extent that they provide an indication of the potential risks to consumers on an ongoing basis.<sup>38</sup>

Therefore, rather than being seen in isolation, entry arrangements should be seen in the broader context of the regulatory package that a successful licence-holder would encounter—and, in particular, the ongoing requirements placed on licence-holders, which we address next.

## 2.4 Ongoing requirements

Ongoing requirements represent the regulatory commitments that companies have as licence-holders in the energy supply market. Ofgem has had limited historical experience of regulating large numbers of non-legacy suppliers. Non-

<sup>37</sup> One possible entry arrangement that was proposed but not taken forward by Ofgem that has the potential to retain strong incentive effects well past the 'point in time' of entry would be the introduction of capital requirements.

<sup>38</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, Table 1: Assessment of broad policy options, p. 30.

legacy suppliers made up a negligible share of the market before 2013, and remained below 20% up to 2017 (see also appendix A2.2).

Ofgem has described its ongoing arrangements monitoring regime prior to the Supplier Licensing Review as consisting of two main approaches:

- monitoring proxy indicators of financial risk, such as rapid customer growth, pricing, use of the balancing mechanisms, and payment deadlines for government schemes;
- informing suppliers of the importance of communicating with Ofgem as a priority if they have any concerns about their financial position.<sup>39</sup>

Ofgem undertook the Supplier Licensing Review in 2018–20 seeking to: address the poor risk management practices seen from some suppliers; foster more responsible governance and increase accountability; and increase its degree of effective market oversight.<sup>40</sup> Accordingly, Ofgem considered interventions in its ongoing monitoring arrangements in a number of areas in order to meet these objectives. These are summarised in appendix A3.2.

Of the interventions considered by Ofgem in the 2018–20 review, the most relevant to the causes and costs of the 2021 supplier failures are Ofgem's proposals to better protect against cost mutualisation—in particular, in relation to existing customer account balances. At the start of the Supplier Licensing Review in 2018, Ofgem noted that:

...we are considering whether these arrangements could be improved and that **we can ensure the failing supplier takes a greater responsibility for their share of the costs of failure**. Specifically, whether new rules or restrictions are needed to **further protect consumer credit balances and minimise wider detriment** to the market if a supplier fails...

... customers who pay by direct debit, which is almost two-thirds of all customers, typically pay a uniform rate across the year... it is commonplace for customers to have – at various times – either a credit on their account with their supplier (if they have overpaid) or a debit (if they have underpaid)...

... under the current regulatory framework, there are no restrictions on how suppliers use any customer account balances which they may hold. **In practice, suppliers – to varying degrees – use account balances as part of their working capital**. This is not an uncommon practice across different sectors in the economy.

... The current arrangements mean that while consumer credit balances are protected in the event of supplier failure, the costs of honouring these (along with other exit costs) can be passed to other suppliers and ultimately to consumers, through Last Resort Supply Payments. We are considering ways that such costs might be reduced or avoided. It is **our view that suppliers should bear their share of the risk of failure**.<sup>41</sup> [emphases added]

Ofgem's indicative list of options for intervention, which it considered as part of its 2018 consultation, was as follows:<sup>42</sup>

- imposing maximum limits on credit balances, meaning that suppliers would have to more regularly return credit balances;

<sup>39</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, Table 1: Assessment of broad policy options, p. 31.

<sup>40</sup> Ofgem (2019), 'Consultation – Supplier Licensing Review – Ongoing requirements and exit arrangements', 22 October.

<sup>41</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, Table 1: Assessment of broad policy options, pp. 36–37.

<sup>42</sup> Ibid.



- restricting suppliers from offering terms that incentivised customers to maintain credit balances;
- restricting suppliers from using credit balances as working capital—for example, holding funds in separate ring-fenced accounts (or requiring suppliers to provide security cover for the value of consumer credit balances that they expected to hold during the following year);
- reducing the time that suppliers have to issue final bills and return credit balances to former customers.

Following a June 2019 workshop with stakeholders and suppliers in which strong support was expressed for tangible commitments to protect credit balances such as parent company guarantees or insurance facilities, in October 2019 Ofgem proposed the introduction of a requirement for suppliers to put in place arrangements to protect a minimum of 50% of their customer credit balances in the event of their failure. It was proposed that suppliers would have three to six months to implement the new requirement.<sup>43</sup>

In February 2020 Ofgem announced a considerably slower timetable for the introduction of protection of customer prepayment balances, to be phased over multiple stages, on the basis of feedback from stakeholders:

While generally supportive of the policy intent behind our proposals and the need for action in this area, stakeholders raised a number of complex issues, which we consider merit further investigation and analysis.<sup>44</sup>

The first phase was the introduction of a financial responsibility principle (FRP), which took effect on 22 January 2021. However, subsequent analysis of phase 2, as part of a later March 2021 consultation, suggested that Ofgem's original proposal to protect 50% of customer prepayment balances was assessed to be more expensive (at the time) than the ex post cost mutualisation through the Last Resort Supply Payment claim process (i.e. SoLR—see section 2.5). Moreover, Ofgem was concerned that, as the cost of insuring balances would be greater for small suppliers, the policy risked raising barriers to market entry and reducing product choice and customer benefit.<sup>45</sup>

In place of measures to directly protect a proportion of prepayment balances, Ofgem proposed a package of two policies to remedy the concerns: first, the 'autorefund policy', which would require suppliers to refund any credit balances above £0 at the end of each contract year; and second, the 'threshold policy', under which the amount of credit balances that suppliers would be permitted to hold would be limited, with Ofgem requiring suppliers to protect customer prepayment balances above a fixed threshold.<sup>46</sup> However, this would not be implemented prior to the 2021 wholesale price increase and subsequent supplier failures.

Over the years preceding the supplier failures in 2021, ongoing requirements can therefore be characterised in the following terms:

- suppliers entered in the context of very limited entry requirements or checks prior to June 2019;

<sup>43</sup> Ofgem (2019), 'Consultation – Supplier Licensing Review – Ongoing requirements and exit arrangements', 22 October, p. 19.

<sup>44</sup> Ofgem (2020), 'Update on timing and next steps on the Supplier Licensing Review', 3 February.

<sup>45</sup> Ofgem (2021), 'Supplier Licensing Review: reducing credit balance mutualisation', 17 March.

<sup>46</sup> Ofgem (2021), 'Supplier Licensing Review: reducing credit balance mutualisation', 17 March.

- once in the market, there were no ongoing requirements restricting the use of customer prepayment balances as a form of working capital, with Ofgem explicitly noting the practice as early as 2018;
- there were no requirements on entering with minimum levels of capital, or indeed for maintaining certain levels of total or working capital on an ongoing basis. This provided an opportunity for suppliers to enter the market with minimal capital by using customer prepayments as working capital in the short term, to fuel their growth in market shares;
- the lack of a requirement to maintain minimum levels of capital has important incentive properties. First, the injection of shareholders' private capital into a business means that the owners have money at risk in the event of insolvency, or 'skin in the game'. This reduces the risk of moral hazard (i.e. incentives to take excessive risk). Second, the act of raising capital prior to entry, and/or on an ongoing basis, incentivises scrutiny and due diligence of a firm's business plans as investors will want to assure themselves of its prospective and ongoing viability;
- a number of additional ongoing arrangements were introduced in 2020, but for the most part these took the form of principles rather than restrictions on suppliers.

As we note above in section 2.2, in coming to this position, Ofgem did not use a consistent framework for comparing different options for intervention and selecting the options that best protected the consumer interest. We outline proposals for such an 'effective competition' framework as part of our recommendations in section 5.

In the next section, on exit arrangements, we address the scope for moral hazard that arose from the ability to enter the sector with low costs, and the behaviours that this may have incentivised.

## **2.5 Exit arrangements**

Exit arrangements cover the rules, processes and legislation in place to manage a supplier's exit from the market. At the point of insolvency Ofgem either directly allocates an exiting supplier's customer book to another supplier—through the SoLR process—or, if the supplier is too large, appoints a temporary special administrator through the SAR regime. As set out in more detail in appendix A2.2, until 2016 Ofgem had limited experience of supplier failure in the market, with the last failure prior to this point occurring in 2008.

Under the SoLR regime the customers of an insolvent supplier are transferred either to another supplier determined through a bidding process (in which the customer book is awarded to the winning licensee), or to a supplier directed by Ofgem. Since the introduction of SoLR arrangements in March 2001 (following implementation of the Utilities Act 2000 licensing schemes and standard licence conditions), Ofgem has issued revised guidance in 2003, 2008 and 2016.<sup>47</sup> Following a consultation in June 2016, Ofgem introduced measures in its last revision of SoLR guidance to guarantee existing customer credit balances—with these being recovered, where necessary, by an industry levy.

Under the SAR regime, Ofgem seeks the Secretary of State's consent to apply to the court for an energy supply company administration. A court-appointed

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<sup>47</sup> Ofgem (2003), 'Supplier of Last Resort: Revised guidance'. Ofgem (2008), 'Supplier of Last Resort: Revised Guidance', December. Ofgem (2016), 'Guidance on supplier of last resort and energy supply company administration orders', 21 October.

special administrator then manages the company until it can be sold. This was introduced through legislation in 2011 (the Energy Act 2011).

Ofgem introduced three new policies to minimise the disruption associated with supplier exit as part of its Supplier Licensing Review.<sup>48</sup> These did not materially affect exit or the likely costs of mutualisation, but instead were focused around the process itself.<sup>49</sup>

Under both the SoLR and SAR regimes, following insolvency of a supplier its customers are protected, with the costs of this protection being mutualised across future bill payers or taxpayers respectively.<sup>50</sup> There are three material categories of cost that are typically mutualised following insolvency:

- customer prepayment credit balances of the failed supplier when it entered insolvency;
- following the introduction of the Default Tariff Cap, the difference between the prevailing cost of wholesale energy and the allowance for wholesale costs in the Default Tariff Cap at the time (the direct fuel cost contribution);
- any shortfall in RO payments owed by the failed supplier when it entered insolvency (see appendix A4).

Following the recent supplier crisis in 2021, the level of SoLR levy claims up to December 2021 has led to a £68 average increase per customer for the next Default Tariff Cap period (April 2022–September 2022). We note that this does not yet include the mutualised costs associated with Bulb, which currently sit with the taxpayer; BEIS has extended a £1.7bn funding facility to Bulb's Special Administrator.<sup>51</sup> The high level of mutualised costs that have resulted from recent supplier failures represents a significant increase in customer bills, increasing the scale of the affordability challenge and being particularly likely to affect vulnerable customers.

Considered in the broader context of the regulatory package that a licensee faces in terms of entry arrangements and ongoing requirements, this creates two types of incentive that are likely to be at odds with the protection of consumer interest. These are set out in turn below.

### **Moral hazard created by low costs of exit**

There are no requirements placed on licence-holders to enter with, and maintain on an ongoing basis, a predefined level of capital. To the extent that suppliers are able to build up a short-term liquidity buffer through customer prepayments and the collection of RO payments (see appendix A4), this has enabled some suppliers to participate in the market without committing significant shareholder capital.

For such suppliers, entry into the energy supply market has been characterised in some stakeholder interviews as a 'free bet' in which they could take a position in the market (such as undercutting rivals by leaving a proportion of their position unhedged) and suffer minimal consequences in the event of

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<sup>48</sup> Ofgem (2020), 'Supplier Licensing Review: Ongoing requirements and exit arrangements – Decision', 26 November.

<sup>49</sup> The three changes related to customer interactions with administrators in the event of supplier failure, customer book sales (i.e. trade sales in place of a supplier entering the SoLR process), and SoLR commitments. These are summarised in appendix A3.2.

<sup>50</sup> We understand from discussion with Ofgem that taxpayer costs from the SAR process can be reallocated to bill payers at a later stage.

<sup>51</sup> As of 31 March 2022.

insolvency. This protection from the consequences of risk-taking may have led to incentives to pursue riskier business models than if suppliers had had greater levels of 'skin in the game'.

However, while the 'free bet' that suppliers were taking was costless from their perspective, it was not free for future bill payers in the event of a company failure. In such cases, not only would consumers have to pay the kinds of mutualised cost set out above, but these costs would also probably be greater as suppliers had used up a large proportion of collected prepayments as working capital on their exit trajectory.

### **Extracting financial derivatives and declaring early insolvency**

At the point of exit, a supplier's customers are transferred via the SoLR process, while its assets are subject to liquidation as part of insolvency proceedings. Therefore, any assets that have residual value are not used to reduce the mutualised cost (in net terms) as the result of a supplier's exit. This is a distributional outcome that has raised concerns in the context of recent supplier failures.

In particular, given the marked increase in wholesale prices, it has been observed that some of the suppliers that have recently failed with (partially) hedged positions in commodity markets held valuable in-the-money derivatives at the point of failure. If these derivatives were held within the failed business, they would be liquidated as part of the insolvency proceedings—any residual value, after creditors had been paid, would thereby accrue to shareholders. And if the hedged positions had been entered into by a group, subsidiary or parent undertaking, this would allow for any value of the derivatives at the point of firm failure to accrue to the related company.

This topic has been cited as one of concern by some stakeholders—i.e. that the cost of failure is mutualised and borne by bill payers, while any residual asset value at the point of failure could accrue to the shareholders of the failed firm after creditors are paid off in insolvency proceedings.

It should be noted that the government has taken recent measures, which are intended to remediate this concern, by imposing a windfall tax that would be levied on a supplier that disposed of its assets (including derivatives) 'in a way that disadvantages consumers':<sup>52</sup>

Ofgem has today announced its intention to reinforce regulatory measures which mean that suppliers must have ownership or control over the assets they need to run and operate their business, including hedges. Ofgem has also clarified that the value of all material assets used for the operation of an energy supply business, such as a hedging contract, must not be disposed of in a way that disadvantages consumers.<sup>53</sup>

Absent this intervention there was concern that, when faced with financial distress, the owners of energy supply companies would have an incentive to extract in-the-money derivatives (or other assets), and then declare the supplier insolvent. Owners would then be able to benefit from the value of hedging instruments while the cost of servicing the (unhedged) transferred customers from the failed supplier would be mutualised across future bill

<sup>52</sup> We understand that the windfall tax is intended to be a temporary measure.

<sup>53</sup> Letter by Secretary of State for Business, Energy & Industrial Strategy, 'Public Interest Business Resilience and Protection Measures in the Energy Sector', 28 January, accessed on 23 February 2022 at: [https://data.parliament.uk/DepositedPapers/Files/DEP2022-0081/Public\\_Interest\\_Business\\_Resilience\\_Protection\\_in\\_the\\_Energy\\_Sector.pdf](https://data.parliament.uk/DepositedPapers/Files/DEP2022-0081/Public_Interest_Business_Resilience_Protection_in_the_Energy_Sector.pdf).

payers. This is because SoLR levy claims would cover the gap between the current wholesale price of energy and the Default Tariff Cap allowance. In interviews, stakeholders have raised specific instances of this having happened over 2021–22.<sup>54</sup>

## **2.6 Corporate governance, assurance, and other constraints on companies' behaviour**

In addition to entry, exit and ongoing arrangements, Ofgem relied on other constraints on company behaviour that it expected would promote the resilience of suppliers and thereby protect consumer interests. In particular, constraints on company behaviour can also be imposed in the form of higher standards in corporate governance, assurance, audits and self-regulation in response to industry codes. This section first looks at the changes to risk management through Ofgem's Supplier Licensing Review, as well as the role of industry codes. It then examines processes outside of Ofgem's regulatory regime—in particular, the role of audits. To the extent that Ofgem relied on suppliers to self-regulate within a liberalised market, it implicitly relied on the discipline of such mechanisms and agents (i.e. company boards and auditors, and their adherence to industry codes), and it is therefore important to assess their effectiveness.

### **2.6.1 Ofgem's role**

Since the beginning of the Supplier Licensing Review reforms, Ofgem has sought to improve how it regulates company behaviours by promoting more responsible risk management, improving governance, increasing accountability, and enhancing market oversight.

Notably, the FRP was introduced as part of the Supplier Licensing Review reforms in ongoing requirements and exit arrangements announced in 2020. Ofgem explained that:

The FRP acts as an over-arching obligation – supporting one of the key aims of the SLR [Supplier Licensing Review] by ensuring suppliers act in a more financially responsible manner and take steps to bear an appropriate share of their risk.<sup>55</sup>

In its final guidance on the FRP, Ofgem stated that it would adopt a risk-based approach, allocating more regulatory resources to scrutinise the high-risk suppliers, which was intended to protect consumers and reduce the potential costs of mutualisation. The regulatory interventions set out by Ofgem included undertaking a dynamic assessment, requesting an independent audit, and the possibility of moving immediately to enforcement action (e.g. to secure customer credit balances) if considered appropriate.

While the details of the dynamic assessment that is to be undertaken are not written explicitly into the supplier licence conditions, detailed descriptions of the independent audit were added in November 2020. As outlined in the new licence conditions, the audits:

will include one (or more) of the following areas of the licensee's business: a) financial stability; b) customer service systems and processes; or c) where a

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<sup>54</sup> For example, in the recent failure of Pure Planet (January 2022).

<sup>55</sup> Ofgem (2021), 'Supply Licensing Review: Final Guidance on the Financial Responsibility Principle', 22 March, p. 1.

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licensee cannot provide adequate information under Condition 28C [milestone assessment].<sup>56</sup>

Since the independent audits are non-periodic and would be commissioned only at Ofgem's discretion, their effectiveness would be highly dependent on whether the dynamic assessment process is robust and enabled timely interventions. If implemented successfully, the interactions of these regulatory mechanisms (i.e. dynamic assessments with independent audits leading to timely interventions) could reduce the costs of failure, which are borne by taxpayers through SoLR levy claims (£1.8bn up to December 2021) and SAR costs (£1.7bn funding facility with BEIS provided to Bulb).

Moreover, Ofgem is currently consulting on proposals for prescriptive rules to reduce the scale of credit balances at risk of mutualisation in the event of supplier failure. If implemented, these rules would reduce the future SoLR levy claims related to credit balances, which amount to £70m up to the end of 2021 (see Figure 3.2).<sup>57</sup>

### The role of industry codes in regulating company behaviour

In addition to supplier licence requirements imposed by Ofgem, suppliers need to comply with industry codes—such as the Connection Use of System Code administered by National Grid and the Balancing and Settlement Code administered by Elexon.<sup>58</sup> Collectively, these codes govern transactions between generators, networks and suppliers. In its Supplier Licensing Review, Ofgem commented that its historical (up to 2018) approach had been to:

... consider[ed] that financial institutions, parent companies and other equity providers are able to demand, and be more capable of conducting, more rigorous tests than Ofgem, and that the entry testing and credit cover arrangements **under the industry codes provided protection**. [emphasis added].<sup>59</sup>

However, while it is the case that industry codes effectively govern relationships between specific intermediaries, our understanding from discussion with stakeholders and a review of the relevant industry codes is that there are no specific measures in place to discipline the *overall* financial resilience of companies.

For example, the Balancing and Settlement Code governs the payments in relation to the balancing mechanism and the imbalance settlement processes. As part of its monitoring process, Ofgem reviewed the suppliers that had missed payments to Elexon. While failure to comply with this industry code could be indicative of a supplier being in a financially precarious situation—and indeed being monitored as such—the converse is not necessarily the case. The requirement to comply with the Balancing and Settlement Code does not discipline suppliers to remain financially resilient, and nor does compliance with

<sup>56</sup> GEMA (2021), 'Gas Act 1986: standard conditions of gas supply licence', 25 October, para. 5B.2, accessed on 10 April 2022 at: <https://epr.ofgem.gov.uk/Content/Documents/Gas%20supply%20standard%20licence%20conditions%20consolidated%20-%20Current%20Version.pdf>.

<sup>57</sup> Ofgem (2021), 'Action plan on retail financial resilience', December, accessed on 22 April 2022 at: [Action plan on retail financial resilience \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/publications/open-letter-domestic-energy-suppliers-financial-resilience). Ofgem (2022), 'Open Letter to domestic energy suppliers - Financial Resilience', 14 April, accessed on 22 April 2022 at: <https://www.ofgem.gov.uk/publications/open-letter-domestic-energy-suppliers-financial-resilience>.

<sup>58</sup> Elexon (2022), 'The Balancing And Settlement Code', 22 February, accessed on 22 March 2022 at: <https://www.elexon.co.uk/documents/bsc-codes/bsc-consolidated/consolidated-bsc-operational-2/>.

<sup>59</sup> Ofgem (2018), 'Supplier Licensing Review', 21 November, p. 16.

the Balancing and Settlement Code necessarily demonstrate financial resilience.

### **2.6.2 The role of auditors**

In its May 2018 working paper on the 'ongoing requirements' and 'exit arrangements' phases of the Supplier Licensing Review, Ofgem stated that:

It is a supplier's responsibility to comply with their obligations. We do not consider it is our role to forensically analyse suppliers' operations and finances.<sup>60</sup>

In the absence of its own checks, Ofgem implicitly relied on suppliers' own governance arrangements as checks, for example it implicitly relied upon external auditors to validate suppliers' financial statements and the financial resilience of suppliers. We have reviewed financial statements for two suppliers (3 and Avro), focusing on the role of auditors, to assess whether it was appropriate for Ofgem to rely on suppliers' own governance arrangements.

#### **Using audit statements and 'going concern' status as a substitute for regulatory assurance**

As has been demonstrated in recent months, energy suppliers are exposed to material volatility in cash flows. For Ofgem to be able to rely on statements validating the 'going concern' status of a supplier in place of its own monitoring and analysis, it would need to be assured that one or more of the following factors hold.

- That material supply-side or demand-side shocks are not likely.
- That the company is not exposed to any material supply-side or demand-side shocks—e.g. it is sufficiently hedged against plausible fluctuations in the price of wholesale electricity and/or gas.
- That the company has sufficient credit lines or parent company guarantees in place to weather any material supply-side or demand-side shocks.
- That the company has sufficient financial reserves (i.e. adequate levels of capital) in place to weather any material supply-side or demand-side shocks.

Based on our review, we do not see that the information on 'going concern' status as published in companies' annual reports necessarily provides Ofgem with the assurance it would require that such conditions hold, without carrying out its own analysis. Our review focuses solely on whether the audit process could serve as a reasonable substitute for regulatory analysis, which, we note, is not the purpose of audit statements or the 'going concern' status.

#### **Case studies of auditors' statements**

In the following boxes we report the 'going concern' statements for two energy suppliers—(3 and Avro). According to the statements that are publicly available through the annual report, the directors and auditors of these companies do not identify any issues in relation to the companies' abilities to continue with their operations. Their auditors confirmed that they did not find

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<sup>60</sup> Ofgem (2018), 'Update on the way forward for the "ongoing requirements" and "exit arrangements" phases of the Supplier Licensing Review', 24 May, para. 1.37, accessed on 31 March 2021 at: [https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/update\\_slr\\_ongoing\\_and\\_exit\\_final.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2019/05/update_slr_ongoing_and_exit_final.pdf).



'material uncertainty' in the information disclosed by the directors in relation to their preparation of a 'going concern' statement.

## Box 2.1 ✂



Note: ✂

Source: ✂



Furthermore, the auditors did not explain any independent analysis that had been undertaken to verify the directors' views that current sources of funding were adequate, and on a letter of support over a 12-month period from the parent company, to confirm the 'going concern' basis of the company. Similar conclusions can be reached by examining the financial accounts for Avro in the next box.

## Box 2.2 Auditors' statement case study 2: Avro

**Avro failed in September 2021.** The latest publicly available report for the company covered the period 1 January 2018 to 30 June 2019 (FY2018+HY2019).<sup>1</sup> In the latest statement, the directors identified the major risks and uncertainties for the company in respect of competition, wholesale market prices<sup>2</sup> and bad debt. However the directors believed that the company was 'in a strong position due to its operation[al] efficiency'.<sup>3</sup> The directors of the company, having taken into account risks and uncertainties, stated:

At 30 June 2019, the Company's current liabilities exceeded its current assets position by £27,488,901 [...] and the company made losses for the period to 30 June 2019 of £28,023,009. Despite this the Company generated cash from its operating activities of £4,795,437. The directors have prepared budgets and cash flows forecasts showcasing the Company's ability to trade for the foreseeable future, meeting its liabilities as they fall due.<sup>4</sup>

This statement from the directors is interesting, as it reiterates a view—✂—that operating losses and negative equity balances are not of concern in the energy supply market.

The auditors' statement confirms the directors' position, without explaining the approach that was taken to independently verify this:

The directors have not disclosed in the financial statement any identified material uncertainties that may cast significant doubt about the company's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months.<sup>5</sup>

Note: <sup>1</sup> Avro Energy Limited (2019), 'Annual Report and Financial Statements for the period from 1 January 2018 to 30 June 2019', 30 June, p. 2. <sup>2</sup> The company reported that it operated a hedging strategy to mitigate the risk of wholesale market movements, working with a number of counterparties across a range of long- and short-term products, and that it made daily adjustments to correct the wholesale position for variances in demand. <sup>3</sup> Avro Energy Limited (2019), 'Annual Report and Financial Statements for the period from 1 January 2018 to 30 June 2019', 30 June, p. 3. <sup>4</sup> Avro Energy Limited (2019), 'Annual Report and Financial Statements for the period from 1 January 2018 to 30 June 2019', 30 June, p. 4. <sup>5</sup> Ibid., p. 6.

Source: Oxera analysis based on annual reports.

The information published in annual reports should be understood as a summary of the audit process, and not necessarily a comprehensive record of all analysis carried out. As noted above, we refer to these excerpts of companies' annual reports solely as a means of identifying evidence on

whether it was reasonable for Ofgem to use them as a replacement for carrying out its own assurance.

We highlight here two issues with any reliance, implicit or explicit, that Ofgem may have placed on the 'going concern' statements that were publicly available from annual reports.

First, that the publicly available information on the audit process for these failed suppliers indicates a potential degree of circularity—where directors state that they expect the company to continue to operate in the foreseeable future (e.g. driven by financial support guaranteed by the parent company) and the statement refers back to this view without reference to additional evidence or the underlying analysis that the auditor has undertaken.

Second, that the most recent externally available directors' and auditors' assessment of these companies do not provide a sufficiently comprehensive and timely analysis of the risk drivers, to substitute for regulatory monitoring. This does not give Ofgem the necessary degree of assurance that it would require to rely on the directors' and auditors' statements.

### **Concluding remarks on auditors' statements**

Overall, it is clear that routine audit governance arrangements cannot be relied on to obviate the need for Ofgem's own monitoring and scrutiny of financial resilience in the sector. The directors' statements for the companies reviewed acknowledge operating losses and/or net liabilities without raising significant concerns about the companies' ability to remain in operation. Indeed, the directors' statement for 3< expressed the view that having liabilities exceed its assets was expected as part of the company's growth strategy. Notwithstanding operating losses and/or net liabilities, the directors' statements convey expectations of sufficient liquidity to remain operational, often supported by letters of parent guarantees.

In the audit statements available for 3< and Avro, auditors do not provide sufficient detail of the analysis that they have carried out to verify the directors' statements, such that these would provide a robust basis for Ofgem's own regulatory assurance.<sup>61</sup>

It is arguable that Ofgem has implicitly recognised that it cannot rely on routine audits. As part of its Supplier Licensing Review, Ofgem introduced a provision that it could instruct ad hoc independent audits to be undertaken. This was justified on the following grounds:

It is a supplier's responsibility to comply with their regulatory obligations. As such, we generally do not consider it is our role to forensically analyse suppliers' operations and finances. However, in certain instances, independent verification of the root cause of problems in supplier operations and technical assessments of systems and financial information may be proportionate.<sup>62</sup>

While such a provision may have value in certain scenarios, we note a concern that, at the point at which a supplier has been flagged as requiring an independent audit, it may be too late for the results of this process to allow for effective intervention by Ofgem in the consumer interest. Regular spot checks

<sup>61</sup> For example, they do not consistently use statements such as 'based on the work we have performed' and provide details of such work.

<sup>62</sup> Ofgem (2019), 'Supplier Licensing Review: Ongoing requirements and exit arrangements', 22 October, p. 36.

of companies' financial resilience may help to identify emerging patterns that merit further investigation.

We also note that the economic regulator in the water sector, Ofwat, has made provision for additional audit arrangements on a yearly basis. These apply to licensed water companies as part of their annual performance reports—in particular, water companies are required to provide a separate audit opinion. The coverage of this audit opinion includes an evaluation of whether 'the directors' use of the going concern basis of accounting in the preparation of the Regulatory Accounting Statements is appropriate'. It also includes an explanation of how the auditor evaluated management's assessment.<sup>63</sup>

Such a measure could represent one option for Ofgem to consider, in addition to improving the breadth, depth and quality of its ongoing monitoring arrangements for the market.

### The quality and effectiveness of audits

While we do not take a view on the role of the audit process within the general corporate governance process, we note that the quality and effectiveness of audits has been investigated more broadly in a report by Sir Donald Brydon at the invitation of the UK government.<sup>64</sup> Some of his recommendations are particularly relevant to the scope for Ofgem to use audits as a tool to monitor the financial resilience of the energy supply market.

The report explains that the information that stakeholders most want is reassurance about the resilience of a company. At present, this is given through the mechanism of the 'going concern' and, for premium listed companies, the 'viability statement'. The going concern assessment sets the bar too high for directors having to disclose any 'material uncertainties' relating to a company's ability to continue as a going concern, by allowing proposed mitigating action to be taken into account. Strengthening related requirements for auditors will not address this underlying weakness. Moreover, there is demand for more information about the likely survival of the company into an indeterminate future (rather than, for example, 12 months ahead).

Based on the above call for improving the current requirements, the author proposes a **resilience statement** that can be broken down into different time periods about which the directors should be able to make statements with varying degrees of confidence, as follows.<sup>65</sup>

- **The short term** (up to two years): directors would be obliged to state whether, in their opinion, the company has access to the necessary finance to ensure that it can survive for this period, while disclosing any material uncertainties by reference to the Risk Report, and, importantly, before any relevant mitigating action. This statement would be subject to audit in the same way that today's going concern statement is, and would form the basis on which the accounts are prepared.

<sup>63</sup> Ofwat (2021), 'Audit Opinion for the Annual Performance Report 2020-21', April, p. 4.

<sup>64</sup> Sir Donald Brydon (2019), 'Assess, assure and inform, improving audit quality and effectiveness – report of the independent review into the quality and effectiveness of audit', December, p. 80, accessed on 22 March 2022 at:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/852960/br-ydon-review-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/br-ydon-review-final-report.pdf).

<sup>65</sup> Sir Donald Brydon (2019), 'Assess, assure and inform, improving audit quality and effectiveness – report of the independent review into the quality and effectiveness of audit', December, p. 81, accessed on 22 March 2022 at:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/852960/br-ydon-review-final-report.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/852960/br-ydon-review-final-report.pdf).

- **The medium term** (from the end of the short term to five years): directors would state that they have tested the company's probability of survival in relation to declared future scenarios and expressed their assessment of the resilience of the company in the light of that testing. They might also choose to obtain some independent assurance that this work has been undertaken in an appropriate manner. Such assurance would not consider the conclusions, which would remain a matter entirely for the directors.
- **The long term** (beyond five years): here the directors would reference the sorts of threat that the company may face—climate change may provide a good example—and describe why they believe the company is resilient in the face of such threats. This part of the statement would not be required to be subject to further assurance.

If such measures were implemented, either as part of general governance arrangements or as specific requirements placed by Ofgem on the auditors of energy suppliers, they could serve to improve Ofgem's scrutiny of suppliers for the purposes of economic regulation. Such arrangements could provide Ofgem with a considerably higher level of assurance of suppliers' financial resilience.

## 2.7 The price cap

After the 2017 general election, government brought in legislation—the Domestic Gas and Electricity (Tariff Cap) Act 2018<sup>66</sup>—that created a duty for Ofgem to design and implement a price cap for customers on an SVT, referred to as the Default Tariff Cap.<sup>67</sup> While a price cap mechanism (following the CMA investigation) was initially designed for the most vulnerable customers who were on prepayment meters, at the time of introduction the cap was extended to cover 60% of customers.<sup>68</sup> The latest publicly available data published by Ofgem as part of its Retail Market Indicators shows that, as of 1 October 2021, 60% of domestic electricity customer accounts and 58% of domestic gas customer accounts were on a default tariff (i.e. subject to the Default Tariff Cap), excluding pre-payment customers.<sup>69</sup> In February 2022, when Ofgem announced the level of the price cap for the period April 2022–September 2022, Ofgem estimated that approximately 22m households were on a tariff covered by the price cap—relative to around 28m domestic electricity meter points—i.e. 80% of customers.<sup>70</sup>

The price cap was intended to be a temporary measure at the point of its introduction;<sup>71</sup> we understand from stakeholders that it was envisaged that it would act as a 'one-off' adjustment mechanism to the market to incentivise the achievement of operational efficiencies and to promote better functioning of the market. However, the period of application of the cap was extended, and the Act currently sets out that Ofgem will be able to extend the cap to the end of 2023.

<sup>66</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, accessed on 4 February 2022 at: [https://www.legislation.gov.uk/ukpga/2018/21/pdfs/ukpga\\_20180021\\_en.pdf](https://www.legislation.gov.uk/ukpga/2018/21/pdfs/ukpga_20180021_en.pdf).

<sup>67</sup> At the time, customers on an SVT represented around 60% of the market. Ofgem (2018), 'Default Tariff Cap: Decision Final Impact Assessment', 6 November, p. 13.

<sup>68</sup> Ofgem (2018), 'Default Tariff Cap: Decision Final Impact Assessment', 6 November, p. 10.

<sup>69</sup> Ofgem, 'Retail market indicators', accessed on 10 April 2022 at: <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/retail-market-indicators>.

<sup>70</sup> Ofgem (2022), 'Price cap to increase by £693 from April', 3 February, accessed on 22 April 2022 at: <https://www.ofgem.gov.uk/publications/price-cap-increase-ps693-april>.

<sup>71</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, para. 37, accessed on 23 February 2022 at: <https://www.legislation.gov.uk/ukpga/2018/21/notes/division/6/index.htm>.

## Designing the price cap

In designing the cap, the Act required Ofgem to:

exercise its functions under this section with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to the following matters— (a) the need to create incentives for holders of supply licences to improve their efficiency; (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts; (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts; (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.<sup>72</sup>

We note that these conditions required Ofgem to carefully balance a number of objectives, which can involve trade-offs—for example, a limited level of ‘headroom’ in the price cap may promote efficiency but reduce the ability to incentivise switching.

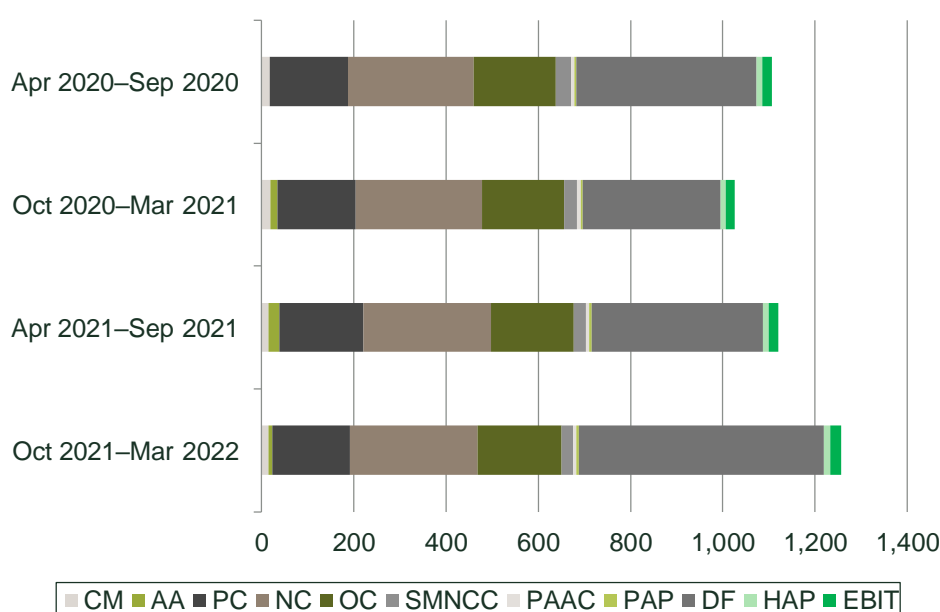
In terms of economic incentives, we note that while Ofgem's regulatory policies have sought to promote competition in the energy retail market by encouraging market entry, a price cap has the potential to distort free market competition, by limiting suppliers' ability to set tariffs above the cap.

By calibrating the price cap to deliver stretching levels of cost efficiency relative to prices observed in the market at the time, the price cap may have left some suppliers with insufficient headroom to deal with shocks—for example, whether demand-related or in relation to commodity costs. It was Ofgem's explicit intent in calibrating it that the price cap should be ‘a tough cap that ensures loyal consumers pay a fair price that reflects efficient costs’.<sup>73</sup> That is, the measure was designed to be tough in reflecting efficient costs, and to address a potential ‘loyalty penalty’ arising from consumers not switching their energy supplier despite being on a non-favourable tariff. It should be noted, however, that the perception of a ‘tough’ cap is not consistent across the industry. In stakeholder interviews, some suppliers have considered that the cap has been set at a level that has not allowed for sufficient levels of profitability in the industry, while others have provided the perspective that advances in technology and cost efficiencies enable frontier companies to achieve costs that are below the assumptions embedded within the cap. The following figure shows the composition of the price cap.

<sup>72</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, accessed on 4 February 2022 at: [https://www.legislation.gov.uk/ukpga/2018/21/pdfs/ukpga\\_20180021\\_en.pdf](https://www.legislation.gov.uk/ukpga/2018/21/pdfs/ukpga_20180021_en.pdf).

<sup>73</sup> Ofgem (2019), ‘Our strategic narrative for 2019 – 23’, July, p. 14.

**Figure 2.3 Composition of the price cap for dual fuel (£/year)**



Note: CM = capacity market cost; AA = adjustment allowance; PC = policy cost allowance; NC = network cost allowance; OC = operating cost allowance; SMNCC = Smart Metering Net Cost Change; PAAC/PAP = payment method adjustment; DF = direct fuel cost; HAP = headroom allowance percentage; EBIT = EBIT (Earnings Before Interest and Taxes) margin.

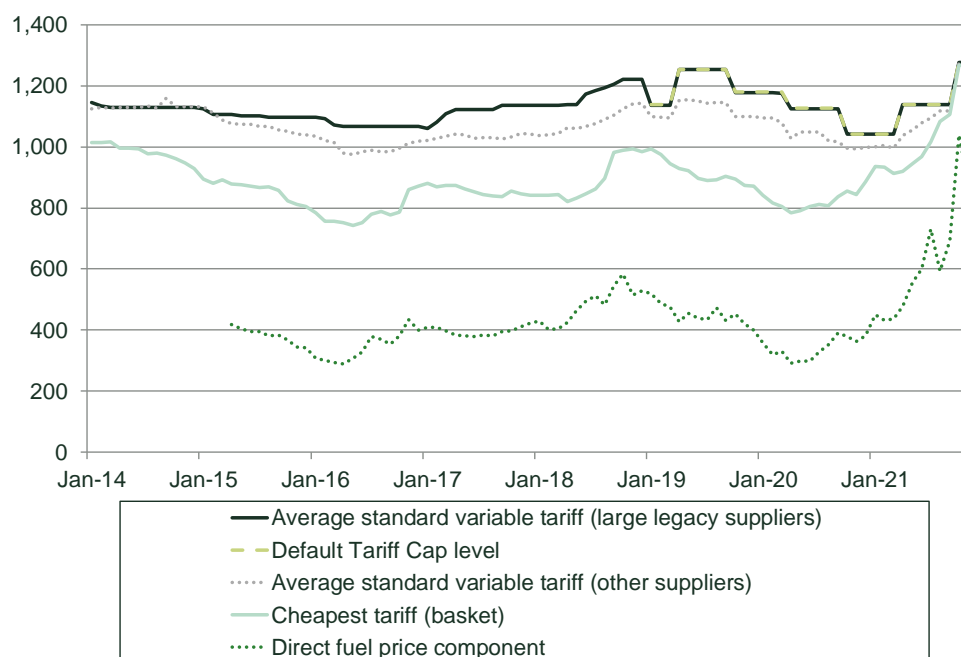
Source: Oxera analysis based on Ofgem (2022), 'Supplementary model - default tariff cap level v1.9', January.

In terms of its regulatory policy, Ofgem had the option to set a less stringent (higher) price cap over time. This would have tended to leave more headroom for suppliers to price under the cap while remaining profitable (see section 3.2.3 for evidence of suppliers' losses), and to also hold greater buffers for cost volatility. Within the existing mechanisms this could have been achieved through an increase in the headroom allowance, the EBIT margin, and/or a lower level of challenge on operating cost efficiencies. However, holding all else equal, this would have tended to increase the price that customers on the SVT paid. Thereby, paying higher tariffs in the past could have reduced some of the supplier failures that have been observed since autumn 2021, but it is not clear whether this would have been a net benefit that promoted the interest of consumers.

### The price cap in practice

Figure 2.4 shows the evolution of retail prices with the introduction of the Default Tariff Cap. Large legacy suppliers have priced the SVT at the level of the cap. Non-legacy suppliers have, on average, undercut it, while following the stepwise movements in the Default Tariff Cap, which is revised every six months. This provides some evidence that the cap acts as a competitive benchmark that suppliers take into account in their pricing policy. Cheaper (non-SVT) tariffs seem to be revised more frequently than the cap.

**Figure 2.4 Evolution of the Default Tariff Cap (dashed line) compared with cheaper tariffs and the direct fuel price component (£/year)**



Note: The tariffs are based on a dual fuel energy tariff. The direct fuel price component is the part of the price cap that can be directly linked to gas and electricity prices. Here, the direct fuel cost component is based on the actual daily prices rather than based on the six-month average of the prices as in the actual price cap.

Source: Oxera analysis based on Ofgem tariff data.

Due to the six-month periodicity with which the cap is set, changes in input prices are passed through to tariffs with a delay. This means that suppliers make windfall gains when wholesale prices fall below the level assumed when the cap was set (because the cap is adjusted downwards with a lag). Conversely, suppliers make windfall losses when rising wholesale prices increase above the level assumed when the cap was set.

However, the dynamics of competition in the market mean that these effects are not symmetric. When wholesale prices fall, suppliers are able to undercut the SVT with fixed tariff offerings. Subject to the degree of competition and the level of switching in the market, this may limit the extent to which suppliers are able to benefit from the gap between the price cap and wholesale prices, as competitors will take their customers if they do not reduce prices. Conversely, when wholesale prices rise, the SVT acts as a ceiling and suppliers are exposed to the full differential between wholesale costs and the price cap.

### Recent wholesale price increases

In light of the recent significant increase in wholesale electricity and gas prices, this issue becomes more prevalent. Figure 2.5 below shows how input prices rose significantly towards the end of 2021, causing even the cheaper tariffs to increase. Figure 2.5 demonstrates the impact of the delayed adjustment of the price cap. It shows the direct fuel component of the price cap itself (stepwise line in dark green), as well as two measures of the wholesale price.

- The darker green line shows the direct fuel component based on the average price six months before. This line cuts through every corner of the

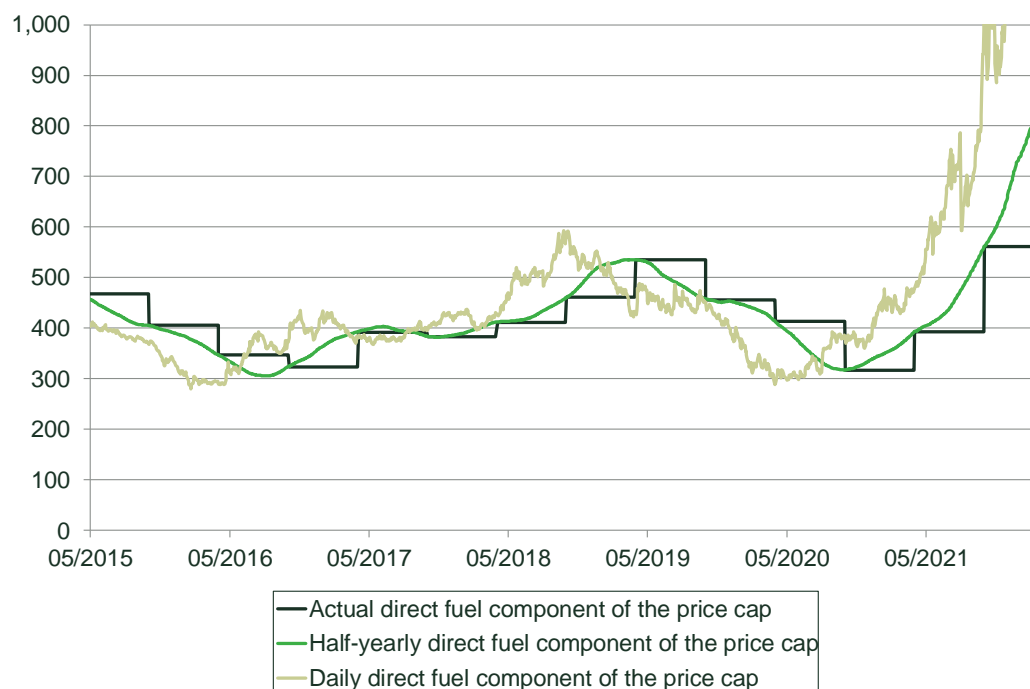


actual price cap line because it uses the same methodology as the price cap but is updated on a rolling basis. This line represents what the direct fuel contribution would be if Ofgem used an identical price cap methodology but updated it every day, instead of every six months.

- The lighter green line shows the direct fuel component if it was updated based on daily prices. In line with the mechanics of the Ofgem price cap, it uses the demand-weighted six-month, 12-month and 18-month futures prices based on peak load and baseload. However, it looks only at the demand weighted price of that day, rather than the six-month average of the previous period, as in the actual price cap. This line represents what the direct fuel contribution would be if Ofgem set it daily and based it on the latest available information.

This analysis shows that, from late 2020 onwards, the direct fuel component of the price cap is below the other measures of wholesale costs. This means that suppliers—even those who are hedging for six-month periods—have paid more for energy than they are allowed to charge customers (assuming that the other components of the price cap are accurate). Towards the end of 2021, this delta grows, requiring suppliers to fund the increasing difference between the costs that they incur for gas and electricity, and the costs that they can pass on to consumers.

**Figure 2.5** Direct fuel component of the price cap, on a daily basis and based on rolling six-month averages (£/year)



Note: The direct fuel price component is the part of the price cap that can be directly linked to gas and electricity prices. Here, the daily direct fuel cost component is based on the actual daily prices rather than based on the six-month average of the prices as in the actual price cap. The half-yearly direct fuel component is linked to the six-month average of the prices and is updated daily. The y-axis is truncated at £1,000 to increase readability. The highest price is £2,630 (reached on 22 December 2021).

Source: Oxera analysis based on Ofgem (2022), 'Annex\_2\_wholesale\_cost\_allowance\_methodology\_v1.9', January.



While a significant and persistent increase in wholesale prices would always have been problematic for suppliers—especially those that are not sufficiently hedged against commodity price increases—the price cap has meant that they could not increase tariffs in line with input costs, thereby increasing the likelihood of failure. If the end of a fixed tariff that a consumer has with a supplier coincided with the period from September 2021, this would leave the supplier seeking to re-hedge the customer at current market rates while being able to charge the customer only at the level of the Default Tariff Cap.

Ofgem could have shortened the period of time between updates to the price cap—i.e. it could have updated the cap more frequently. This would have allowed suppliers to charge a price that would have been closer to the actual costs incurred for unhedged customers. However, for customers, it would have shortened the period over which bills would be stable, which may be undesirable from a budgeting perspective.<sup>74</sup> In terms of the price cap, there is no one single solution that Ofgem could have implemented as a pure improvement to the status quo, as many of the effects are likely to be distributional in nature and lead to trade-offs. In other words, in seeking to reduce the costs of supplier failure with the design of the price cap, potential trade-offs could have had a negative impact on customers in the form of higher bills, especially for loyal consumers who did not switch (if more headroom had been built into the cap), or more volatile bills (if more frequent updating of the cap had been implemented).

In addition to the lag in suppliers recovering wholesale costs, the interaction of the price cap and the SoLR scheme leads to higher costs being mutualised through the SoLR scheme. When a supplier fails and exits the market via the SoLR route, another supplier is appointed that takes on the failed supplier's customers. These customers are put on an SVT, which is subject to the price cap. Any reasonable additional costs that the supplier of last resort is incurring from taking on these customers can be claimed from an industry levy on future consumers (see section 2.5). This includes the difference between wholesale costs that suppliers incur and the wholesale cost that they can recover from their customers.<sup>75</sup> The price cap—in combination with increasing wholesale costs—thereby increases the level of mutualised costs, which are claimed back via the SoLR process. This is because the price cap limits how much suppliers can recover from their new customers via tariffs while actual wholesale costs to suppliers increase (i.e. without the price cap they would be able to recover more from the new customers they take on and therefore less via SoLR levy claims).<sup>76</sup>

Finally, we understand that, when establishing the price cap, Ofgem made a specific (so far, unused) provision in the licence conditions to disapply the cap in the event of significant and unanticipated changes to wholesale prices:

... we have opted to update wholesale costs on a six-monthly basis. This is a relatively short update period and will result in more frequent price updates than is typical at present... Furthermore, we have also included a provision within the licence conditions to allow us to, subject to consultation, **make more urgent changes** to the models used to update the wholesale component of the cap ... we would only use these powers to make changes to the models where either

<sup>74</sup> In particular, vulnerable customers may value predictability of household bills. However, it is also possible that some customers may prefer (smaller) frequent changes to bills rather than (larger) periodic bill shocks.

<sup>75</sup> Ofgem (2021), 'Last Resort Supply Payment claim (LRSP) process', 29 October, p. 2.

<sup>76</sup> This is a distributional issue. Without the price cap, the customers from failed suppliers would be put on a higher SVT with the new supplier. Rather than mutualising the costs of re-hedging new customers across all bill payers, this would mean that the cost is borne by the affected customers.

there were **significant and unanticipated changes in factors determining suppliers' costs** ...<sup>77</sup> [emphasis added]

However, it should be noted that this provision has time-inconsistent incentive properties. Specifically, the regulator would face a high degree of scrutiny and pushback were it to discontinue the use of the price cap when there is a sharp increase in suppliers' costs. This is because it would be precisely at this time that maintaining low prices would be most valued by consumers, if general inflationary pressures were also heightened.

## 2.8 Conclusion

In summary, we have set out our analysis of the incentives created by Ofgem's approach to regulation at three key stages in the lifecycle of an energy retailer: the point of entry, ongoing regulatory requirements, and the point of exit (for those suppliers who fail). At each point, Ofgem's regulatory approach directly affects a given supplier's business model—and indirectly the sector as a whole through the aggregate effects of supplier actions on the degree of competition, financial resilience and market confidence.

Considering the overall package of incentives that a licensee faced across the supplier lifecycle, we find that Ofgem's approach to regulating the market created the opportunity for suppliers to enter the market and grow to considerable scale while committing minimal levels of capital; indeed, many energy suppliers report net liabilities where liabilities exceed assets (i.e. equity balances are negative). This created the opportunity for prospective suppliers to enter into the market on the basis of a 'free bet'. By pursuing a high-risk/high-reward business model, such suppliers would benefit from the upside, while being able to exit costlessly if the downside materialised.

We also identify a potential loophole around the transfer of financial derivatives to parent companies, which has since been closed through a combination of new regulation by Ofgem, and legislation introduced by BEIS.<sup>78</sup>

As part of its recent Supplier Licensing Review, Ofgem reviewed a number of these issues and introduced (or planned to introduce) changes to address some of these concerns. We note above, however, that Ofgem might have benefited from a clearer framework for evaluating the costs and benefits of proposed interventions in the supplier market. Such a framework would be underpinned by Ofgem's primary statutory duty to protect the consumer interest. We outline proposals for such an 'effective competition' framework as part of our recommendations in section 5.

Next, we reviewed Ofgem's reliance on principles, industry codes and companies' governance arrangements—in particular, directors' financial statements and auditors' statements. From a review of relevant industry codes, we find that these are unlikely to have been sufficient to discipline suppliers to maintain financial resilience, although they might have served as a symptom or early warning system for suppliers who were entering financial instability. A sample of audit statements from suppliers shows that these did not provide sufficient independent assurance to obviate any need for Ofgem to undertake its own monitoring and scrutiny of energy suppliers. We outline two recommendations for the use of auditors going forward. One is based on how Ofwat requires additional independent audit statements as part of annual regulatory reporting. The second is to require a resilience statement that can

<sup>77</sup> Ofgem (2018), 'Default Tariff Cap: Decision Final Impact Assessment', 6 November, p. 108.

<sup>78</sup> We understand from discussion with Ofgem that the windfall tax is intended to be a temporary measure.

be broken down into short-, medium- and long-term periods, about which the directors should be able to make statements with varying degrees of confidence about their company's financial resilience.

Finally, we assessed the design and implementation of a price cap for customers on an SVT, a customer segment constituting around 60% market share. Noting the inconsistency of such a market distortion, in the context of what is otherwise a procompetitive regulatory regime, we identify four specific concerns with the implementation of the price cap (in particular in the context of wholesale price rises of the magnitude observed in 2021):

- calibrating a 'tough' price cap may have left some suppliers with insufficient headroom to deal with shocks;
- in the event that wholesale prices rise above the wholesale cost allowance provided for in the Default Tariff Cap, the cap acts as an effective ceiling, preventing tariffs from increasing and preventing suppliers from being able to fully recover wholesale costs;
- the periodicity of the price cap (revised every six months) exposes suppliers to such a gap for a significant period of time;
- the interaction of the price cap and the SoLR scheme leads to higher costs being mutualised through future customer bills in the event of simultaneous supplier failure and rising wholesale prices.

As movements in spot commodity prices are an exogenous risk factor, with recent increases in volatility, it could be argued that the risk to the supplier should be reduced or transferred in the price cap. This could be achieved in a number of ways cited in this section, such as having higher headroom in the price cap, having shorter lags in the pass-through of wholesale costs, and/or using uncertainty mechanisms.<sup>79</sup> However, any change to the price cap is likely to involve trade-offs and distributional concerns.

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<sup>79</sup> An uncertainty mechanism in this case could, for example, involve the use of a reopener for the level of the price cap if spot prices exceed a specified threshold over a specified time period.

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### 3 The root causes and costs of supplier failure

Having set out the historical and regulatory context of the energy retail sector, this section focuses on the root causes and costs of supplier failure. The stakeholder interviews that we have undertaken, and other materials that we have reviewed, point to several supplier and market characteristics that have led to the recent developments in market exit. These characteristics are analysed in this section, which is structured as follows.

- First, in section 3.1, a brief overview is given of the levels of market entry and exit, of which the causes are unpacked in the subsequent sections.
- Section 3.2 assesses the financial resilience of the suppliers, with a focus on the following.
  - Section 3.2.1 analyses the liquidity and working capital of suppliers in the market to assess whether this has been at adequate levels.
  - Section 3.2.2 focuses on the level of equity balances and dividends—evaluating how equity positions for suppliers that failed declined over time, and also how equity balances evolved as more customers were acquired, to understand the economic business models for new entrants.
  - Section 3.2.3 looks at profitability margins.
  - Section 3.2.4 (and appendix A6) summarises the evidence on hedging arrangements and assesses the evidence in relation to insufficient hedging provisions for failed companies.
  - Having analysed the individual financial aspects, section 3.2.5 comments on the financial resilience of suppliers in the round.
- Based on insights from stakeholder interviews and the evidence on financial metrics of different suppliers, section 3.3 summarises two unsustainable business models that (some) failed suppliers are likely to have followed. These business practices left them exposed to demand- and supply-side shocks, which are correlated across the industry, leading to correlated failures of suppliers, as well as high costs of failure.
- Additional relevant material is set out in appendices A5 and A6 to this report.

We seek to develop an understanding of the root causes of supplier failure by considering a sample of both suppliers that failed and suppliers that are still in operation.<sup>80</sup>

Throughout, where overall industry data is not available from Ofgem over the relevant period, we focus on a consistent sub-sample of firms, both ones that have failed and ones that continue to operate (to date), for four size categories.<sup>81</sup> The selection criteria for selecting firms was to develop a cross-

<sup>80</sup> As of March 2022. Market conditions continue to be challenging for suppliers at this point in time. Throughout the report we refer to suppliers that continued to operate as of March 2022, but note that there could be additional supplier exits in the future.

<sup>81</sup> Our size categories are based on Ofgem's categories for retail suppliers and the licence conditions of these suppliers. We have classified suppliers based on their position in July 2020. Large legacy suppliers: as categorised by Ofgem internally and in its publication of retail market indicators (see Ofgem, 'Retail market indicators', accessed on 22 February 2022 at: <https://www.ofgem.gov.uk/retail-market-indicators>). Large non-legacy suppliers: more than 200,000 customers; the suppliers' licence conditions require milestone assessments at the threshold of 200,000 domestic customers (see Ofgem (2021), 'Standard conditions of

section of suppliers that comprehensively captured the different types of firm across the industry. Note that in subsequent sections we use the shorthand 'active' for those suppliers that continued to operate in the market. The firms are:

- large legacy suppliers (continued to operate): EDF, British Gas;
- large non-legacy suppliers (continued to operate): OVO, Octopus;
- large non-legacy suppliers (failed): Bulb, Avro;
- medium-sized suppliers (continued to operate): Opus Energy, ESB Energy;
- medium-sized suppliers (failed): Utility Point, Pure Planet, People's Energy;
- small suppliers (continued to operate): Dual Energy, BES Utilities;
- smaller suppliers (failed): CNG Energy, PFP Energy, Green Supplier.<sup>82</sup>

A breakdown of all failures since September 2021 is provided in the table below, including the SoLR levy claim made by the acquiring supplier.<sup>83</sup> It demonstrates that the majority of failures relate to small suppliers whose corresponding SoLR claims are less than 1% of the overall SoLR levy claims. The rows in bold refer to the failed companies that we have focused on for the purpose of the financial analysis in this section. These companies were chosen on the basis that they:

- are a representative mix of large, medium and small suppliers;
- overall represent the vast majority (82%) of SoLR levy costs.<sup>84</sup>

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gas supply licence', 25 October, 28C.2). Medium-sized suppliers: between 50,000 and 200,000 customers; the suppliers' licence conditions require milestone assessments at the threshold of 50,000 domestic customers (see Ofgem (2021), 'Standard conditions of gas supply licence', 25 October, 28C.1). Small suppliers: less than 50,000 customers.

<sup>82</sup> Green Supplier ceased trading in September 2021. It is an entirely separate entity from, and has no connection to, Green Energy UK, which (as of April 2022) continues to operate as an active supplier in the energy market.

<sup>83</sup> The supplier of last resort has up to five years to submit a claim, so additional SoLR levy claims are possible.

<sup>84</sup> Some SoLR levy claims were also submitted for failures prior to September 2021. However, these were minor compared with the recent amounts (just under £60m compared with the £1.8bn since September 2021). This means that the companies that we focus on cover 82% of all SoLR levy claims since September 2021 and 80% of all SoLR levies that were submitted overall. The £1.8bn figure covers wholesale costs (£1.7bn since September 2021), as well as smaller components for credit balances, working capital and onboarding & migration.

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**Table 3.1** SoLR levies for failures since September 2021 and companies covered in our sample (bold)

Date of entry	Date of failure	Name	SoLR claim made by acquirer (£)	Percentage of all SoLR claims
<b>Sep-15</b>	<b>Sep-21</b>	<b>PFP Energy</b>	✗	✗
May-19	Sep-21	MoneyPlus Energy	✗	✗
<b>Aug-17</b>	<b>Sep-21</b>	<b>People's Energy</b>	✗	✗
<b>Jan-18</b>	<b>Sep-21</b>	<b>Utility Point</b>	✗	✗
<b>Jan-16</b>	<b>Sep-21</b>	<b>Avro</b>	✗	✗
<b>pre-15</b>	<b>Sep-21</b>	<b>Green Supplier</b>	✗	✗
Nov-16	Sep-21	ENSTROGA	✗	✗
Apr-17	Sep-21	Igloo Energy	✗	✗
pre-15	Sep-21	Symbio Energy	✗	✗
<b>Apr-17</b>	<b>Oct-21</b>	<b>Pure Planet</b>	✗	✗
May-20	Oct-21	Colorado Energy	✗	✗
pre-15	Oct-21	Daligas	✗	✗
Jun-19	Oct-21	GOTO Energy	✗	✗
Oct-19	Nov-21	Bluegreen Energy Services	✗	✗
Mar-20	Nov-21	Omni Energy Limited	✗	✗
pre-15	Nov-21	MA Energy Limited	✗	✗
Jul-17	Nov-21	Zebra Power Limited	✗	✗
Oct-17	Nov-21	Ampoweruk Ltd	✗	✗
<b>pre-15</b>	<b>Nov-21</b>	<b>CNG Energy</b>	✗	✗
Jan-20	Nov-21	Neon Reef Limited	✗	✗
Feb-19	Nov-21	Social Energy Supply Ltd	✗	✗
<b>Sep-15</b>	<b>Nov-21</b>	<b>Bulb</b>	n.a.	n.a.
Dec-17	Nov-21	Orbit Energy Limited	✗	✗
Jan-19	Nov-21	Entice Energy	✗	✗
pre-15	Dec-21	Zog Energy Limited	✗	✗
Jan-17	Jan-22	Together Energy Retail	✗	✗
Total			1,843,664,732	100%
Covered in Oxera sample of failed companies			1,518,633,839	82%

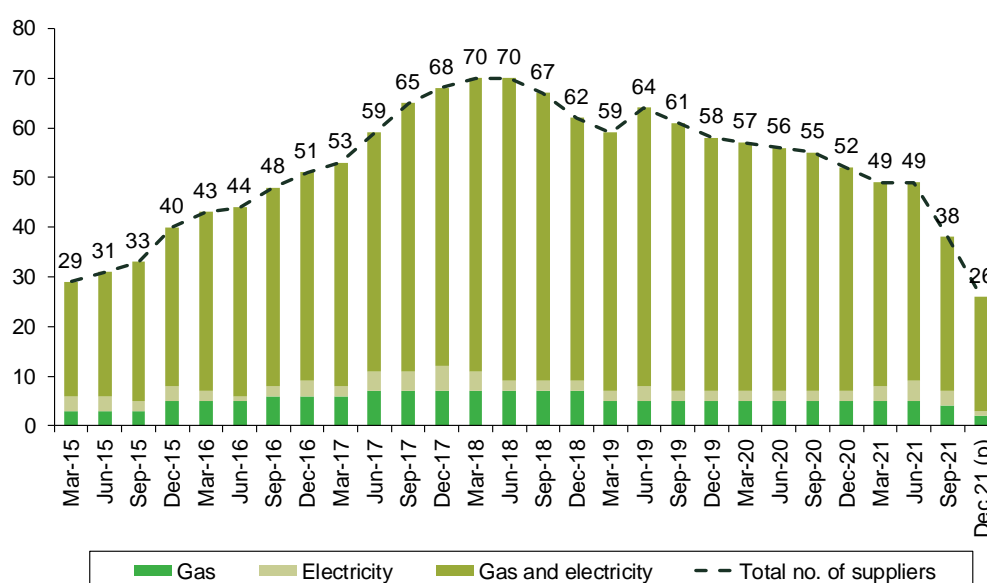
Note: The entry dates relate to the first month in which a company appears in Ofgem's internal market share data. Where this is not available, it relates to the month in which the company was incorporated according to Companies House.

Source: Date of entry based on market share data provided by Ofgem and Companies House; date of failure based on Forbes (2022), 'Failed UK Energy Suppliers Update', 18 February, accessed on 22 February 2022 at: <https://www.forbes.com/uk/advisor/energy/failed-uk-energy-suppliers-update/>; SoLR claims data provided by Ofgem, publicly available data relating to Last Resort Supply Payments can be accessed at: <https://www.ofgem.gov.uk/publications/faster-solr-levy-process-consents-last-resort-supply-payments>.

### 3.1 Context of entry and exit

Up to 2014, the six legacy suppliers accounted for over 90% of market shares before a number of new suppliers emerged. The non-legacy suppliers continuously increased their market share, reaching around 30% in 2019, and around 40% when taking into account OVO's acquisition of SSE (at the start of 2020). The figure below shows the number of suppliers over time, which increased steadily from 2015 to 2018, peaking in 2018 at 70 suppliers. A number of supplier exits began in 2019, leading to a decline in the number of retailers. With rising wholesale prices in the second half of 2021, the number of suppliers decreased significantly with nearly 30 supplier exits in 2021.<sup>85</sup>

**Figure 3.1 Number of suppliers over time**



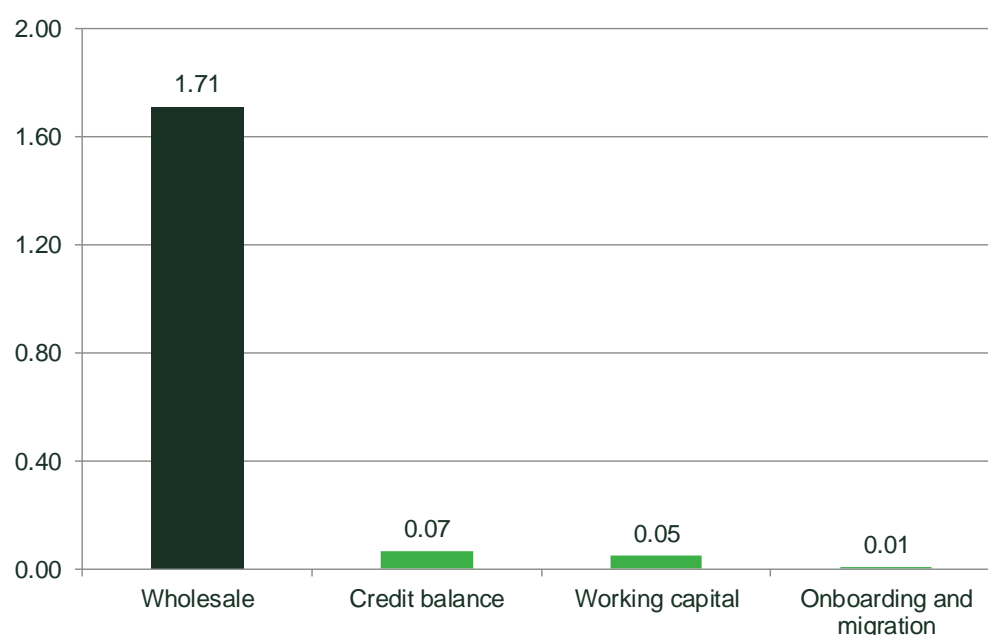
Note: The (p) in December 2021 means that the values for that entry are a prediction.

Source: Ofgem data on number of active suppliers.

We also note that the failure of these firms has imposed a high mutualised cost on GB bill payers at the point of exit, via the SoLR claims process. The chart below shows that the majority of these claims from September 2021 to 22 December 2021 correspond to the 'wholesale' cost category—claims against the SoLR levy that are attributable to the difference between the current wholesale cost of serving customers who were transferred from failed suppliers and the direct fuel cost component of the Default Tariff Cap.

<sup>85</sup> Ofgem (2022), 'Recent supplier exits and take-over suppliers', accessed on 22 February 2022 at: <https://www.ofgem.gov.uk/news-and-views/blog/how-youre-protected-when-energy-firms-collapse>.

**Figure 3.2 SoLR levy claims from September 2021 (£)**



Source: Ofgem internal data.

### 3.2 Analysis of companies' ability to absorb shocks

An important area of focus in our assessment of supplier failures is analysis of companies' ability to absorb external shocks, such as COVID-19-induced demand uncertainties in 2020 and the increase in wholesale prices in 2021. Specifically, our analysis covers four key areas that affect supplier resilience:

- liquidity and working capital;
- equity and dividends;
- profitability;
- hedging arrangements.

In the rest of this section, we set out our findings for each area. This analysis should be viewed in the context of the scope of our work—to explore the evidence that was or could have been available to Ofgem in order to understand the root causes and costs of supplier failure.<sup>86</sup> Important factors that cannot necessarily be fully controlled for, given the limitations of available data include:

- the annual frequency of data available prior to Ofgem's collection of monthly financial resilience data from suppliers in 2020;
- differences in customer types and preferences, such as the proportion of customers that pay by direct debit;
- non-disclosed aspects of companies' commercial strategy.

<sup>86</sup> This report is not intended to be an exhaustive or forward-looking analysis of the financial resilience of the sector. In particular, where we present analysis of historical financial data for suppliers still in operation, this is as a reference point for suppliers that failed, in order to draw inferences on which factor or factors were associated with supplier failure.



### 3.2.1 Liquidity and working capital

Liquidity measures a company's ability to meet its short-term cash requirements for operational activities, such as paying suppliers and employees, and financing activities, such as debt repayments. A company with higher levels of liquidity is generally more resilient to short-term shocks that reduce its cash inflow (e.g. due to reduced sales) and/or increase its cash outflow (e.g. due to increased costs of purchasing energy).

A commonly used measure of liquidity by financial analysts is the current ratio, which represents the ratio of current assets to current liabilities. A ratio that is greater than 1 means that current assets are greater than current liabilities. Therefore, the higher the ratio, the more liquid a company is.

For our analysis, we have calculated the current ratios of our sample of firms before and during the pandemic. Figure 3.3 and Figure 3.4 present the current ratios for suppliers from financial year 2015 to 2020—using the four size categories defined above. ✂ This finding points to a low level of liquidity within the retail energy supply market, not just for suppliers that failed.

#### Figure 3.3 ✂

✂

Note: ✂

Source: ✂

#### Figure 3.4 ✂

✂

Note: ✂

Source: ✂

During the pandemic period—for which Ofgem has collected monthly financial accounting data from the suppliers—there is some evidence that low levels of liquidity are correlated with a higher incidence of failure. Specifically, for the failed suppliers, liquidity has generally been poor compared with their peers. ✂. This is presented in Figure A5.1 and Figure A5.2 in appendix A5.

In addition to the current ratio, we have examined suppliers' net working capital levels. The daily operations of companies require working capital, which is composed of operational cash, inventory, accounts receivable, and accounts payable. The level of net working capital measures a company's liquidity and its ability to meet the short-term operational costs of paying its supply chain and other obligations. This is demonstrated in Figure 3.5 and Figure 3.6, which show that the levels of net working capital of almost all failed companies (with the exception of CNG Energy) have been below those of active peers from FY2015 onwards.

#### Figure 3.5 ✂

✂

Note: ✂

Source: ✂

We also note that, for some small companies that would go on to fail in 2021, levels of net working capital had been negative over several years, as highlighted in the figure below.

**Figure 3.6** ✂

✂

Note: ✂

Source: ✂

Beside the level of liquidity, it is important to assess sources of liquidity. In particular, as highlighted in section 2.4, a source of concern in this market is that suppliers may be over-reliant on customer credit balances for financing their operational needs. Accordingly, we have examined the levels of customer credit balances held over time, as a proportion of total assets, for our sample of suppliers.

For failed companies in the pre-pandemic period (with the exception of CNG Energy), the level of customer credit balances varies over time but generally accounted for a high proportion of total assets relative to peers that continued to operate<sup>87</sup> (see appendix A5).<sup>88</sup> In particular, for Utility Point and Pure Planet, the amount of customer credit held exceeded total assets. Similar trends have been observed during the pandemic (Figure 3.7 and Figure 3.8), where most failed suppliers in our sample have shown relatively high levels of reliance on customer credit balances as a proportion of their assets, compared with suppliers that continued to operate.

**Figure 3.7** ✂

✂

Note: ✂

Source: ✂

**Figure 3.8** ✂

✂

Note: ✂

Source: ✂

For completeness, we also set out customer credit balances (reported as deferred income) as a percentage of current assets in Table 3.2. Failed companies generally have higher shares of customer credit balances as a ratio of their assets, although there is variation in the ratios over time, and CNG Energy is atypical as it is the retail arm of a gas shipping wholesaler. It is worth noting that, while reliance on customer credit balances does not in and of itself lead to failure ✂, the financial costs that result from the failure of suppliers with high customer credit balances could be disproportionately high as these will be subject to recovery from bill payers as a mutualised cost within the SoLR claims process.

This analysis provides insight to understand the credit balance position across the industry, and to compare between groups of suppliers (e.g. to compare suppliers that failed with those that remain active in the market); however, it is subject to data limitations. We note that this analysis—particularly the annual information reported prior to 2020—should be considered in the context of the

<sup>87</sup> Proxied by deferred income.

<sup>88</sup> According to the companies' annual accounts, deferred income represents the monies received from customers in advance of the delivery of gas and electricity that may be returned to the customer if future delivery does not occur. For some companies, deferred income is reported as part of 'accruals and deferred income'.

limitations of taking an annual snapshot of customer credit balances. Observing annual data does not, for example, allow us to see how balances vary over the course of the year, or how these are affected by the selected tariffs and preferences of their customers.

**Table 3.2** Deferred income as percentage of current assets for the period FY2015–20 and as percentage of forecast current assets for selected months

	Company	2015	2016	2017	2018	2019	2020	Jul-20	Dec-20	Jul-21	Nov-21
Small companies	CNG Energy (failed) <sup>1</sup>	4%	4%	3%	3%	7%	16%	6%	6%	9%	
	Green Supplier (failed) <sup>2</sup>					214%	46%	26%	86%	49%	
	People's Energy (failed) <sup>3</sup>			8%	24%	30%		40%	29%	29%	
	PFP Energy (failed) <sup>4</sup>				11%	10%	18%	27%	39%		
	Pure Planet (failed) <sup>5</sup>					161%	149%	28%	21%	18%	
	Utility Point (failed) <sup>6</sup>					123%	124%		75%		
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Large companies	Avro (failed) <sup>7</sup>							81%	81%	74%	
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕

Note: <sup>1</sup> CNG Energy failed in November 2021. <sup>2</sup> Green Supplier failed in September 2021. <sup>3</sup> People's Energy failed in September 2021. <sup>4</sup> PFP Energy failed in September 2021. <sup>5</sup> Pure Planet failed in October 2021. <sup>6</sup> Utility Point failed in September 2021. <sup>7</sup> Avro failed in September 2021. ✕ For the cells with no values we do not have the data for that particular company in the given year/month.

Source: Oxera analysis based on companies' financial statements and Ofgem data.

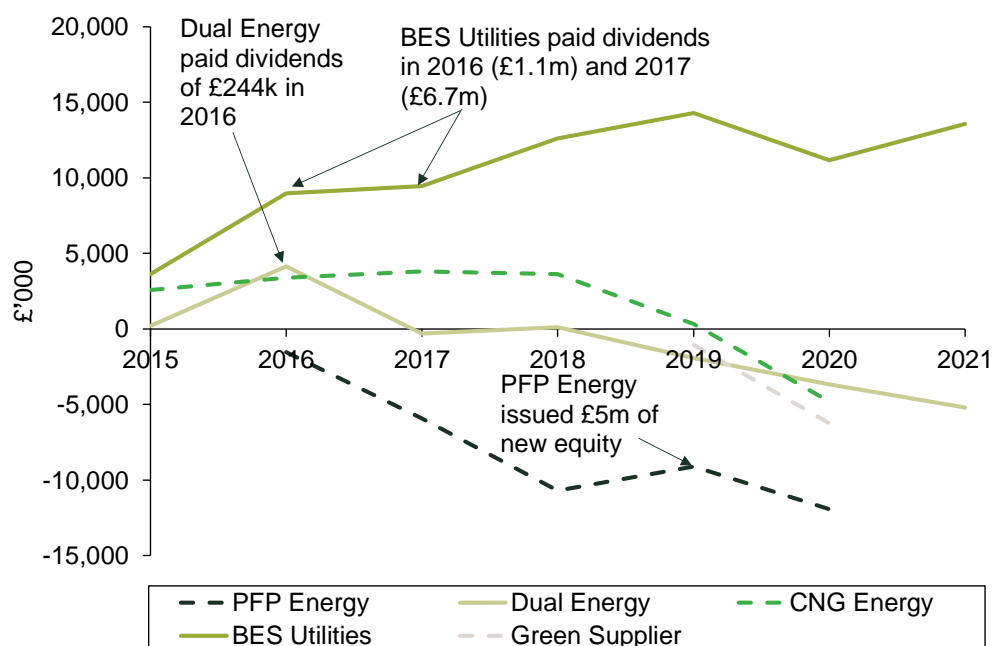
### 3.2.2 Equity and dividends

As a residual claim to a company's assets after all liabilities are paid, equity balances measure a company's solvency and long-term capital adequacy, which is crucial for absorbing short-term and long-term shocks.

A change in equity balances from year to year is driven by capital reductions (e.g. share buybacks and dividend payments), capital contributions (e.g. equity issuance), and the retained earnings during each financial year. In our analysis, we have examined the changes in equity balances for our sample of suppliers between 2016 and 2020, and the drivers of these changes.

Figure 3.9 and Figure 3.10 set out the change in equity balances for small and medium suppliers. From FY 2016 to FY 2020, only active suppliers with positive equity balances (Opus Energy, Dual Energy and BES Utilities) paid dividends. Two active companies (Dual Energy and ESB Energy) and all failed companies had negative equity balances at the end of FY 2020. PFP Energy and Utility Point issued new equity of £5m and £14,454 respectively in FY 2019 to top up their negative balances, which were offset by the net losses incurred during FY 2020, leading to more negative equity balances at the end of FY 2020.

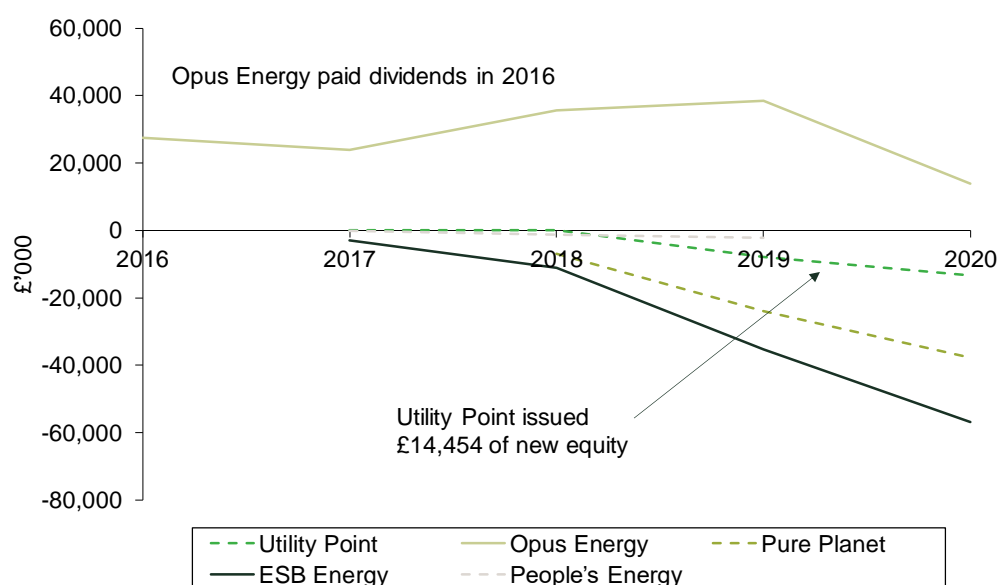
**Figure 3.9 Equity balances for small suppliers, FY 2016–20**



Note: Dual Energy was acquired by SmartestEnergy Limited on 6 December 2019 and rebranded to SmartestEnergy Business Limited.

Source: Oxera analysis of companies' financial data from Companies House.

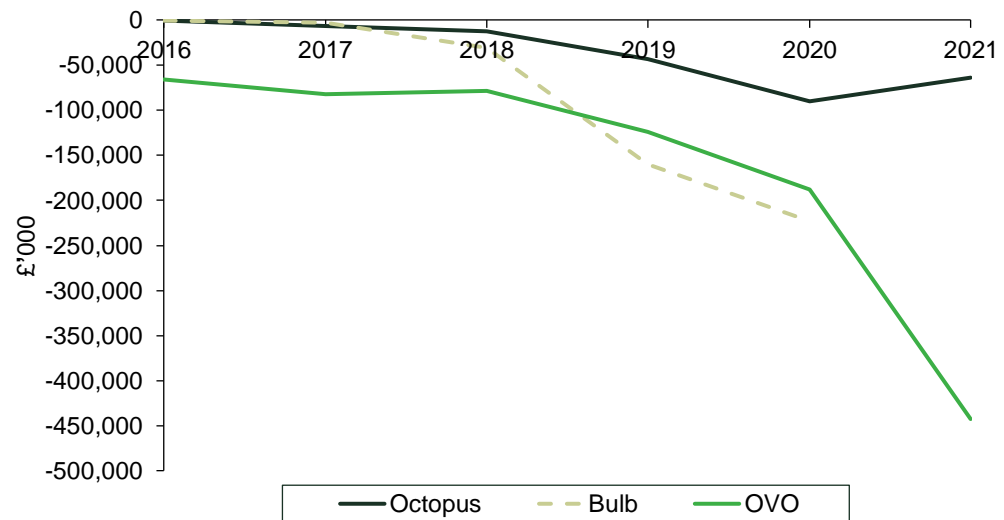
**Figure 3.10 Equity balances for medium suppliers, FY 2015–20**



Source: Oxera analysis of companies' financial data from Companies House.

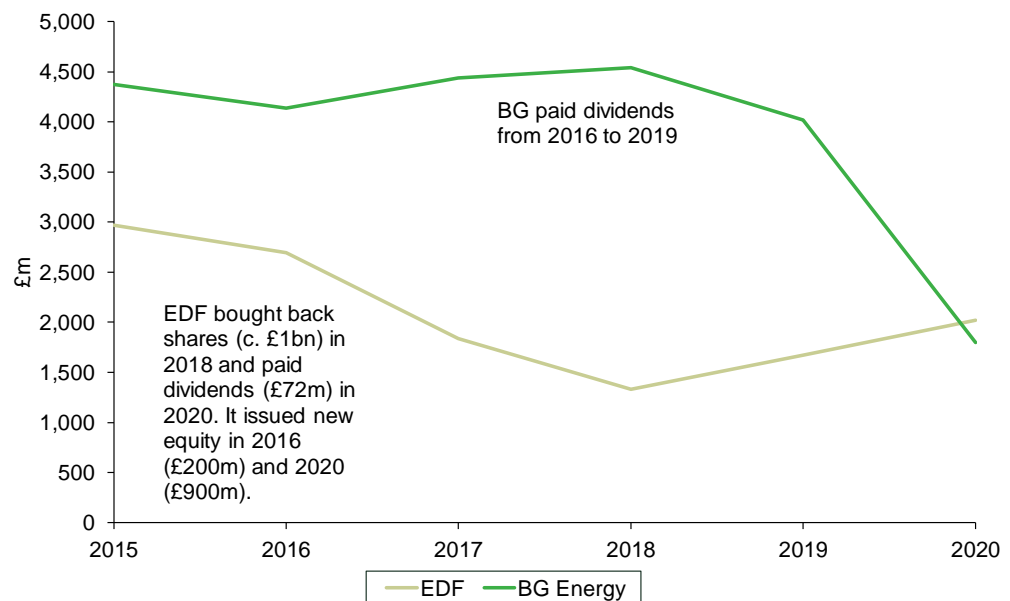
Similar trends are observed for large non-legacy and legacy suppliers, where the failed company Bulb did not issue any dividends.

**Figure 3.11 Equity balances for large non-legacy suppliers, FY 2016–20**



Source: Oxera analysis of companies' financial data from Companies House. Avro is excluded from this analysis as it issued financial results only for FY 2017 and FY 2018+HY 2019 (together in one annual account). It did not record any dividend payments in these two sets of financial results.

**Figure 3.12 Equity balances for large legacy suppliers, FY 2015–20**



Note: although the financial statement for British Gas Trading Limited shows payment of a dividend in 2020, we understand that this relates to an internal transfer between British Gas Trading Limited and Centrica Group (which relates to an inter-company loan) recorded as a dividend. At a group level, Centrica last paid an (interim) dividend in 2019, and has not paid dividends since (as of 2 May 2022), based on information accessed at: <https://www.centrica.com/investors/shareholder-centre/dividends/dividend-history/>.

Source: Oxera analysis of companies' financial data from Companies House.

In summary, it appears that supplier failure is associated with persistent negative equity balances. This association is likely to be driven by the following two factors.

- As discussed at the beginning of section 3.2.1, equity is the residual claimant to assets after all liabilities are paid. Therefore, negative equity balances leave suppliers with no cushion to absorb shocks that reduce their assets and/or flexibility to increase their liabilities.
- Negative equity incentivises exit and liquidation, where investors are absolved from paying for the negative equity balances (i.e. net liabilities).

The negative equity balances of at least four active suppliers included in our analysis (Octopus, OVO, ESB Energy and Dual Energy) coincide with the systemic decline in industry profitability, as evidenced by Ofgem's retail market indicators, which showed negative combined operating income across the large legacy suppliers since 2019.<sup>89</sup>

Moreover, we found that dividends payments do not seem to be a cause of supplier failure, as none of the failed companies paid any dividends in the years preceding their failure. However, from stakeholder interviews we note that there are other ways of removing cash from companies (e.g. through payments to affiliate companies for general corporate services), which are difficult to detect in analysis of financial statements, especially for non-publicly traded companies with limited financial disclosures.

We also analysed the hypothesis raised by several stakeholders that some suppliers have been using growing customer books to finance themselves. This suggests that businesses relied on receiving customer balances prior to the provision of services, and used these prepayments to fund the ongoing costs of the business and to act as a buffer against any short-term shocks, while relying on growth in the customer base to keep ahead of future liabilities. This is analysed by comparing customer growth rates to levels of equity. If this is the underlying economic business model, then, as long as growth rates are high, we would expect equity to remain relatively high, but as growth slows down, the level of equity would be expected to decline.

This hypothesis is tested in the data for the failed companies in our sample. In the chart below we can see that Bulb initially experiences significant growth, which then slows down. At the same time, its total equity declines slightly. Equity then drops sharply from 2018 to 2019 when customer growth has stagnated. The trend for the other failed companies is similar, although the drop in equity is less pronounced, declining steadily as customer growth slows down; we report the charts for these other companies (Utility Point, Pure Planet, PFP Energy, People's Energy) in appendix A5.

**Figure 3.13** ✂

✂

Source: ✂

### 3.2.3 Profitability and margins

It is also important to note that the levels of profitability in the retail market have declined in recent years, as measured in terms of pre-tax margins. Ofgem has observed, in relation to the profit margins of the 'big six' suppliers (see Figure 3.14):

Between 2009 and 2016, the average combined gas and electricity pre-tax domestic supply margin across the large legacy suppliers grew from around 1%

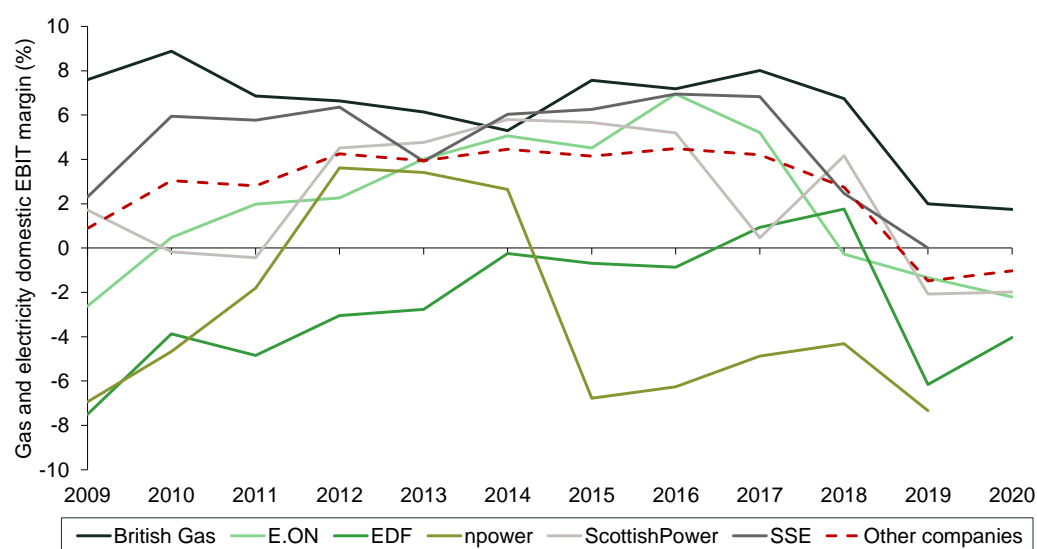
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<sup>89</sup> As set out in Figure 3.14.

to around 4%, with significant differences between the suppliers' margins. Between 2017 and 2019, profits earned by the large legacy suppliers continued to vary substantially, but generally showed a decrease and became negative on average in 2019.<sup>90</sup>

The data on profitability margins of the 'big six' is collected by Ofgem, and similar reporting by Ofgem is not available for all of the companies in our sample. We have, accordingly, undertaken primarily analysis based on data from Companies House on the profit margins for companies in our sample of non-'big six' large suppliers as well as medium and small suppliers. The evidence is consistent with negative margins in the industry, in particular since 2018 (see Figure 3.15).

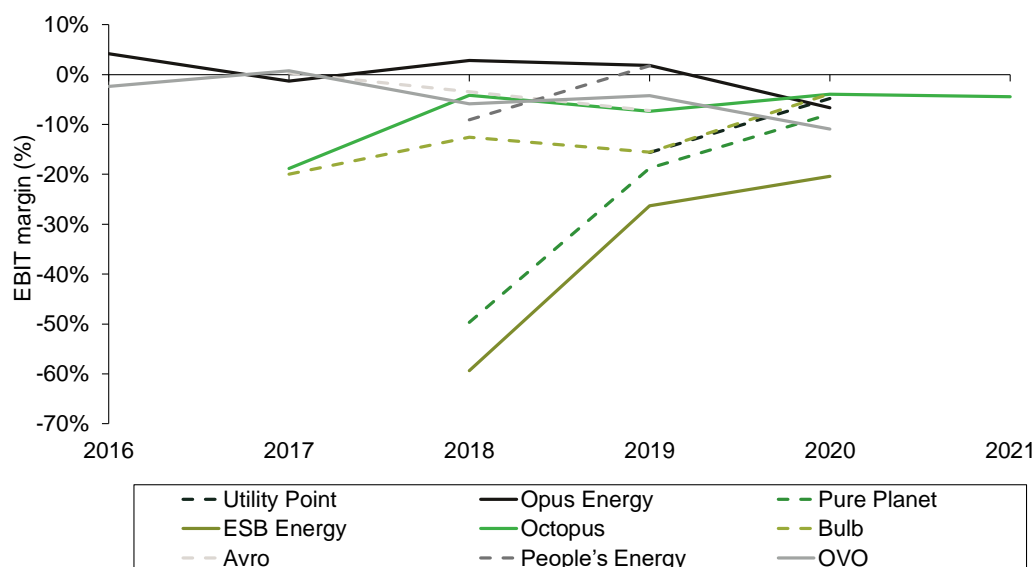
**Figure 3.14 Pre-tax domestic supply margins of the large legacy suppliers, combined electricity and gas, 2009–20**



Note: The data and detailed methodology underlying this chart is available on Ofgem's website. For British Gas, this excludes exceptional items and certain re-measurements, which if included would result in negative margins in some years.

Source: Ofgem, 'Retail market indicators', accessed on 10 April 2022 at: <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/retail-market-indicators>.

<sup>90</sup> Ofgem (2022), 'Data Portal', Retail Market Indicators, accessed on 24 February 2022 at: <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/retail-market-indicators>.

**Figure 3.15 Profitability for large and medium non-legacy suppliers, combined electricity and gas 2015–21**

Note: The supply margins shown in this chart are the ratio of a company's EBIT to its total revenues. A supplier's margin is calculated by subtracting from a company's total revenue its total direct costs, total indirect costs (such as operating costs), depreciation and amortisation. Small companies are reported in appendix A5.5. Note that the number for Opus Energy for FY2016 is based on a nine-month figure. The value for Pure Planet for FY2018 is based on a six-month period. The value for Avro for FY2019 is based on a sum of FY2018+HY2019 figures.

Source: Oxera analysis based on companies' annual statements.

Similar levels of profitability are observed across both companies that failed and those that did not fail.

### 3.2.4 Hedging

In the retail energy supply market, robust hedging arrangements are important in absorbing the shock of any rapid and sustained increase in wholesale energy prices. As shown by the collapse of Bulb, inadequate levels and horizons for hedging arrangements could be (and have been) detrimental to a supplier's survival during the current energy crisis.<sup>91</sup>

We set out our analysis of suppliers' disclosure of hedging arrangements in appendix A6, which is based on the information that suppliers have provided to Ofgem. We find that failed companies had lower willingness to report hedging arrangements prior to failure, and those that did report had, on average, poorer hedging arrangements than those that are still active. However, hedging alone is not sufficient for determining a supplier's propensity to fail, as shown by the failed suppliers that were relatively well hedged, and some active suppliers that had relatively low levels of hedging and/or were hedged over a relatively short horizon.

While the hedging arrangements for individual suppliers need to be assessed on a case-by-case basis, we observed that there are three ways in which suppliers can (and have) insulate (insulated) themselves from input price

<sup>91</sup> See *Financial Times* (2022), 'UK energy supplier Bulb's hedging strategy led to collapse, report shows', 11 January, accessed on 10 April 2022 at: <https://www.ft.com/content/8bdc2216-ac34-4185-90a1-92613f622680>.



volatility, and that the active suppliers often adopted one or more of these approaches:

- entering into long-term supply agreements with wholesale suppliers ✕;
- passing on the cost of hedging to customers ✕;
- hedging a significant proportion of demand exposure over an extended period of time (most active suppliers).

### 3.2.5 Financial resilience in the round

In conclusion, our findings on liquidity and working capital, changes in equity balances, industry profitability and hedging arrangements show that supplier failure can be manifested in all of these areas. In particular, all failed companies had negative and deteriorating equity balances in the years leading up to their failure. These negative equity balances reduced the suppliers' abilities to absorb external shocks such as the COVID-19-induced demand uncertainties and the rapid and sustained increases in wholesale energy prices. They also implied low opportunity costs of exit, where the investors can walk away from negative equity balances and the potential losses of customer credit balances, due to mutualisation of costs as part of the SoLR process. Most of the failed suppliers in our sample also (i) had poor liquidity and low levels of capital; (ii) were over-reliant on customer credit balances to finance their operations; and (iii) either unhedged, or not substantively (i.e. more than 50% over nine months or more) hedged, positions. This is summarised in Table 3.3 below. For each supplier, the area(s) that limited their abilities to absorb shocks is highlighted in orange.

With the exception of CNG Energy, the other failed suppliers had at least two areas that limited their ability to absorb shocks. In the case of CNG Energy, its failure is attributed mainly to the loss of key customers, which accounted for c. 80% of its customer base.<sup>92</sup> Such severe demand shocks are unlikely to be mitigated even with sufficient liquidity and a well-hedged portfolio.

<sup>92</sup> Report from Interpath Advisory joint administrators, reported in TheBusinessDesk.com (2022), 'Collapsed gas shipping business owed £82m', 4 February, accessed at 10 April 2022 on: <https://www.thebusinessdesk.com/yorkshire/news/2088612-wait-for-payment-continues-for-creditors-of-collapsed-gas-shipping-business>.

**Table 3.3 Overview of the failed companies in Oxera's sample**

	Category	Customer type	Failure month	Working capital adequacy	Working capital composition	Hedging	Equity balances
✂	✂	✂	✂	✂	✂	✂	✂
<b>Avro</b>	Large non-legacy	Domestic only	Sep-21	Current ratio consistently at 1 from June to December 2020	Highly reliant on customer credit balances (c. 80% of total assets in 2020)	Low hedging levels (20% for three months out and 15% for nine months out)	Negative in FY 2020
<b>Utility Point</b>	Medium	Domestic only	Sep-21	Current ratio consistently below 1 from June to December 2020	Highly reliant on customer credit balances (peaks at around 90% of total assets in 2020)	Limited disclosure even after Ofgem specified its Request for Information (RFI) questions on hedging in April 2021	Negative in FY 2020
<b>Pure Planet</b>	Medium	Domestic	Oct-21	Current ratio consistently below 0.5 from June to December 2020	Moderately reliant on customer credit balances (briefly peaked at around 25% of total assets in February 2021 and dropped to 12% in one month)	High levels of hedging for three months out. No hedging for variable tariffs beyond three months	Negative in FY 2020
<b>People's Energy</b>	Medium	Domestic and non-domestic	Sep-21	Current ratio consistently below 1 from June to December 2020	Reliant on customer credit (up to 40% in 2020)	Moderately high levels of hedging (67% to 46%) for six months out	Negative in FY 2020
<b>PFP Energy</b>	Small	Domestic and non-domestic	Sep-21	Current ratio consistently below 1 from June to December 2020	Reliant on customer credit (up to around 40% of total assets in 2020)	High levels of hedging for at least nine months out (91% for three months out and c. 70% for nine months out for both gas and electricity)	Negative in FY 2020
<b>CNG Energy</b>	Small	Non-domestic	Nov-21	Current ratio consistently above 1 from June to December 2020	Limited reliance on customer credit (consistently below 10% of total assets in 2020 and 2021)	Fully hedged for fixed contracts for at least nine months out; limited disclosures on overall level of hedging	Negative in FY 2020
<b>Green Supplier</b>	Small	Domestic and non-domestic	Sep-21	Current ratio consistently above 1 from June to December 2020	Highly reliant on customer credit (peaks at around 90% in 2020)	Limited disclosure even after Ofgem specified its RFI questions on hedging in April 2021	Negative in FY 2020

Note: 'Current ratio' refers to a commonly used measure of liquidity by financial analysts, which represents the ratio of current assets to current liabilities. All variables with the exception of 'Equity balances' are computed using Ofgem RFI data that contains values from June 2020 to November 2021.

Source: Ofgem RFI data and company financial data from Companies House.

In summary, our findings show that, while all the factors discussed above can be used as leading indicators for supplier failures, none of these individual factors alone predict failure. Instead, it is the combination of multiple factors that has reduced suppliers' abilities to absorb external shocks, which had started to manifest at the beginning of the COVID-19 pandemic and intensified significantly during the energy crisis in 2021. This suggests that there is no single measure that can be introduced to address weaknesses in suppliers' financial resilience and to prevent failure.

### 3.3 Business models and evidence of 'systemic' risk

The stakeholder interviews and other materials reviewed have suggested that market entry did not necessarily and always occur because new companies had more innovative solutions or found ways to operate more efficiently. Instead, these sources have pointed to two types of unsustainable business model that were pursued to varying degrees by some fast-growing suppliers. Specifically, there are features of:

- a *growth* model, under which businesses relied on receiving customer balances prior to the provision of services. Suppliers used these prepayments to fund the ongoing costs of the business and to act as a buffer against any short-term shocks. They then relied on growth in the customer base to keep ahead of future liabilities, making the strategy unsustainable in the long term during times when growth slows down;
- a *timing* model, under which suppliers undercut hedged rivals by entering at favourable moments in the market, entering into long-term supply agreements with customers based on prevailing low spot rates. By not sufficiently hedging, this strategy eventually leads to failure if spot prices increase persistently.

These business models are not mutually exclusive, and companies may have followed a mixture of the two.<sup>93</sup> For instance, continuous growth might have been sustained over periods with falling wholesale prices by undercutting players that had more expensive hedging arrangements in place.

#### The growth model—evidence and systemic risk

The link between customer growth rates and equity is shown in Figure 3.13 and in appendix A5.4, demonstrating a positive relationship between growth rates and equity. When growth rates are high, equity is still fairly high, but as soon as growth slows down, equity declines. This is supporting evidence for the growth model.

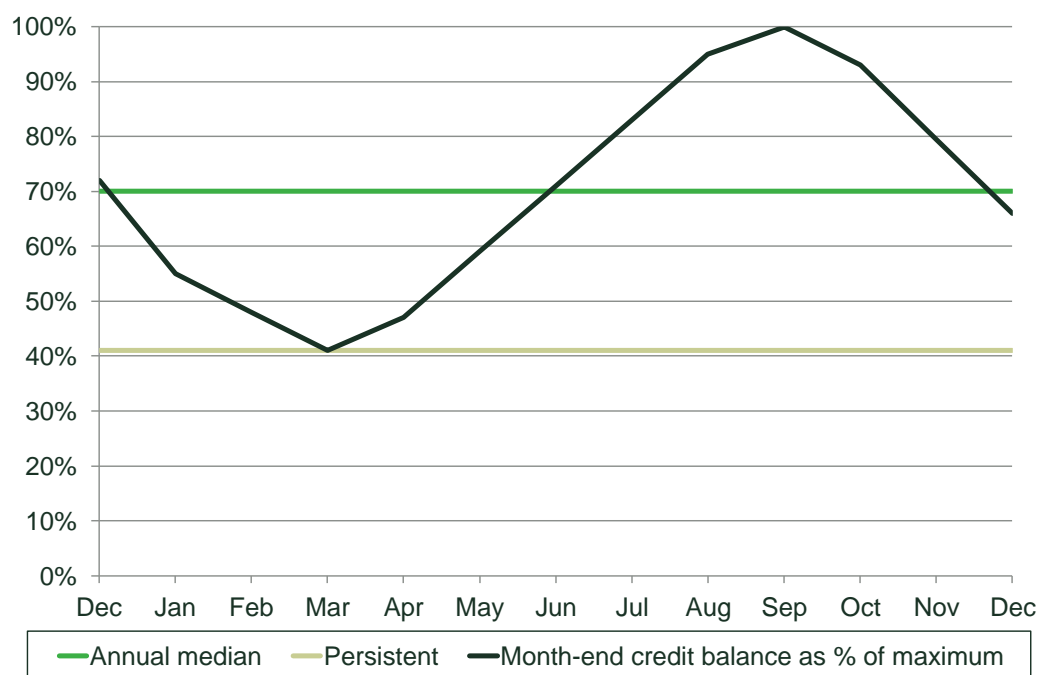
Additional evidence can be found in Ofgem analysis from 2018, which explored seasonal trends in customer credit balances held by suppliers.<sup>94</sup> This is set out in Figure 3.16, which shows the proportion of customer credit balances held by a supplier in a given month as a percentage of total credit balance for the year by month (dark green). Rather than fluctuating around 0, as might be expected by suppliers that use only direct debits to smooth bills for customers, the average proportion of customer credit balances held in a given month is 70%

<sup>93</sup> The description of these business models does not represent a taxonomy of all supplier business models in the retail market.

<sup>94</sup> It is unclear from the underlying Ofgem report whether the analysis was carried out for the market as a whole or for a subset of the market, such as failed suppliers. The implications of the degree of prepayment balances being retained by companies—implicitly to be used as working capital—demonstrate the viability of the growth model within the regulatory system designed by Ofgem.

of the total bill for the year, with a persistent credit position of 40% held across the year.

**Figure 3.16** Seasonal trends in customer credit balances (dark green), with minimum (light green) and average (mid green)



Source: Ofgem (2018), 'Supplier Market Outlook: Does supplier failure reflect market health?', 26 March.

The growth model would be exposed to any shocks, i.e. to either the cost of supply or the level of demand. By relying on prepayments to make up a large proportion of available liquidity, suppliers that needed to draw down on these balances to fund short-term cash shortfalls that arose as a result of unexpected supply or demand shocks could find themselves facing financial difficulties unless they were able to raise prices (limited as a result of competition with the Default Tariff Cap) or grow their customer base (which might not be possible in the event of a sector-wide supply or demand shock). In particular, it might be difficult to raise liquidity through prepayments from customer growth at times of rising wholesale prices due to the price cap. The lag in wholesale costs being reflected in the cap means that SVTs (which are capped) are more attractive to customers than other, more cost-reflective tariffs. However, undercutting the price cap at these times to attract customers is likely to be a loss-making strategy given high wholesale prices.

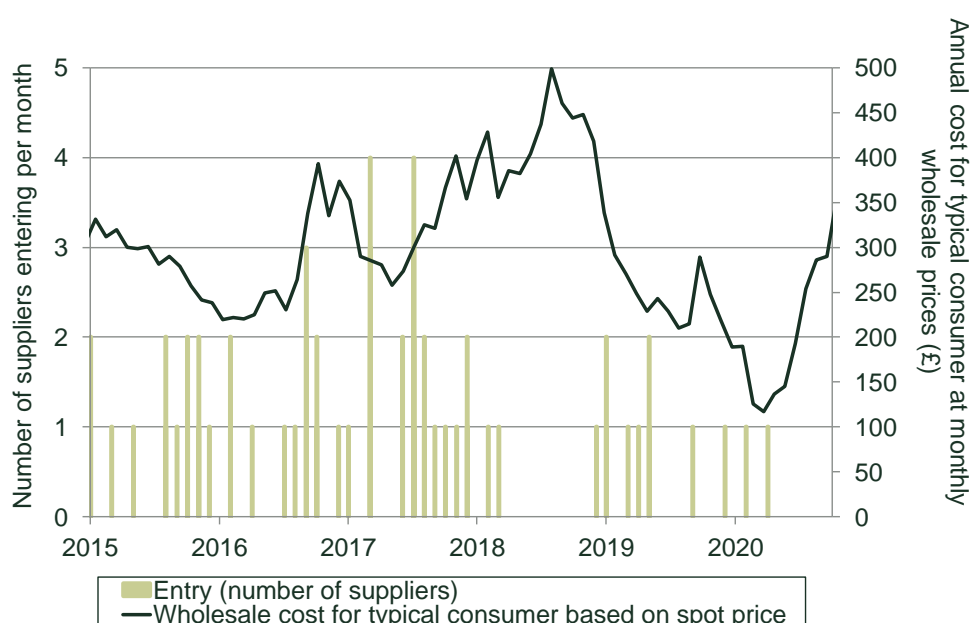
This type of business model leads to higher costs being mutualised when companies fail compared with the failure of companies that were not using prepayments as working capital to the same extent. This is because, at the point of failures, these companies would have high levels of customer prepayments, which then need to be mutualised.

To address the adverse effects of this business model, additional regulatory requirements would be necessary. In particular, it would be helpful if companies were required to demonstrate sufficient levels of working capital that are not based on customer prepayment balances.

### The timing model—evidence and systemic risk

To assess whether companies were following the timing model described above, Figure 3.17 plots the monthly wholesale cost for gas and electricity (line) against the number of firms entering the market in that month. It broadly shows the pattern that we would expect under the timing model—i.e. it shows entry of several firms almost every month between late 2015 and early 2018. When the wholesale price increases in 2018, firms stop entering the market, while entry picks up again in 2019 during low prices. The recent cost rise is not shown on this chart to avoid distortions.

**Figure 3.17** New entry into the supply market (bars, left axis) against wholesale spot prices (line, right axis)



Note: The wholesale cost is calculated using electricity and gas spot prices. These are multiplied by TDCVs of 12,000kWh for gas and 2,900kWh for electricity.

Source: Wholesale prices from Ofgem, 'Wholesale market indicators', accessed on 2 February 2022 at: <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/wholesale-market-indicators>; TDCVs from Ofgem (2020), 'Decision on revised Typical Domestic Consumption Values for gas and electricity and Economy 7 consumption split', 6 January; entry dates calculated based on market share data provided by Ofgem.

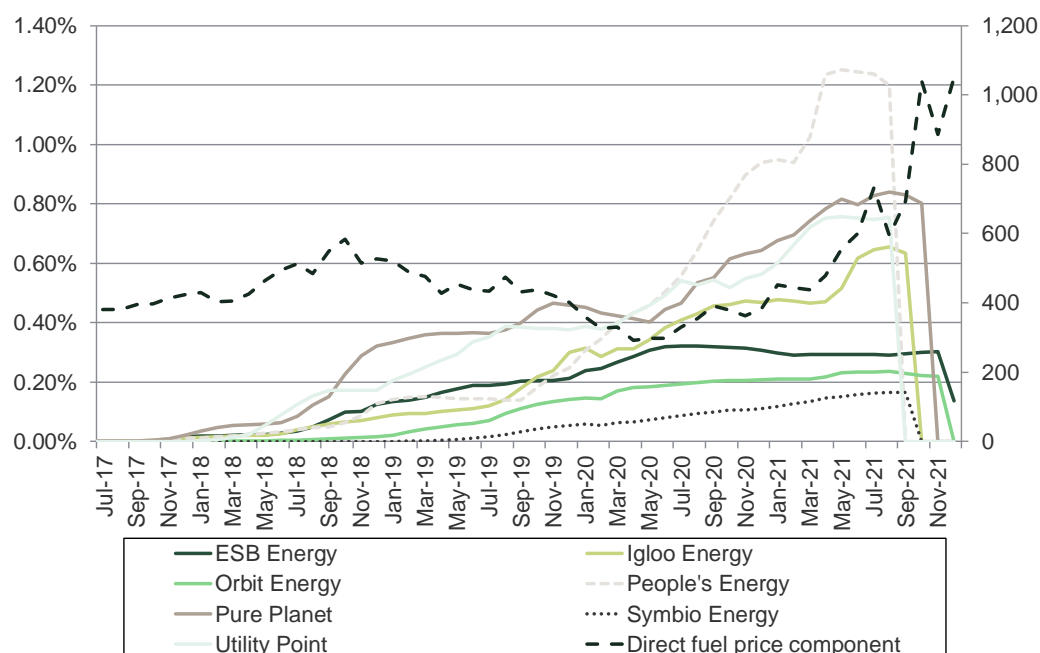
The above chart provides some evidence of suppliers entering the market during times of relatively low spot prices. While the correlation is not perfect, there are two reasons why suppliers might not enter exactly at the troughs in wholesale prices:

- entering the market takes time, at least since the disappearance of the 'supplier in a box' model. We understand from discussion with Ofgem and industry participants that the lag between a supplier wanting to enter the market and it acquiring customers has been at least nine months since the 'supplier in a box' model of entry was withdrawn;
- suppliers ideally want to enter at a point when wholesale costs will continue to fall. If they enter exactly at the trough, they will be faced with increasing wholesale prices.

Next, we analyse whether there is evidence for firms aggressively pursuing higher market shares in times of low wholesale costs. Evidence for specific

firms supports this. The figure below shows the market share for the companies that have exhibited greatest growth between 2018 and 2021. The market shares of these companies all grew by a factor of more than 15 over this period. The chart shows that these companies grew particularly quickly in the period following the low wholesale costs that were experienced in early 2020. All seven companies failed in late 2021 after experiencing a slow-down in growth.

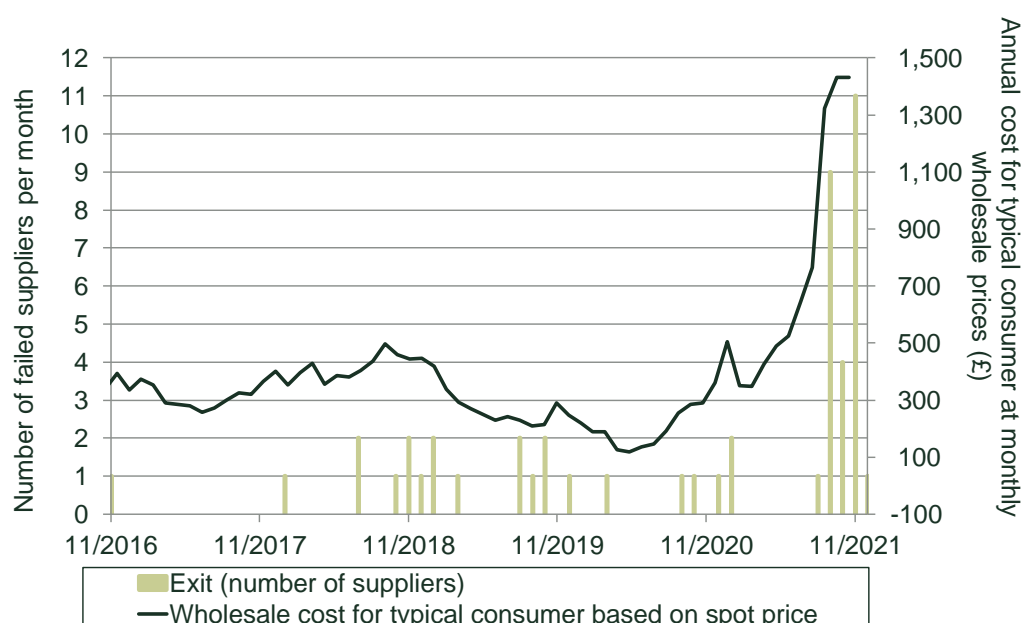
**Figure 3.18 Market share of fast-growing companies (left axis) and wholesale costs (dashed line, right axis)**



Note: The companies are selected on the basis that they have grown the most (over 15x) between 2018 and 2021 and also have had over 5,000 customers. Note that all of these seven companies have failed in 2021.

Source: Oxera analysis based on Ofgem market share data.

The timing model was particularly exposed to wholesale price volatility as it relied on suppliers being able to consistently undercut other suppliers that had hedging arrangements in place—and doing so while avoiding losses. This business model would inevitably lead to large financial losses to a supplier in the event of a large and unanticipated increase in wholesale prices—exacerbated if a higher level of wholesale price rises than anticipated persisted over a longer time period. The evidence on the timing of supplier failures seems to support this. Figure 3.19 shows that the increases in supplier failures correspond to increases in underlying wholesale market prices for gas and electricity.

**Figure 3.19 Wholesale spot prices (line) against supplier failures (bars)**

Note: The wholesale cost is calculated using electricity and gas spot prices. These are multiplied by TDCVs of 12,000kWh for gas and 2,900kWh for electricity.

Source: Wholesale prices from Ofgem, 'Wholesale market indicators', accessed on 2 February 2022 at: <https://www.ofgem.gov.uk/energy-data-and-research/data-portal/wholesale-market-indicators>; TDCVs from Ofgem (2020), 'Decision on revised Typical Domestic Consumption Values for gas and electricity and Economy 7 consumption split', 6 January; exit dates based on data provided by Ofgem and Forbes (2022), 'Failed UK Energy Suppliers Update', 18 February, accessed on 22 February 2022 at: <https://www.forbes.com/uk/advisor/energy/failed-uk-energy-suppliers-update/>.

This demonstrates that there is some evidence for the correlation between the underlying wholesale cost and both market entry and exit: under the timing model, entry occurred often at low wholesale prices and exit occurred usually at relatively high wholesale prices, especially if they were persistently high.

As well as creating an increased risk of failure, the timing business model is exposed to failure at the point at which the costs that would need to be mutualised across the sector are greatest. As noted above, this arises as customers of failed suppliers that are transferred through the SoLR process are placed onto the, SVT which is regulated with a lag to current wholesale prices through the Default Tariff Cap. Any gap between current wholesale prices and the SVT that the SoLR auction winner attains is funded through the SoLR levy and mutualised across future energy customers through bills. At the point at which wholesale prices are sufficiently volatile to lead to the failure of suppliers following a timing business model, the gap between the Default Tariff Cap and actual cost to serve will be greater. Moreover, the larger and more persistent the wholesale price rise, the greater the incidence of failure and the greater the associated costs.

To avoid supplier failures as a result of the timing model, additional checks may have been necessary to ensure the sustainability and resilience of supplier business models. For instance, companies would need to demonstrate a robust business model that shows sufficient protection against wholesale cost increases—e.g. in the form of hedging.

These market-wide dynamics can explain why the risks and costs of supplier failure magnified over time. According to stakeholder interviews, while the



earlier failures in 2018/19 were perceived by Ofgem as not being particularly costly, and as signals of less efficient firms exiting the market, a prolonged period of low wholesale prices coupled with few rules around capital adequacy has led to the entry and significant growth of smaller players. The correlation between entry and exit (which are both linked to wholesale market dynamics), as well as growing customer books of these smaller, less resilient suppliers, has led to a correlated mass exit of firms affecting millions of customers.

Through the combination of the systemic risks set out above, the market that had emerged by 2020/21 did not prove resilient in the face of an unprecedented rise in wholesale energy prices. This was exacerbated by:

- a lag in the pass-through of wholesale fuel costs in retail energy prices—in particular, a six-month price cap based on allowed wholesale prices that have been far below prevailing spot prices from September 2021 onwards, and a SoLR process that has mutualised this cost differential across future bill payers in the event of supplier failure, have led to a high cost of failure being spread across bill payers;
- the low levels of financial resilience have been caused by some suppliers' pursuit of riskier business models—both enabled and incentivised through capital inadequacy and the use of customer balances.

As set out at the start of this section, the consequence has been a large financial burden placed on future consumers, in the wider context of affordability challenges faced by bill payers.

We have considered whether a conglomerate business model in energy retail (i.e. the provision of joint services, such as integrated energy and telephony services) is a cause of the recent supplier failures. Specific examples of conglomerate business models cited by stakeholders include Solarplicity and 3<. These specific suppliers do not constitute relevant recent losses from which lessons are to be learnt, given that they failed prior to the relevant period (Solarplicity failed in 2019) or remain active in the market (3<).<sup>95</sup> However, we note that, to the extent that a conglomerate business model or a vertically integrated business model leads to higher or lower resilience of the energy supply licence-holder, this would be of interest to Ofgem in its future monitoring of the resilience of the sector. We understand from suppliers whom we have interviewed that Ofgem requires reporting for the stand-alone energy retail business for large suppliers, but that smaller players may be exempt from reporting for energy retail on a stand-alone basis. This implies the following.

- For large suppliers, any monitoring information that Ofgem receives is 'pure play', and any other activities (besides energy retail) would not be reported, and nor would they be relevant to its financial monitoring. Of course, if other activities, such as energy trading, are profitable or loss-making, this could pull up, or drag down, the financial position of the conglomerate. However, Ofgem is responsible for regulating energy supply so it is appropriate that its regulation would be focused on the position of the ring-fenced entity. The retail ring-fence should operate such that there is no cross-subsidy received from, or conferred on, activities other than gas and electricity supply.
- For smaller suppliers, if they are exempt from reporting their energy retail activities on a stand-alone basis then Ofgem would be effectively monitoring the financial position across energy retail and other activities. On the one

<sup>95</sup> Ofgem (2019), 'Ofgem protects customers of failed supplier Solarplicity', 13 August, accessed on 2 May 2022 at: <https://www.ofgem.gov.uk/publications/ofgem-protects-customers-failed-supplier-solarplicity>.



hand, this may provide it with reassurance that the smaller suppliers' aggregated financial position is stable. On the other hand, it would be contrary to the principle that the retail ring-fence should operate such that there is no cross-subsidy received from, or conferred on, activities other than gas and electricity supply. Accordingly, in its future monitoring of the sector, it may be appropriate for Ofgem to require financial reporting of energy retail activities on a stand-alone basis, even for smaller suppliers (as is the case for larger suppliers).

### **3.4 Conclusion**

We have identified a number of contributing factors to the root causes and costs of the extensive supplier failures in the market in 2021.

First, we have gathered evidence from stakeholders of two business models that have been sustained by various features of Ofgem's regulation of the market, which particularly exposed suppliers to supply or demand shocks and contributed to market instability. These are: a timing model where suppliers enter at favourable moments in the wholesale market; and a growth model where suppliers rely on customer prepayments to fund their growth.

In both cases, it seems plausible from our assessment that these models were followed by some suppliers, with reference to the incentives faced by suppliers in the market from the regulatory regime. While it is not possible to conclusively determine the extent to which these business models were used by some suppliers in the financial and market data, the empirical evidence does support aspects of both hypotheses.

We address the issue of whether the emergence of such business models represented a desirable outcome from the perspective of Ofgem, the CMA and government in terms of delivering consumer protection through competition in section 4. In terms of the narrower question of the causes of, and costs associated with, recent supplier failures, suppliers that followed such business models are likely to have faced relatively high exposure to shocks such as the recent wholesale price volatility.

Second, consistent with our understanding of the timing model and the growth model, we have identified that a number of suppliers that would go on to fail had the following common characteristics: (i) negative equity balances in the years leading up to their failure; (ii) poor liquidity and low levels of working capital; (ii) over-reliance on customer credit balances to finance their operations; and (iii) either unhedged, or not substantively (i.e. more than 50% over nine months or more) hedged, positions. These factors limited the suppliers' abilities to absorb shocks amid demand uncertainties and rapid and sustained increases in wholesale energy prices. However, it should be noted that some companies that did not fail also showed some of the above characteristics, making it more difficult to predict failure based on individual financial indicators, and highlighting the importance of undertaking regular in-the-round assessments.

Finally, as regards the risks and costs of supplier failure, we note that there is moral hazard in the market. In particular, suppliers with poorer levels of capital adequacy may have been more likely to pursue riskier business models, such as the timing and growth models outlined in section 3.3, as they had less to lose—having entered at minimal cost and facing no barrier to exit. To the extent that this held, this led to a situation in which those suppliers that were most likely to face financial distress in the event of a wholesale price shock as

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a result of pursuing riskier business models were those that were least able to weather the storm as a result of lower capital adequacy.

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## **4 Assessment of Ofgem's role in recent supplier failure**

In this section, we structure our review of Ofgem's role in recent supplier failures across the following key areas, in turn:

- aspects of Ofgem's approach to regulating the market that contributed to the root causes and costs of supplier failure;
- how this approach to regulation affected the costs of failure borne by current and future consumers;
- examples of regulatory precedent for such measures from other sectors with relevant areas of similarity to the energy supply market;
- whether Ofgem could have improved how it monitored the financial resilience of the market using available market information (or information that it could have reasonably requested), and whether this would have enabled it to better mitigate some of the causes or costs of supplier failure;
- our findings on the cultural and operational drivers underpinning how Ofgem set and implemented regulatory policy in the retail sector.

### **4.1 Approach to regulating the market**

To remediate the risk of supplier failures that subsequently occurred there were several regulatory options at Ofgem's disposal that could have mitigated either the risks of failure, the costs of failure, or both:

- requiring a substantial commitment of shareholder equity prior to market entry, with sufficient monitoring of dividends to ensure that suppliers retained 'skin in the game' and had something to lose on market exit to reduce moral hazard;
- setting and monitoring minimum levels of capital adequacy, in line with growth in suppliers' customer books, on an ongoing basis;
- requiring and verifying third-party or parent company guarantees that protected prepaid customer balances—or otherwise limiting the use of prepaid customer balances as working capital;
- requiring third-party or parent company guarantees that protected RO sums—or influencing government to require more frequent settling of these balances;
- being assured, through credible information received from suppliers and ongoing stress-testing, that suppliers' arrangements to mitigate demand- and supply-side shocks were fit for purpose;
- requiring a higher degree of assurance from directors of a supplier in relation to its business model, how its cash flow position has evolved, and how risks are managed (including hedging policies);
- requiring the company's auditor to write a report to the regulator annually on their assessment of solvency and any risks to it.

Individually, or as a collective package, these measures would have led to a sector in which (i) all suppliers were capitalised to better absorb shocks to supply or demand/bad debt; and (ii) through requiring suppliers to have 'skin in the game', they would have been better incentivised to pursue more

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sustainable and robust business models and avoid costly failure (in terms of losing shareholder capital). It is also interesting to observe that, in several instances (e.g. the use of minimum capital requirements, or limits on the use of customer credit balances), Ofgem did consider introducing changes to the regime. However, Ofgem generally chose not to impose such restraints, which could reduce competition in the market.

It is indeed likely that such changes would also have raised barriers to entry and required a number of players that had already entered the market to either substantially change their business model or exit the market. Switching rates—which had been highlighted as a key mechanism to improve market outcomes by the CMA in its Energy Market Investigation—would probably have been lower if there was a market with fewer, more financially resilient players, potentially pricing at higher levels. However, in making such policy choices, we did not see evidence of analysis on trade-offs (i.e. weighing up the costs and benefits of reduced market entry as a result of these changes).

It is important that Ofgem does not reactively swing from one end of a competition-resilience spectrum to the other. Rather, Ofgem should determine the retail market that it considers will best meet its statutory objectives—in particular, its primary duty to protect the consumer interest, and priorities in the future policy environment (e.g. net zero), and accordingly assess the characteristics of suppliers that would be desirable in such a market. Its future approach to regulation should then enable the relevant business models of such suppliers and preclude alternatives. In so doing, Ofgem will need to explicitly consider the role of competition in a sustainable, long-run steady state.

#### **4.2 Mitigating the costs of failure through a different regulatory approach**

Developing a robust quantification of the proportion of costs that might have been avoided if specific measures had been taken, and what the optimal bundles of such measures would be, falls outside the scope of this review. Such an analysis would necessitate modelling the financial resilience of the sector under a number of plausible regulatory counterfactuals. It would also require all relevant costs to have been realised, which is not currently the case.

Moreover, the focus of this review and our recommendations are centred around the lessons that Ofgem can learn from recent supplier failures in terms of how it approaches future regulatory challenges, rather than solving the specific problems of a set of past failures or quantifying the cost to customers of specific regulatory decisions.

However, from our review of evidence to date, we are able to provide a view on potential drivers of higher costs to consumers resulting from recent supplier failures that might have been reasonably avoided. We have identified the following sources of costs that were mutualised across the consumer body and that could have been avoided (although not fully)<sup>96</sup> had Ofgem adopted a different approach to regulation:

- the economic value of assets lost to customers through insolvency proceedings;

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<sup>96</sup> Measures to foster a more financially resilient sector might have reduced the degree of competitive pressure in the market, and led to customers paying higher prices in the years leading up to the recent supplier failures in 2021.

- the economic value of assets lost to customers where these were transferred outside of the regulatory ring-fence prior to a supplier failure—in particular, financial derivatives such as commodity price hedging instruments;
- the value of prepaid customer credit balances held by a supplier at the point of failure;
- the value of unmet RO payments at the point of failure;
- costs associated with the transfer of customers from one supplier to another through the SoLR process;
- costs from the SAR process (as yet unknown<sup>97</sup>).

We note that these cannot be directly related to the figures currently in the public domain on the level of mutualised cost. The publicly available figures are:

- the £1.8bn in SoLR levy claims made since September 2021—split into wholesale (93.4%), customer credit balance (3.6%), working capital (2.6%), and onboarding and migration;<sup>98</sup>
- the £1.7bn loan facility currently available to the administrators of Bulb under the SAR regime;
- any future SoLR claims or extension of additional lines of credit to companies under the SAR regime.

The cost to taxpayers of loan facilities made available from the SAR process will not be known until the point of divestment, and it is therefore not possible to estimate a direct taxpayer cost at this time. The same holds for the cost to bill payers/taxpayers in the event of additional SoLR levy claims or an extension of additional lines of credit to companies under the SAR regime.

This leaves the £1.8bn in SoLR levy claims made from September 2021. Of these, the following components of SoLR levy claims can be considered as direct costs, borne by customers, that could have been avoided had Ofgem regulated the market differently:

- SoLR levy claims for customer credit balances (£66m)—customer balances collected by the failed suppliers that need to be covered by the new suppliers;
- SoLR levy claims for working capital (£48m)—financing or opportunity costs incurred by the appointed new supplier SoLR due to the time lag between incurring other costs and being recompensed through the SoLR levy;
- SoLR levy claims for onboarding and migration (£6m)—costs to transfer customers to the new supplier.

The remaining £1.7bn in SoLR levy claims correspond to wholesale claims—the gap between the Default Tariff Cap and the wholesale price of energy that

<sup>97</sup> The cost to taxpayers and/or bill payers will not be known until the divestment of Bulb is undertaken.

<sup>98</sup> The £1.8bn cited here covers claims over the period September 2021–December 2021. Forecasts by Ofgem submitted in response to the 'Energy pricing and the future of the Energy Market' Inquiry held by the Business, Energy and Industrial Strategy Committee forecast total claims (including and not incremental to the £1.8bn) at £2.2bn–£2.4bn. Business, Energy and Industrial Strategy Committee (2022), 'Ofgem written evidence: Call for Evidence on energy pricing and the future of the Energy Market', 11 March, para. 49, accessed on 8 April 2022 at: <https://committees.parliament.uk/writtenevidence/107169/html/>.

it costs to take on the customers of insolvent suppliers. These claims reflect the discrepancy between the Default Tariff Cap based on wholesale futures prices up to August 2021 and the wholesale price of energy over the period October 2021–March 2022.

The combination of a SoLR regime that mutualised the immediate costs of taking on new customers, and a price cap that guaranteed that all customers (including those of failed suppliers being transferred) would receive an SVT that was priced substantially below prevailing wholesale energy prices, has served to temporarily insulate the customers of failed suppliers from the immediate problem that no supplier would be willing to serve them under the otherwise prevailing Default Tariff Cap that applied to the SVT. The wholesale component of SoLR levy claims can be seen as the immediate cost of funding this protection.

A proportion of these claims are therefore in effect a transfer of costs among customers (from customers of failed suppliers to the total customer base) and over time (from customers over October 2021–March 2022 to customers over April 2022–September 2022), rather than a cost borne by the customer body as a whole.

We note that a proportion of this cost *is* likely to be attributable to the loss of financial derivatives such as commodity price hedging instruments through the insolvency process, which, as noted above, could have been avoided through a different regulatory approach by Ofgem. A further proportion of costs might also have been averted had Ofgem adopted a different approach to regulation and fostered a more financially resilient sector.

It is unlikely that the £1.7bn gap could have been costlessly eliminated from the consumers' perspective. If, for example, wholesale costs had been passed through with a shorter lag, the current gap would be smaller—but past consumer bills would have been higher. Or, if Ofgem had set a less stringent (higher) price cap over time, this would have given suppliers more headroom.<sup>99</sup> However, holding all else equal, this would have tended to increase the price that customers on the SVT paid. Paying higher tariffs in the past could therefore have reduced some of the supplier failures that have been observed since autumn 2021, although it is not clear to what extent this would have represented a net benefit to consumers.

Our assessment is therefore that a proportion of this claim represents a transfer of costs between customers, rather than a cost borne by the customer body as a whole.<sup>100</sup> Even if a majority of mutualised costs could be characterised as transfers between groups of consumers, this represents a potential source of consumer detriment. However, it would not be appropriate to attribute the full gross transfers involved in mutualisation and taxpayer funding as avoidable consumer costs without the analysis required to support such a conclusion.

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<sup>99</sup> Within the existing mechanisms, this could have been achieved through an increase in the headroom allowance, the EBIT margin, and/or a lower level of challenge on operating cost efficiencies.

<sup>100</sup> Specifically, there are likely to have been transfers of costs from customers of failed suppliers to the total customer base (via mutualisation) and over time—i.e. from customers in October 2021–March 2022 to customers in April 2022–September 2022.

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### 4.3 Regulatory precedents

There are a number of regulatory precedents that Ofgem could seek to draw from in considering how it should amend its approach to regulation. We set out four examples below.

First, Ofgem's own approach to regulating network companies involves a number of arrangements for managing the risk and impact of deteriorating financial health of a network company on consumers. Particularly relevant for the retail sector are the provisions for financial ring-fencing. The key licence conditions are as follows.<sup>101</sup>

- **Disposal of relevant assets**—requires the licensee to provide written notice to the Authority of any proposed disposal of operational control of any assets forming part of its network.
- **Availability of resources**—requires the licensee to ensure it has sufficient resources to carry out its licensed activities and to submit a report to the Authority annually, supported by the licensee's external auditors, confirming availability of financial resources. The condition also prevents the licensee from making or paying any dividend that would cause it to be in breach of its financial ring-fence conditions at any future time.
- **Restriction on activity and financial ring-fencing**—requires the licensee not to conduct any activities other than those of its core business, subject to certain exceptions and specific limitations on the turnover and investment of permitted non-core activities. It also requires the licensee not to enter into an agreement incorporating a cross-default obligation without consent of the Authority.
- **Credit rating**—requires the licensee to maintain an investment grade credit rating.
- **Indebtedness**—requires the licensee not to incur any indebtedness nor create any security, nor guarantee any liability of another person, other than on certain specified terms and for a permitted purpose, or otherwise with the consent of the Authority. It also provides for a cash lock-up in certain circumstances between the licensee and its affiliates.
- **Undertaking from ultimate controller**—requires the licensee to obtain an undertaking from its parent company and any other ultimate controllers that they will refrain from taking any action which may cause the licensee to breach its obligations under the Gas Act or the Electricity Act or its licence.

While it may not be appropriate to apply a number of these provisions to retailers without substantive modification, Ofgem could consider these provisions in developing a proportionate approach to fostering higher levels of financial resilience in the sector. For example, a modified version of the 'availability of resources' condition could be used in place of prescriptive controls on capital balances, hedging arrangements or the use of customer prepayment balances. Also, Ofgem could consider imposing requirements for independent audits in order to identify non-resilient companies at an earlier stage, to potentially impose such remedial actions in a more targeted manner.

Second, more prescriptive approaches have been taken as part of regulation in the financial services sector. It is relevant to note that there is ring-fencing of

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<sup>101</sup> Ofgem (2009), 'Arrangements for responding in the event that an energy network company experiences deteriorating financial health: guidance document', 12 October, Appendix 5, pp. 44–45.

client assets by financial institutions, and that monitoring of solvency and liquidity coverage ratios is routinely undertaken in banks. Besides such measures, the regulator looks at conduct risk. To inform their approach to regulation and assessment of risk, financial services regulators have sought to assess the types of business model that are present in the market, and whether these are in the consumer interest. For example, as part of its transition to a forward-looking, judgement-based conduct supervision model for retail banks and building societies, in 2013 the Financial Services Authority (FSA) carried out analysis of firms' business model strategies to understand whether these business models were sustainable and to identify future conduct risks to customers. This was in the context of its statutory duty to secure an appropriate degree of protection for UK consumers.<sup>102</sup>

Finally, we note that a number of sectors operate schemes to protect customer balances. For example, in the UK rail sector, Train Operating Companies are required by the Department for Transport to purchase insurance to protect customer balances relating to prepaid season tickets.<sup>103</sup> In the aviation sector, the Civil Aviation Authority's Air Travel Organiser's Licence (ATOL) protection scheme requires ATOL-holders (travel businesses selling air package holidays) to pay a fee of £2.50 per customer into an industry fund. This fund is managed by the Air Travel Trust and is used to refund, repatriate or reimburse travellers for the cost of repaying for the affected parts of their trip.<sup>104</sup>

#### 4.4 Approach to monitoring the market

Ofgem's approach to monitoring the market has evolved substantially over time. Up to 2016, our understanding from stakeholder interviews and materials received is that Ofgem did not collect and assess information on the financial resilience of suppliers in a systematic manner at any level of the organisation.

In 2016, the year in which GB Energy failed, Ofgem began to produce regular Supplier Financial Stability briefings that were made available to the senior Retail team. These briefings covered the outlook for wholesale market prices and presented a risk assessment of suppliers. The supplier risk assessment covered:

- an assessment of whether suppliers were encouraging growth through low tariffs;
- percentage use of credited volumes with Elexon;
- the number of Elexon payment and credit defaults;
- missed payments;
- use of the balancing mechanism;

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<sup>102</sup> Financial Services Authority (2013), 'Annual report: section 4 – delivering consumer protection', 10 July, p. 59, accessed on 25 February 2022 at: <https://www.fca.org.uk/publication/annual-reports/fsa-annual-report-12-13-section-4.pdf>.

<sup>103</sup> Public Accounts Committee (2009), 'Minutes of evidence', 19 May, accessed on 10 April 2022 at: <https://publications.parliament.uk/pa/cm200809/cmselect/cmpublic/191/9012111.htm>. Department for Transport (2015), 'Arriva Cross Country National Rail Franchise Terms', 15 December, accessed on 10 April 2022 at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/389326/National\\_Rail\\_Franchise\\_Terms.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/389326/National_Rail_Franchise_Terms.pdf).

<sup>104</sup> Civil Aviation Authority, 'ATOL Protection', accessed on 10 April 2022 at: <https://www.caa.co.uk/atol-protection/consumers/about-atol/>.



- preparedness for RO payments in August.<sup>105</sup>

Similar metrics seem to have been prepared as part of monthly GEMA updates on Retail Market Health.<sup>106</sup>

While these metrics are an improvement to the previous status quo, and likely to be useful for Ofgem in predicting supplier failure in preparation for an insolvent supplier entering the SoLR process, they do not provide a systematic view of the financial resilience of the energy supply market, or indeed a complete picture of the financial resilience of individual suppliers.

Of the materials that we are aware of, the papers most akin to a review of industry-wide financial resilience prior to 2020 were the three Supplier Market Outlook reports developed in 2018. In particular, the first report on whether supplier failure reflects market health explored the impact of wholesale price shocks and other contributions to supplier failure—albeit in the context of the UK's departure from the EU.<sup>107</sup> This report contained a detailed assessment of the characteristics of failed suppliers—highlighting a number of the factors that contributed to supplier failure set out in section 3, such as insufficient risk management, the use of customer credit balances, use of RO payments, and difficulties faced by smaller suppliers in obtaining credit lines.

While a useful decomposition of observed drivers of supplier failure—that appears to have informed some of the factors explored as part of the Supplier Licensing Review—this was not accompanied by a systematic analysis of the health of the market as a whole, or a collection of financial resilience metrics. In the absence of alternative analysis that has not been disclosed, we conclude that Ofgem carried out the Supplier Licensing Review without data on the financial resilience of the market as a whole.

The first time that Ofgem collected industry-wide data on financial resilience was in March 2020, following the expansion of the remit of the Regulatory Finance team at Ofgem to the retail market, which had occurred in the previous month. Although this data collection was introduced to assess a different risk—concerns around bad debt levels in the event of an economic downturn in response to the pandemic—as a result of these monthly<sup>108</sup> RFIs, Ofgem was for the first time collecting a fairly comprehensive set of metrics on financial resilience.

It appears that the financial resilience metrics available from this data did not necessarily enable Ofgem to get ahead of the supplier failures that followed the increase in wholesale prices from September 2021. However, from interviews with stakeholders and our review of materials provided to GEMA, we understand that, once the crisis had become apparent, the Retail team was able to effectively use this data to produce timely and insightful analysis that informed Ofgem's response to the crisis. Figure 4.1 sets out an example of the daily analytical updates to management and the team managing the crisis,<sup>109</sup> which included accurate forecasts of when suppliers would enter insolvency.

<sup>105</sup> Review of four Ofgem Supplier Risk Assessment Briefings on 4 May 2018, 29 May 2018, 12 July 2018 and 5 September 2018.

<sup>106</sup> Review of the September 2019 GEMA update on Retail Market Health.

<sup>107</sup> Ofgem (2018), 'Supplier Market Outlook: Does supplier failure reflect market health?', 26 March.

<sup>108</sup> While data was initially collected weekly, the frequency of reporting had reduced to monthly by summer 2020.

<sup>109</sup> The board received the most up-to-date view when they met. Over the second half of 2021 the board met more frequently than usual, at times meeting weekly (typically the board would meet ten times per year).

## Figure 4.1 ✂



Source: ✂

We highlight the three key messages below from our review of Ofgem's approach to monitoring the market.

- First, the level of monitoring of financial resilience carried out by Ofgem prior to 2020 was reactive, and limited to monitoring suppliers that had exhibited signs of financial distress.
- Second, related to the above, at the time of the Supplier Licensing Review being undertaken in 2018, Ofgem had a limited available evidence base to make trade-offs between the benefits of competition and maintaining financial resilience in the sector.
- Third, when it became apparent that the sector was likely to enter a period of financial distress, Ofgem was able to rapidly introduce an RFI of the data that it would require to assess supplier financial resilience (in early 2020) and use this data to carry out relevant analyses to support its monitoring of the market.

Overall, this is symptomatic of a reactive rather than proactive approach to assessing financial resilience in the sector. This is not inconsistent with a key regulatory philosophy that seems to have been prevalent at Ofgem at the time and has been referenced in several stakeholder interviews—that supplier failure is not in and of itself a matter of concern, albeit the costs of failure may be:

...supplier exits are **not a particular cause for concern** in a competitive market, provided there is a sufficient number and diversity of suppliers, and sufficiently low barriers to entry, **to retain incentives for competition and innovation**. The main reason we care is the significant socialised costs to consumers that are accompanying supplier exits at this time, alongside consumer trust in the market, and confidence from suppliers that we are regulating for an investible market.<sup>110</sup> [emphases added]

Over the course of stakeholder interviews, current and past members of Ofgem have acknowledged that the organisation's market intelligence capabilities have been insufficient in terms of both the content of information available and the degree of automation in how data is collected. We understand that work is being done within the organisation to rectify this going forward.

While Ofgem has broad powers to request data—as demonstrated by the information that it has been able to collect from the industry since 2020—we note that publicly available data from Companies House would have been useful information for Ofgem to identify early warning indicators of financial resilience of the sector. This is demonstrated by the pre-2020 analysis set out in section 3.

## 4.5 Findings on the cultural and operational drivers of Ofgem's decision-making

From interviews with stakeholders and a review of internal papers available to GEMA, we have aimed to arrive at an understanding of the relevant drivers of

<sup>110</sup> Ofgem (2021), 'Retail Policy Response – Capping Paper', 12 November.

decision-making at Ofgem that underpinned its approach to the regulation of the retail market. We structure our assessment as follows.

- The role of **vertical information flows** within Ofgem, between Ofgem and GEMA, and with other stakeholders—such as in government.
- The **operational structure and capabilities** of Ofgem—in terms of how the organisation is horizontally structured, access to specific skills, and the extent of any skill gaps.

### Vertical information flows

Interviews with stakeholders have highlighted some evidence of vertical frictions in information flows within Ofgem. Some examples are set out below.

- Discussions with the management and (junior) leadership teams of various retail divisions have revealed that they have perceived themselves to have less access to the board over recent years. They have commented that when they do have access this tends to be in relation to a large policy initiative—such as the introduction of the price cap. However, we note that, given that this perception is inherently anecdotal, we would not expect—and nor have we seen—any documented evidence of team members being unable to obtain access to the board.
- The senior leadership team and GEMA members have described their perception that important decisions can be taken at the level of the operational teams, without a detailed strategic discussion at GEMA, in part due to the legalistic framework of delegation.
- There is some concern at all levels of the organisation about 'knee-jerk reactions', in that the organisation galvanises into action to fix yesterday's problems rather than seeking to understand tomorrow's problems.
- There is a perception of infrequent challenge by the board on the evidence base used, and the balance of risks and costs of different policy options advanced in decision-making.

We note that this list focuses primarily on the areas for improvement, and we have also received extensive positive feedback in terms of how the organisation functions effectively across different layers. This was referenced particularly often, although not exclusively, in relation to how the organisation has been able to respond in an agile, evidence-driven and coordinated way to the recent supplier failures from September 2021.

To supplement this view from stakeholder interviews, we have reviewed the three most recent Board Effectiveness Review papers, from 2017, 2019 and 2021. These papers collate the anonymised views of non-executive and executive members of the board across a wide range of issues relating to the functioning of the board, and identify areas for change and improvement. We found a number of consistent themes across these three reviews that align with the findings above. The first is that the Ofgem board is not consistently able to dedicate sufficient time to critical issues and matters of longer-term strategy and priorities.<sup>111</sup> The second is that the materials and board papers are not

<sup>111</sup> 'Executives ranked second lowest: the board got the balance of its work right and spent appropriate time on critical matters. Non-executives ranked joint second lowest: oral presentations on major items deal with the right issues' (Ofgem (2020), 'Board Review 2017', 7 December, p. 12.) 'Overall Strategy and Performance – lower scores were recorded against questions on the Board having sufficient time and resources to consider longer term strategies and policies.' (Ofgem (2021), 'Board Reviews & Surveys 2014

always of high quality or sufficiently focused for the board to use its time effectively—although this was noted to have improved by the time of the 2021 board review.<sup>112</sup> The third is that the board does not always have full sight of the information required to make informed decisions and comment on the functioning of Ofgem.<sup>113</sup>

On vertical flows of information up to the board, there is also evidence to underpin these concerns available from our review of board papers. The board papers that were reviewed and discussed by the board during the Supplier Licensing Review were either at a stage in the review before the point at which the board could substantively inform the policy positions taken by the Retail team,<sup>114</sup> or after policy options had been shortlisted, consulted on with industry and refined for direct approval by the board.<sup>115</sup> Over the course of the Review, there is limited documented evidence of Ofgem seeking direct feedback from the board on:

- the high-level approach taken to weight trade-offs between competition, financial resilience and other objectives in relation to the consumer interest;
- the broad set of policy options available, such as controls on working capital or prepayment balances;
- the specific decision to defer requirements to ring-fence customer prepayments in favour of introducing the FRP.

However, there is evidence of exceptions to this in the papers submitted to the board, for example as part of papers tabled for the 27 February 2019 meeting:

Licensing provides a 'one off' entry test. We proposed at consultation that there should also be new ongoing requirements on suppliers that are targeted to:

- Raise the standard of supplier risk management and planning practices, and promote responsible approaches to growth

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to 2019', 9 February, p. 4.) 'In NED interviews we heard that the Board needs more strategic materials and input. While we understand that a strategy review is under way, the Board needs to arrive eventually at a place where clear strategic objectives have been developed with ExCo and it is better placed to then review best case options as a regulator, trade-offs and choices, and entertain a range of scenarios. More than one NED described the struggle for the Board in *joining thing up and seeing the big picture*.' (Ofgem (2021), 'Board effectiveness Review', 30 June, para. 3.7.)

<sup>112</sup> 'Non-executives ranked lowest/Executives ranked fourth lowest: Advance material on major decision items is good quality.' (Ofgem (2020), 'Board Review 2017', 7 December, p. 12.) 'Working Practices—lower scores were recorded against questions on the CEO and COO reports striking the right balance, Board time spent on strategic issues vs reserved matters, volume and frequency of information/monitoring reports and the nature/content of GEMA papers.' (Ofgem (2021), 'Board Reviews & Surveys 2014 to 2019', 9 February, p. 4.) 'It is clear that there have been recent improvements to Board and committee papers, and the quality of some of these can be high. In terms of the supporting governance documents and policies, however, while we found some well crafted documents, many were not quite of the quality we would expect of a government department.' (Ofgem (2021), 'Board effectiveness Review', 30 June, para. 2.1.)

<sup>113</sup> 'Non-executives ranked joint second lowest: major discussion well informed about the external environment. Executives ranked lowest: The board notices where delivery is above or below plan and acts.' (Ofgem (2020), 'Board Review 2017', 7 December, p. 12.) 'Authority composition and capability – lower scores were recorded against questions on the right mix of experience, knowledge and skills to maximise performance, NED induction procedures, and the diversity of views when making a decision. Working Practices – lower scores were recorded against questions on adaptive working, being up to date with the latest developments and getting the balance on the agenda right.' (Ofgem (2021), 'Board Reviews & Surveys 2014 to 2019', 9 February, p. 4.) 'The majority of NEDs agreed with each statement, with the exception of *The Board has a sound decision-making and monitoring framework which helps the organisation deliver on its objectives*, where half of them disagreed. Three of eight disagreed that the Board has a clear line of sight into critical areas of performance, and three of eight disagreed and/or didn't know (one) whether the Board is fully sighted on the key risks facing Ofgem, and whether risk is appropriately referenced in any report.' (Ofgem (2021), 'Board effectiveness Review', 30 June, para. 3.12.)

<sup>114</sup> That is, the board papers tabled for board meetings on 13 July 2017, 15 March 2018 and 25 September 2019.

<sup>115</sup> That is, the board papers tabled for board meetings on 29 May 2019 and 26 February 2020.

- Enhance visibility, and ability to monitor, potential financial instability in the market so we can act where needed. Enabling effective management of any supplier failure
- Minimise the impact of a supplier failure
- Contribute to maintaining a constructive relationship with Ofgem

It may be appropriate to adopt a package of measures to ensure a robust and proportionate overall approach. We are considering:

- Ongoing 'fit and proper' requirement, so that there is more accountability and we have more oversight of who owns and runs supply businesses,
- Regular reporting, risk based monitoring, and/or targeted measures to give us more regulatory tools to oversee and address supplier resilience and/or impacts of failure,
- Credit balance and/or prudential requirements that would impact the way that companies operate, to mitigate impact and/or likelihood of failure.

**We are seeking GEMA guidance on appetite for new regulatory interventions on active suppliers.<sup>116</sup> [emphasis added]**

We note that, over the same time period, decisions over the implementation, design and level of the price cap seem to have dominated the board's agenda—with four board sessions in which price cap papers were tabled over the period May to October 2018.

This aligns closely with the GEMA rules of procedure and the schedule of reserved matters to the board. The list of matters reserved for a decision of the Authority comprises:<sup>117</sup>

[1. to 9. a number of matters relating to the management of Ofgem outside the scope of this review]

10A: The strategy or overall approach to control or limit the charges, incentives or revenues of a licensee.

10B. The final policy decision informing proposals to modify significantly any licence condition(s) that control or limit the charges, incentives or revenues of a licensee, but not including the operation of existing price control policy.

11. The decision to make a market investigation reference to the Competition and Markets Authority.<sup>1</sup>

12. The decision to issue a notice relating to a proposal to make an application for an order providing for activities to become licensable activities.<sup>2</sup> The decision to make a reference to the Competition and Markets Authority (CMA) for the CMA to investigate and report on whether the fact that the activities are not licensable activities operates, or may be expected to operate, against the public interest.

13. The making of any statutory instrument.

14. Any other function of the Authority specified in an Ordinary Resolution

15 The decision to publish a statement of policy on the Authority's approach to the imposition of penalties or other sanctions, restitution or redress for breach of any licence condition, relevant requirement or any other provision enforceable by the Authority.

Note: <sup>1</sup> Contained or referred to in section 36A of the Gas Act 1986 and Section 43(2A) of the Electricity Act 1989. <sup>2</sup> Under section 41D of the Gas Act 1986 or Section 56B of the Electricity Act 1989.

We note that the only aspect of this framework of delegation that indicates a role for the board in informing Ofgem's approach to ongoing policymaking in the absence of either a material change of circumstances or a change in licence conditions is 10A. However, at least in terms of the Supplier Licensing

<sup>116</sup> Ofgem (2019), 'Supply Licensing Review – new entry requirements and next stages', 27 February.

<sup>117</sup> Ofgem (2010), 'Rules of Procedure of the Gas and Electricity Markets Authority', 29 September.

Review, the interpretation of 10A seems to have been to involve GEMA only at the initial stages of policy options, rather than throughout the review. While, with the benefit of hindsight and the analysis set out in section 3, this may not have been optimal, it is understandable in the context of the other policy priorities that Ofgem faced at the time around the price cap and, later, the RIIO-2 network price controls.

One key regulatory decision that Ofgem made as part of the Supplier Licensing Review was to dilute its initial implementation of a provision requiring suppliers to protect 50% of customer prepayment balances to an FRP with a delayed phasing of prepayment balance protection. It is instructive to consider the timeline over which this decision was made, and the extent to which the board was consulted on this decision on an ongoing basis. We set out this chronology in Box 4.1.

#### **Box 4.1**      **Chronology of decision-making on measures to reduce cost mutualisation as part of the Supplier Licensing Review**

**25 September 2019:** Ofgem board meeting where the Retail team sought guidance from the board on how it should approach the ongoing requirements and exit arrangements part of its review. The main document is fairly light on detail in terms of cost mutualisation, stating only that:

... some of the proposed requirements may involve significant changes to supplier financing (for example credit balance protections).<sup>1</sup>

However, the accompanying annex gives more detail, stating the intent to introduce policies:

... requiring suppliers to put protections in place for credit balances and government schemes/policies (subject to our Impact Assessment analysis) to mitigate the impact in the event of failure (so they bear this risk and mitigate it accordingly). This could be parental/third party guarantees, escrows etc.<sup>2</sup>

The board minutes for this meeting state that:

The Authority discussed the document and agreed with the recommendations. The Board discussed the current legislative powers, noting that, in the main, they relate to licence requirements. The Board further agreed that moving to a principle-based approach will provide more leeway with compliance and enforcement matters.<sup>3</sup>

At this point, it is clear that the intent of the Retail team is to introduce protection of customer credit balances.

**22 October 2019:** initial proposals for cost mutualisation protections published as part of the first round of consultation of the *ongoing requirements and exit arrangements* part of the Supplier Licensing Review—as part of this, Ofgem sets out its proposal to require suppliers to protect 50% of customer prepayment balances.

**3 February 2020:** letter published by Ofgem setting out the concerns raised by some stakeholders with the immediate implementation of Ofgem's proposal to require suppliers to protect 50% of customer prepayment balances, and proposing that this initially be replaced by a high-level principle with further measures to follow under a phased approach.

**19 February 2020:** tabled board paper covering progress on the *ongoing requirements and exit arrangements* part of the Supplier Licensing Review to GEMA outlining progress of the supplier licensing review (one of 14 agenda items).

**26 February 2020:** Ofgem board meeting at which this progress was discussed. The board paper explicitly states that:

We propose to introduce a high-level principle to help ensure that suppliers take action to mitigate the need for costs to be mutualised, in the event of failure.<sup>4</sup>

It also outlines the narrative and rationale for later phasing of more prescriptive measures to protect customer prepayment balances. However, the Supplier Licensing Review was item 11

on the board agenda and was classified as an Information Paper rather than as one of the headline items for discussion. The minutes from the meeting report that:

The Authority noted the paper.<sup>5</sup>

**25 June 2020:** second round of consultation of the *ongoing requirements and exit arrangements* part of the Supplier Licensing Review published, with protection of customer prepayment balances replaced by an FRP.

**26 November 2020:** published decision document on the initial stages of the *ongoing requirements and exit arrangements* part of the Supplier Licensing Review confirming the introduction of an FRP.

Note: <sup>1</sup> Ofgem (2019), 'Supplier Licensing Review update and next steps', 18 September, p. 4. <sup>2</sup> Ofgem (2019), 'Annexes for GEMA paper A19/93: Supplier Licensing Review update and next steps', 18 September, p. 2. <sup>3</sup> Ofgem (2020), Minutes of a meeting of the Gas and Electricity Markets Authority, 25 September, p. 4. <sup>4</sup> Ofgem (2020), 'Supplier Licensing Review update and next steps', 19 February, p. 2. <sup>5</sup> Ofgem (2020), 'Minutes of a meeting of the Gas and Electricity Markets Authority', 26 February, p. 4.

Source: Oxera review of relevant documents and stakeholder interviews.

From this chronology it is clear that the board had delayed sight of an inflection point in how Ofgem intended to protect customer balances through the replacing of prescriptive measures to protect 50% of customer prepayment balances, as it had earlier signalled to the board, with an FRP. By the time the issue was raised, as part of the February 2020 board meeting, this change in policy had already been signalled publicly to the market. Moreover, at the February board meeting, this topic was for information only, and therefore it is likely that it did not take up substantial time on the board agenda. Although in the event the board appears to have accepted this change in policy, this chronology could have made adopting a different position challenging with external stakeholders.

In practice, it is not feasible for members of the board to have the same in-depth knowledge as the operational and management teams; notwithstanding this, the board needs access to timely information that drives decisions by the operational and management teams. Therefore, vertical information flows need to effectively prioritise critical information to facilitate the board's understanding of strategic policy choices and its subsequent decision-making. This implies a complex and iterative process of refining information flows between the teams and the board: the board needs to ensure that the framework for prioritisation is clear below it, while ExCo and the directorships need to ensure that critical information is being made available to the board on a timely basis. This means that the board needs to be clear in asking for information, but teams also need to be agile in selecting and prioritising those sources of information that allow for critical understanding of choices, and permit for challenge by the board. The board also needs to ensure that there are appropriate processes in place for important documents to be discussed in board meetings.

One tool that has already been developed by Ofgem is a decision log, which is collated and provided to the board on a 'for information, not necessary to review' basis. This is provided with the intention of keeping the board apprised of 'difficult' and significant decisions expected to come to the board and significant decisions under delegated authority. However, it is one of a large number of documents provided to the board and does not provide an accompanying strategic narrative—for example, on relative priorities or trade-offs in policy options. As an example, the January 2020 decision log update contained 25 upcoming or new matters reserved for a decision by the board, and 31 delegated decisions flagged as 'difficult' or 'decision'. The conclusion of

the ongoing arrangements and exit requirements part of the Supplier Licensing Review was the 48th item listed.<sup>118</sup>

Finally, as regards vertical information flows, looking outside of Ofgem, there have been some concerns raised around timely information exchange between Ofgem and the government in a business-as-usual environment. Specific aspects that have been raised by stakeholders include the extent to which early warning indicators about concern in the retail industry have been raised by Ofgem to government, and about the concentration of relationships (e.g. Chair to Chair counterpart, or CEO to CEO counterpart), rather than a more dispersed set of business-as-usual meetings and information exchanges between management, leadership and governance teams.

### **Operational structure and capabilities of Ofgem**

A second dimension of our review of Ofgem's internal ways of working are its operational structure and capabilities.

The nature of the issues that Ofgem has and will continue to face in how it regulates the retail market will need to draw on cross-disciplinary skills across Ofgem, requiring the evidence base to draw from:

- financial analysis of supplier resilience, e.g. identifying and monitoring relevant indicators, undertaking financial analysis, and potentially stress-testing;
- economic policy and cost–benefit analysis of the trade-offs between different approaches to regulating the market;
- an understanding of how the energy supply market works, the incentives faced by market participants, and different supplier business models;
- relationships held with suppliers and other stakeholders.

A combination of skills from the energy retail industry, financial analysts, and regulatory expertise is needed to understand the demand side—i.e. knowledge of industry retail business models, incentives, and financial and operational performance—as well as the supply side—i.e. wholesale price movements and supply chains.

Related to the above, we have observed that horizontal frictions in information flows have taken the form of divisional silos between the Retail teams at Ofgem. Importantly, there appears to have been a delineation of responsibilities between functions that have been variously described to us as the 'Retail team', the 'Retail Compliance and Monitoring team' and the 'Regulatory Finance' team. These appear to broadly correspond with the divisions that are classified as 'Regulatory - Enforcement & Emerging Issues', 'Regulatory – Retail' and 'Analysis & Assurance' in the current version of the Ofgem organisation chart.<sup>119</sup>

This has had two practical implications for Ofgem's ability to monitor the retail market.

- First, there has been a dispersion of responsibility for understanding the holistic balance of risks and rewards to suppliers, the incentives they face,

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<sup>118</sup> Ofgem (2020), 'Decision Log Update', 22 January.

<sup>119</sup> Ofgem (2022), 'Ofgem organisation chart', 7 February.

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their business models, and the overall state of how well functioning the market is.

- Second, there has been a dispersion of the technical skills required to undertake the analysis, which would permit such a holistic perspective to be reached—as no one team would have all of the required market and financial analysis skills.

The dispersions of responsibility and skills can be related to a number of the findings set out earlier in this section. In particular:

- the focus of the Supplier Licensing Review, carried out by the Retail team, on minimising the effect of the proposed measures on the level of competition in the market (in terms of number of suppliers and degree of switching) and the absence of financial resilience analysis;
- the focus of the supplier watchlist indicators given to the board (prior to 2020), carried out by enforcement and compliance, on regularly monitored compliance metrics such as suppliers' use of Elexon credit balances, missed payments, and preparedness to meet requirements under the RO.

The effectiveness with which this can be remedied has also been demonstrated by the introduction of the first collection of industry financial metrics, analysis of stress-testing and assessment of financial resilience analysis in early 2020.<sup>120</sup> Although this analysis, carried out in response to the anticipated demand shock from COVID-19, did not identify the later supplier failures in response to wholesale price rises, it nonetheless already demonstrates an improvement in organisational effectiveness by more closely integrating the 'Regulatory – Retail' and 'Analysis & Assurance' teams within Ofgem.

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<sup>120</sup> Based on stakeholder interviews.

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## 5 Recommendations and lessons learnt

In relation to the perspective of our review, our objective is not to focus on specifying a particular regulatory approach that solves the problems of yesterday. Instead, we aim to provide Ofgem with recommendations for how it can best ensure that its regulatory regime is targeted at the problems of tomorrow.

From our review of recent supplier failures, we can comment on how Ofgem might consider future-proofing its regulatory regime to mitigate the likelihood of large supplier failures leading to high levels of mutualised costs.

Broadly, there seems to be a spectrum of options available between two distinct policy options. We set out both options, and the spectrum between them, in Figure 5.1.

**Figure 5.1** Regulatory policy options to reduce the risk and cost of future supplier failures



Source: Oxera.

- At one end, Ofgem would seek to introduce a number of regulatory policies designed to reduce or eliminate both the *ability of* and *incentive for* suppliers to pursue riskier business models with lower levels of capital. This would be, for example, through a combination of ring-fencing customer balances and maintaining capital requirements on an ongoing basis. While Ofgem would need a degree of assurance, potentially through a more explicit role for auditors, that companies were complying with the rules it set for the market, at this point it could pursue a less onerous regime of stress-testing and/or monitoring, on the basis that suppliers' incentives were more aligned with its own (in terms of avoiding failure and adopting sustainable business models) and the consequences or costs of failure were lower (as customer balances would be protected). Such a 'rules-based' approach could be characterised as a continuation of Ofgem's policies around leaving financial monitoring with company management. However, rules would be introduced to ensure that suppliers' incentives are compatible with minimising the incidence of failure and minimising the cost of failure when it occurs. This approach may preclude certain business models and serve to reduce the number of suppliers in the market at a given time. However, if the requirements are correctly targeted, the firms that would otherwise have entered the market are those with the highest risks of exiting the market and imposing costs on the remaining suppliers and/or customers.
- At the other end, instead of introducing regulation to constrain companies' behaviour, Ofgem could undertake frequent and rigorous monitoring of companies' financial resilience—including regular stress-testing of suppliers' business models. It could then target interventions at those suppliers that fail financial resilience assessments. This would be conditional on Ofgem being able to develop a comprehensive set of leading indicators that enable

it to intervene sufficiently early to minimise the likelihood or cost of supplier failure, and on an ability to analyse supplier business models. This option may be more compatible with Ofgem's historical policy preference to maximise the range of players and types of business model in the market. However, it places a greater regulatory burden on Ofgem to carry out frequent robust analyses of the market and to have the necessary powers to be able to intervene successfully. Moreover, although less limiting than direct restrictions on capital and use of customer balances, this approach may still impose a burden on suppliers to provide frequent data across a range of metrics. In addition, if the interventions are to be successful in reducing the negative consequences of supplier failure, they may need to be imposed relatively early. Such interventions could result in either the earlier failure of such companies or their relative competitiveness being reduced, because the necessary intervention increases their costs. At the time when intervention is required to reduce the costs of likely future failure, it may be hard to make such an intervention if the immediate impact is to bring the time of failure forward to the present day.

In practice, the choice of regulatory policy design and specific interventions is unlikely to sit at either end of the spectrum, in seeking a pragmatic balance of responsibilities in a well-functioning market that protects consumer interests (e.g. in terms of the degree of competition and financial resilience) between the regulator and the industry.

Moving beyond specific regulatory interventions to minimise the impact of recent supplier failures, we can draw a broader set of lessons learnt and recommendations from an assessment of the causes of recent supplier failures, as follows.

1. The determination of the **consumer interest**—i.e. of both existing and future consumers—is key. Where policy trade-offs are to be made, they should be guided by an explicit weighing up of the expected costs and benefits to consumers along dimensions of consumer interest that are defined ex ante.

*Recommendation(s): Develop a 'living' framework for how consumer interest is defined and measured.*

2. The definition of the criteria and the expected characteristics of **effective competition** is valuable,<sup>121</sup> to provide a framework against which to assess whether intended outcomes are being achieved on an ongoing basis. Ofgem already monitors relevant metrics such as the degree of market concentration, switching, and price dispersion in the form of deviations from the SVT over time. Further to this, analysis of effective competition should consider whether the market can sustain the same number of market players in the longer term, e.g. by examining ongoing profitability. It is important to emphasise that, in so doing, the focus would not be on switching to a zero supplier failure regime, but on understanding the risks of failure ex ante. Another feature of effective competition that Ofgem should consider is the extent to which competition delivered innovative business models that were in the consumer interest—with a specific focus on furthering the net zero objectives set by the government.

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<sup>121</sup> While an existing review into effective competition was recently carried out as a requirement of the Domestic Gas and Electricity (Tariff Cap) Act 2018, we note that the scope of this framework does not include issues such as financial resilience, supplier exit or mutualised costs. See Ofgem (2019), 'Framework for assessing whether conditions are in place for effective competition in domestic supply contracts', 3 October.

*Recommendation(s): Develop a framework for how effective competition is defined and measured, and revise the current existing dashboard supplied to the board on market indicators.*

Note that, while options 1 and 2 represent a responsibility for Ofgem in terms of framework design and monitoring, the responsibility for implementation is effectively shared with industry as companies will have the responsibility to report accurate information against the framework that is developed.

3. In terms of the process that is adopted for decision- and policymaking going forward, it is important that the identification and selection of options is then guided by these ex ante frameworks. Specifically, going forward, it is important that the qualitative and quantitative criteria that are decided on for the delivery of the consumer interest and effective competition are then used to make **evidence-based policy trade-offs**, including in the competition-resilience spectrum.

*Recommendation(s): Use the consumer interest and effective competition frameworks to make decisions on future market design options. These include the options that are currently being weighed up as part of the ongoing Retail Financial Resilience review to mitigate the risk of 'swinging too far' in the other direction of the competition-resilience pendulum. In developing the evidence to make these trade-offs, Ofgem should consider how it can most effectively use data and digitalisation to support them.*

4. The nature of this evidence base needs to be understood as drawing on cross-disciplinary skills in Ofgem. We have observed that **horizontal frictions in information flows** have taken the form of divisional silos between the different teams working on the retail sector at Ofgem. A combination of skills from the energy retail industry, financial analysts, and regulatory expertise is needed to understand the *demand side*—i.e. knowledge of industry retail business models, incentives, and financial and operational performance—as well as the *supply side*—i.e. wholesale price movements and supply chains.

*Recommendation(s): Addressing these horizontal frictions is likely to require both structural change<sup>122</sup> and a culture of more frequent collaboration. Ensure that the technical mix of skills in the team(s) that undertake regulation of the retail market includes the relevant financial, regulatory and industry expertise on both the demand side and the supply side. We understand that this is the intent of the new 'market intelligence' team that is being coalesced within the Retail division.*

5. Furthermore, there has been evidence of **vertical frictions in information flows** within Ofgem. These are outlined in more detail in section 4, but in general can be characterised as:
  - a) a lack of clarity around when the management and (junior) operational leadership teams have access to the board to escalate issues;
  - b) a legalistic framework for determining when issues should or should not be escalated to the board—as a result of which there may have been implicit delegation of important policy decisions to the executive or less senior operational leadership teams;

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<sup>122</sup> For example, the cross-divisional span of the regulatory finance function is a constructive change since early 2021.

- c) at times, a lack of internal and external challenge to status quo positions held by the Ofgem board—for example, the weight it placed on its regulatory philosophy to promote competition.

*Recommendation(s): Addressing these vertical frictions with a forward-looking focus is likely to require sustained two-way effort. Operational teams should be encouraged to seek board input in formal and informal ways, for example by placing a rotating item on the board agenda to hear a 'State of the Union' from different divisions within Ofgem as a business-as-usual measure rather than one that is instituted at a time of market stress. The framework for delegated decision-making should also be periodically reviewed, e.g. every two to three years, to ensure that it remains fit for purpose as the objectives and policies of retail regulation evolve with market changes. The board should be prepared to challenge policy choices and decisions in line with consumer interest and effective competition frameworks.*

6. It has been raised by many stakeholders that the agility and responsiveness of Ofgem in dealing with the recent supplier failures has been exemplary at all levels of the organisation (i.e. the GEMA, CEO, and team management levels) in 'crisis mode' analysis and communications. However, there have been concerns about **timely information exchange between Ofgem and the government in a business-as-usual environment**. Specific aspects that have been raised by stakeholders include the extent to which early warning indicators about concern in the retail industry have been raised by Ofgem to government, and the concentration of relationships as single points of information exchange (e.g. Chair to Chair counterpart, or CEO to CEO counterpart) rather than a more dispersed set of meetings and information exchanges between management, leadership and governance teams.

*Recommendation(s): Undertake an internal review of business-as-usual stakeholder relationship and communication processes between Ofgem, BEIS and other government departments.*

We introduced this section by identifying that Ofgem faces a broader challenge than addressing the specific drivers of recent supplier failures, and have set out our recommendations to strengthen the forward-looking regime rather than directly fix specific past issues. Nonetheless, we wish to highlight a number of specific remedies that might be introduced both to address the specific weaknesses that have materialised from the current crisis, *and* to future-proof the system as a whole. These include introducing a degree of ring-fencing of customer balances, changing the requirements on the provision of board assurance and auditor assurance to Ofgem, and introducing regular reporting of relevant financial metrics. We note that such changes are already being reviewed as part of Ofgem's ongoing Retail Financial Resilience action plan, as quoted below:

Ofgem action plan [15 December 2021]:

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). [emphases added]

Note: <sup>1</sup> Ofgem (2022), 'Action plan on retail financial resilience', Call for Input, 15 December, p. 4.

As such, these specific policy remedies would supplement a wider programme of organisational and cultural change to regulate a better-functioning retail market. It remains vital that the perspective in undertaking these reviews is that Ofgem does not reactively swing from one end of a competition-resilience spectrum to the other, for which clearly defined consumer interest and effective competition frameworks would provide important anchors.

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## A1 Ofgem market review terms of reference

The Ofgem board is appointing advisers to carry out an independent review of its role in the recent supplier failures as regulator of the GB retail energy market, with the following terms of reference. This will go beyond assessing Ofgem's role in ongoing market monitoring, and will include how it set the system of licensing and regulation that shapes the structure of the supplier market—with reference to Ofgem's statutory duties and the regulatory approach it has adopted to balance competing policy priorities. The output of this review will be an outcomes-focused report setting out the advisers' assessment of lessons learnt and recommendations.

The advisers will investigate:

1. The causes of recent UK energy supplier failures in the context of how the energy market has been designed, how it is regulated and how it functions. We envisage that this work could include a high-level review of:
  - market characteristics, such as entry and exit barriers, capitalisation requirements for new entrants, levels of profitability, the degree of competition—including the extent of customer switching;
  - the licensing requirements that influence risk, for example in relation to working capital and guidance on hedging commodity prices;
  - the role of the retail price cap in influencing the financial position of the suppliers;
  - effectiveness of market stabilisation mechanisms (e.g. SAR and SoLR).
2. The ongoing information and evidence base that Ofgem set in place to facilitate its risk based decision making approach to regulating the retail market. This includes monitoring of the health of the retail market in general, and the risks and costs associated with supplier failure in particular—which may include: (i) the processes Ofgem set in place to receive ongoing information about energy supplier failure risk; and (ii) whether Ofgem was collecting and analysing the right information to robustly monitor and identify risk in the retail market. This assessment includes consideration of how Ofgem's evidence gathering and monitoring is informed by policy objectives, including the promotion of competition, delivery of innovation and maintenance of market confidence.
3. The extent to which the consumer interest was effectively protected by how Ofgem responded to information that was, or could have been available to it, drawing from (1) and (2) and without the benefit of hindsight.
4. Distil lessons learnt and outcomes-focused recommendations from this review.

The advisers should develop and implement a methodology for answering these issues (listed as 1 to 3 above) that may cover, but is not limited to:

- a) interviews with internal stakeholders, including members of the Ofgem board and Ofgem executive team, as well as other external stakeholders;
  - b) quantitative analysis that was or could have been available to Ofgem on the financial and operational resilience of suppliers over time;
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- c) qualitative assessment of information in board papers and other materials that were or could have been available to the Ofgem board;
- d) review of other relevant policy papers, regulatory decisions and supporting impact assessments, including Ofgem documents setting out regulation, licensing and governance for the retail supply market and relevant findings leading up to, and directly following the CMA Energy Market Investigation (2014–16);
- e) assessment of relevant precedent from other sectors or jurisdictions with similar characteristics to the retail energy supply market in GB.



## A2 Ofgem's historical and policy environment

### A2.1 Ofgem's statutory duties

Ofgem's approach to regulation is anchored in its statutory duties. Ofgem's principal objective across all of its regulation of electricity and gas markets is:

to **protect the interests of existing and future consumers** in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems.<sup>123</sup> [emphasis added]

Correspondingly, and as set out in our terms of reference,<sup>124</sup> we centre our review of Ofgem's role in recent supplier failures around the same principal objective.<sup>125</sup>

In addition, Ofgem has two secondary duties that are relevant to its regulation of the supplier market. First:

The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by **promoting effective competition** between persons engaged in, or commercial activities connected with, the... supply of gas... or supply of electricity;<sup>126</sup> [emphasis added]

Second:

In performing these duties, the Authority must have regard to the need to secure that licence holders are **able to finance the activities** which are the subject of obligations on them.<sup>127</sup> [emphasis added]

We note that there is some disagreement among stakeholders within Ofgem<sup>128</sup> as to whether the financeability duty applies to energy suppliers. This is on the basis that some stakeholders take the view that, at least prior to the introduction of the Default Tariff Cap, Ofgem did not place substantive obligations on retailers. Accordingly, they claim that Ofgem's decisions did not meaningfully constrain retail business models or operations, and therefore Ofgem's decisions did not affect their financeability. This is presented as a contrast to the situation of network companies that, for example, are obliged to connect to new generation or households within their appointed area, while energy suppliers may choose who they supply and on what terms—at least until the introduction of the prepayment, standard variable and Default Tariff caps through government legislation.

For this review we focus on the primary consumer interest duty, and consider the financial resilience in the sector—and market confidence as a whole—as one of several factors that affected the protection of consumer interest.

In addition, we note that Ofgem has a duty to protect vulnerable individuals:

<sup>123</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.3, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>124</sup> See appendix A1 for the full terms of reference.

<sup>125</sup> Where relevant, we also consider Ofgem's duties in the light of primary legislation, e.g. the introduction of the retail price cap in 2018.

<sup>126</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.4, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>127</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.6, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>128</sup> Some of whom are still at Ofgem, and others of whom previously worked at Ofgem.

In performing these duties, the Authority must have **regard to the interests** of individuals who are **disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas**.<sup>129</sup> [emphases added]

Stakeholders have commented on the difficulties that Ofgem faces in balancing its extensive set of duties, both in general and with specific regard to the four duties listed above in the context of regulating the retail market.

One area of potential tension lies in Ofgem's duty to promote competition while maintaining a financially resilient retail sector. We note that there is not necessarily a trade-off between effective competition and maintaining financial resilience in a well-functioning market. However, it is important to consider the scope that interventions to increase competition might have to reduce financial strength. For example, if companies faced intense price pressure then they might face challenges in maintaining ongoing stand-alone profitability, which could then weaken solvency and capital adequacy.

Moreover, it is important to note that not only are Ofgem's statutory duties explicit that protection of the consumer interest is a primary duty, but paragraph 1.5 of Ofgem's published duties and objectives also imposes a duty to ensure that interventions to promote competition should be pursued only if they are in the consumer interest:

Before deciding to carry out its functions in a particular manner **with a view to promoting competition**, the Authority will have to consider **the extent to which the interests of consumers would be protected** by that manner of carrying out those functions and **whether there is any other manner** (whether or not it would promote competition) in which the Authority could carry out those functions which would **better protect** those interests.<sup>130</sup> [emphases added]

We therefore assess the extent to which Ofgem's approach to the energy supply market was consistent with its primary duty by looking at how it identified an optimal balance between competing policy dimensions: promoting competition, securing a financially resilient sector, and protecting vulnerable customers.

## A2.2 Historical market context

How Ofgem determines its approach to regulating the sector will be driven by its interpretation of how best to meet its statutory duties, and it will seek to design the underlying economic incentives in the market in a manner that is consistent with this interpretation. In the discharge of its statutory duties and in determining its policies and approach to the market, Ofgem is influenced, guided and sometimes constrained by the characteristics of the energy retail industry and the broader policy environment. These affect Ofgem's perspective on the key challenges that it had to overcome to better protect the consumer interest, and informed its view on the likely consequences of the decisions that it made.

From stakeholder interviews, our review of publicly available consultations and decision documents, and a review of internal material and papers within Ofgem, we observe three salient characteristics of the market. These have provided important context for many of the decisions that have been taken by

<sup>129</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.7, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>130</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.5, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

Ofgem in the past decade in its approach to regulation and market design in the retail energy sector.

- A. Persistent dominance of the 'big six' large legacy suppliers, whose collective market share in both gas and electricity markets did not drop below 90% until 2015, did not drop below 80% until 2017, and remains at around 60% as of December 2021.
- B. A seemingly financially resilient market up to at least 2017, certainly in terms of the incidence and scale of supplier failures—and, it might be argued, even up to summer 2020.
- C. Relatively stable wholesale prices that from 2010 to the end of 2020 fluctuated between £32/MWh and £61/MWh for electricity (excluding the 5% most extreme days), and between £0.24/therm and £0.68/therm for gas (excluding the 5% most extreme days).<sup>131</sup> By comparison, in the second half of 2021, wholesale prices fluctuated between £91/MWh and £375/MWh for electricity (excluding the 5% most extreme days), and between £0.86/therm and £3.16/therm for gas (excluding the 5% most extreme days).

These key features are explained in turn below.

### **A. Persistent dominance of large legacy retail suppliers**

Figure A2.1 and Figure A2.2 below show how the electricity and gas supply market share of the large legacy suppliers, the three largest non-legacy suppliers to date (OVO, Bulb<sup>132</sup> and Octopus), and all other suppliers evolved over the period 2004–21.<sup>133</sup>

In both products, market share outside of the large legacy suppliers constituted a negligible share of the market until around 2013, with the market share of challengers growing at a steady rate thereafter. In this market context, there has been a focus on promotion of competition from non-legacy suppliers to impose downward pressure on bills, improve service quality, and lead to innovation in the sector.

Concerns about the dominance of legacy suppliers have contributed to the following:

- prioritising regulation that reduced barriers to entry, placed limited controls and restraints on the behaviour of non-legacy suppliers, and sought to 'even the playing field' in seeking to support growth by non-legacy suppliers;
- stakeholders within Ofgem, as well as legacy suppliers, noting that Ofgem has appeared at times to discount some of the representations of the incumbents, with higher weight being accorded to the views of challenger firms, for example as regards concerns about ongoing stand-alone financial profitability in the retail market;<sup>134</sup>
- regulation being introduced by Ofgem, in line with legislation, to impose a tariff cap on bills of consumers considered to be vulnerable or unengaged.

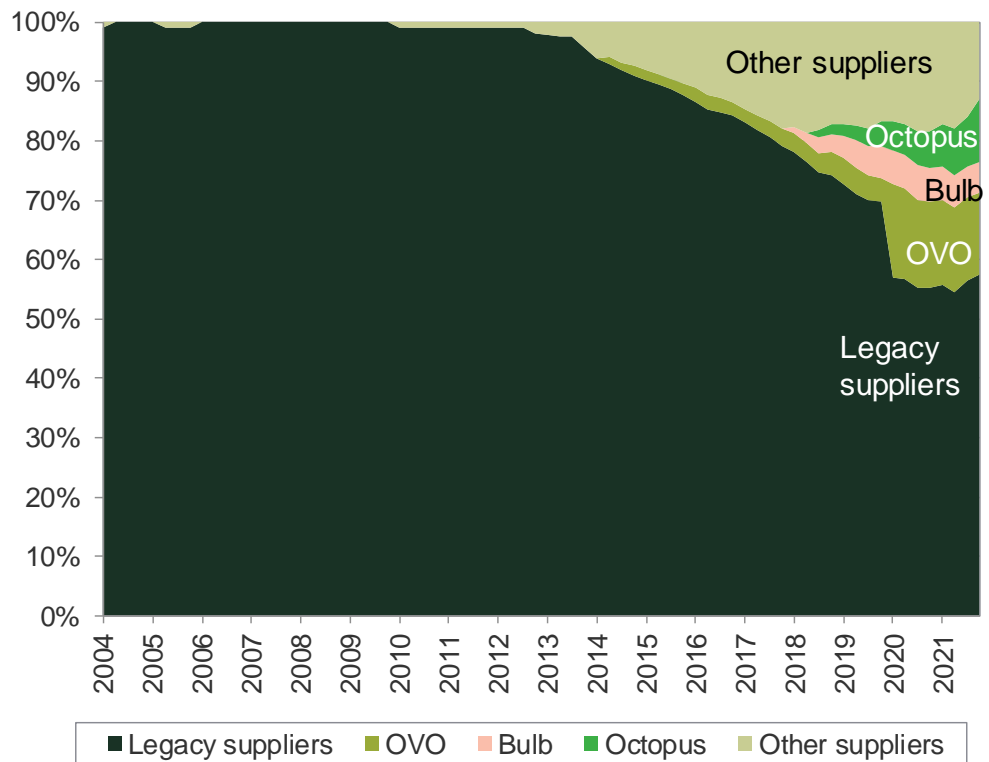
<sup>131</sup> We understand from non-public sources within Ofgem that the increase in gas prices to £2.30/therm observed during the 'Beast from the East' in 2018 was used to calibrate scenario modelling on exceptional wholesale price shocks, in the context of analysis undertaken as part of the introduction of the price cap.

<sup>132</sup> From Q4 2021—i.e. the last value shown—Bulb was in special administration.

<sup>133</sup> Data available only from 2005 for gas supply market share statistics.

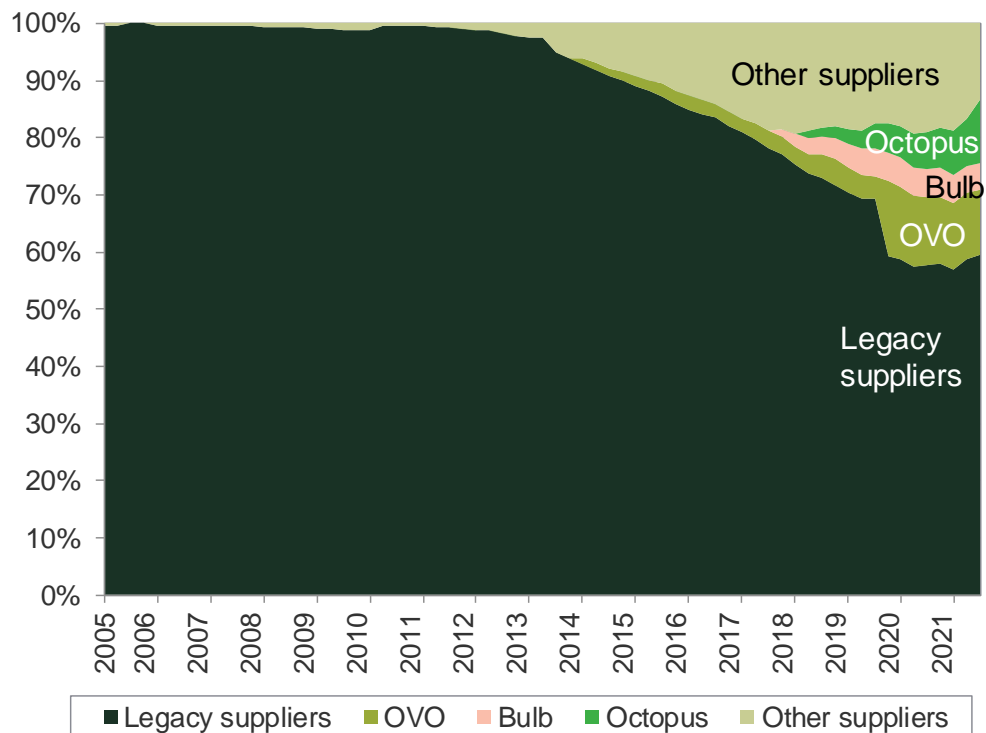
<sup>134</sup> For example, concerns around challenging efficiency targets and limited 'headroom' embedded within the price cap have been cited as having received inadequate weight when raised by legacy suppliers in engagement with Ofgem.

**Figure A2.1 Electricity supply market share (domestic), 2004–21**



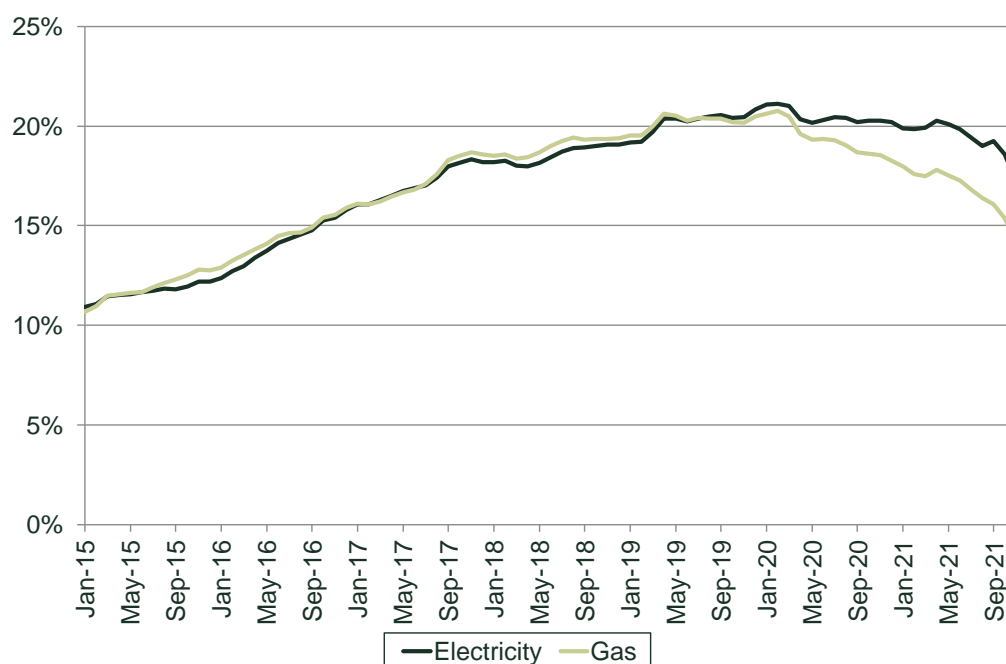
Source: Oxera analysis based on market share data available as part of Ofgem's publicly available Retail Market Indicators data up to Q3 2021, and non-public data on market share by supplier for Q4 2021 taken from *6.4\_Raw domestic market share\_MeterPointData for Board\_Oxera\_2022*.

**Figure A2.2 Gas supply market share (domestic), 2005–21**



Source: Oxera analysis based on market share data available as part of Ofgem's publicly available Retail Market Indicators data up to Q3 2021, and non-public data on market share by supplier for Q4 2021 taken from *6.4\_Raw domestic market share\_MeterPointData for Board\_Oxera\_2022*.

We also note that a key measure monitored by Ofgem throughout the period as an indication of the degree of competition in the market has been the rate of consumer switching. Figure A2.3 below sets out the rate of switching in the electricity and gas supply market over the period 2015–21, which shows that switching rates more than doubled over the period 2015–19 and have declined from 2020 onwards. By this measure, while the degree of competition in the market has increased considerably since the time period over which the CMA Energy Market Investigation took place (2014–16), it has remained below the 25% at its peak in 2020 and below 20% for much of the period. Since the beginning of the COVID-19 pandemic in March 2020, electricity switching rates have broadly plateaued, while gas switching rates have dropped to levels last seen in 2017.

**Figure A2.3 Rate of switching in the electricity and gas supply markets**

Source: Oxera analysis of Ofgem data.

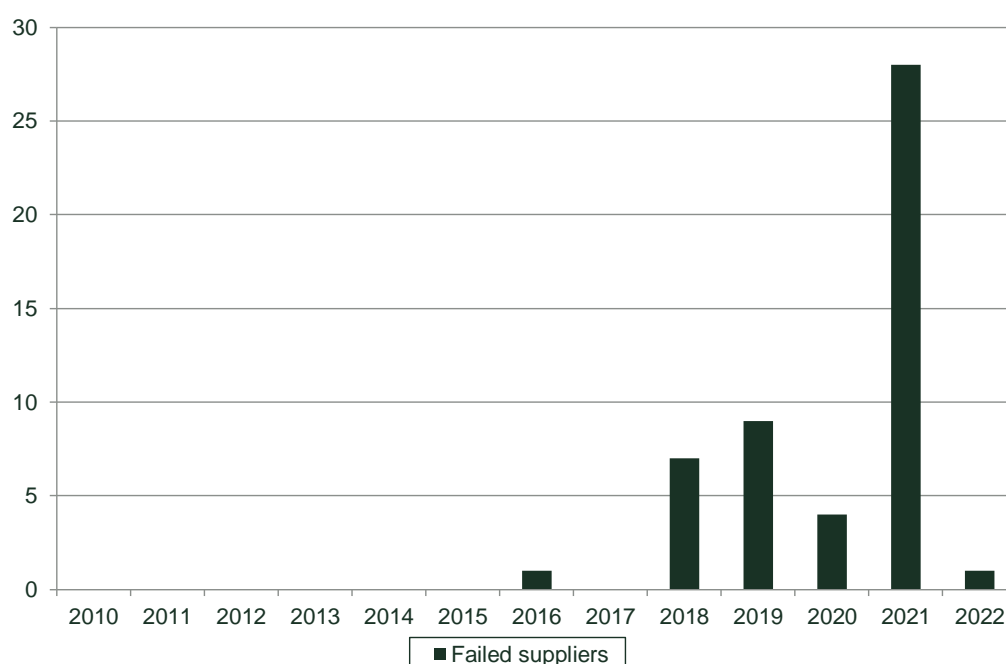
### **B. Historical market stability underpinning low concerns about failure**

A corollary of the small market share occupied by non-legacy suppliers individually—and as an overall industry grouping up to 2015—was that the failure of any non-legacy suppliers would have imposed a minimal degree of mutualised costs by virtue of the small size of the customer book.<sup>135</sup> From interviews with stakeholders, we understand that there was never a regulatory intent to pursue a regime of ‘zero supplier failure’—rather, there was an acceptance that non-resilient players would enter and exit, with an expectation that such players would be small and have low numbers of customers.

Accordingly, there may have been a delay within Ofgem to appreciate the extent to which the potential consequences of non-legacy supplier exits grew (in line with the market shares and growing scale of some of the challenger firms) over the period 2016–21. We note that the market shares of some non-legacy suppliers growing would be a natural consequence of the competition and levels of switching that Ofgem was aiming to promote in the market.

Figure A2.4 sets out numbers of supplier failures over the last 12 years. Notably, prior to the failure of GB Energy in 2016, there had been no supplier failures since 2008.

<sup>135</sup> We assume that the perceived risk of the failure of a legacy supplier (as opposed to orderly exit or acquisition) was considered to be remote given the backing of large parent companies and access to credit lines.

**Figure A2.4 Failed domestic suppliers per year from 2010**

Source: Forbes (2022), 'Failed UK Energy Suppliers Update', 18 February, accessed on 22 February 2022 at: <https://www.forbes.com/uk/advisor/energy/failed-uk-energy-suppliers-update/>.

It is important to distinguish between the perceived risks and costs of failure, and how these have evolved.

- **Risks of failure.** Ofgem's minimal experience of supplier failures prior to 2018 supported a perception that the probability of supplier failure—and concurrent failures of a large number of suppliers—was low.
- **Costs of failure.** The historical market share data shows that new entrants had a small share of the market up to 2015. We understand from conversations with Ofgem stakeholders that the hypothetical failure that Ofgem anticipated was of small player(s) with small customer books. Moreover, the early experiences of the functioning of the SoLR regime (see section 2.5) provided reassurance that the orderly transition of customers from failed suppliers to alternative suppliers could be achieved smoothly, and with low costs<sup>136</sup> to customers.

Finally, we note that, to the extent that Ofgem could have legitimately perceived the failures of non-legacy suppliers to be both an inconsequential and remote prospect up to that point, the current remedial policy stance within Ofgem represents an agile reaction to the current market conditions.

### **C. A decade of stable wholesale prices: 2010–20**

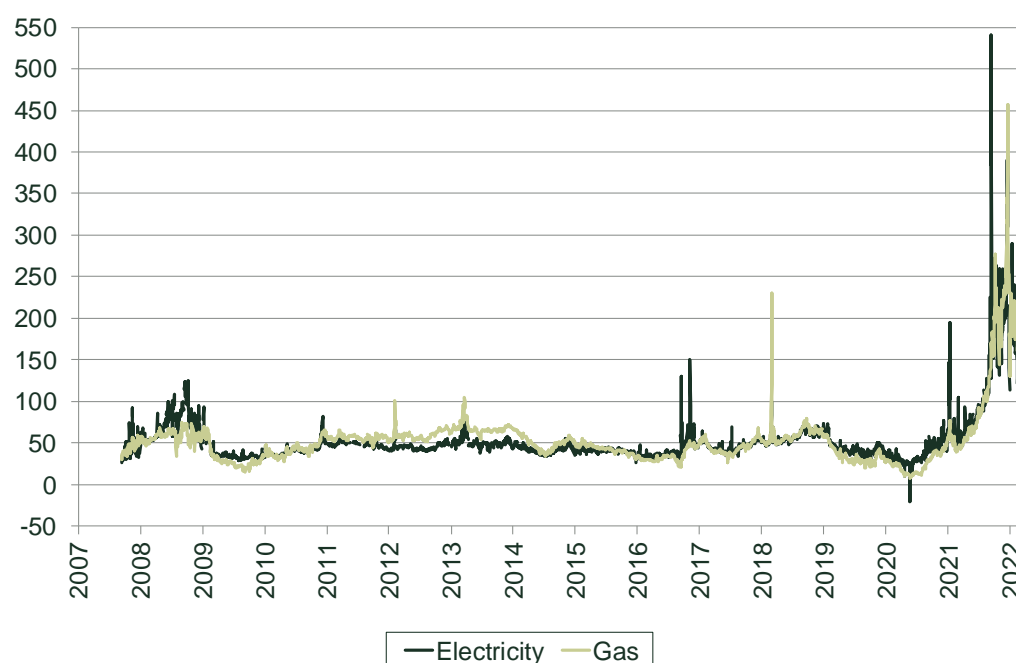
The final important piece of historical market context is that there has been an unprecedented (and largely unpredicted over the relevant timescales) rise in wholesale prices, which has played a role in precipitating recent supplier failures. Figure A2.5 below shows the change in the daily electricity and gas spot prices over the period 2008–22, with a similar picture emerging for the

<sup>136</sup> In terms of both minimal levels of costs being mutualised across the future customer base as a whole, and the minimisation of disruption for the customers of failed suppliers in particular.

forward prices used to set the direct fuel cost component of the Default Tariff Cap (see section 2.6).

It is clear that the wholesale price rise from the middle of 2021 is both higher and more persistent than Ofgem's experience of energy prices in the market in the past decade. The period of stable wholesale prices thereby underpinned the entire period over which the marked increase in the number of new entrants to the retail market was observed.

**Figure A2.5 Daily electricity and gas spot prices (£/MWh, pence/therm)**



Source: Bloomberg (UK Power baseload Forward Day Ahead and UK NBP Natural Gas Forward Day Ahead).

Bringing this together, to the extent that Ofgem's recent experience of historical market evidence will have shaped its approach to regulation of the sector in the past decade, we observe:

- that concerns about the persistent dominance of the legacy suppliers led to a policy focus on incentivising competition;
- that, on the basis of non-legacy supplier market shares and the low incidence of failure up to 2018, both the perceived risk and perceived costs of exit were expected to be low;
- that, to the extent that any stress-testing or modelling of financial resilience was undertaken by Ofgem, prior to 2021 calibrating such modelling to the magnitude of wholesale price increases observed over 2021 may have seemed disproportionate, given the decade of relatively stable prices that had persisted since 2010. We note that there has been minimal evidence of such analysis in the materials that we have received.

### **A2.3 Policy context**

As well as complying with statutory duties and primary legislation (e.g. in relation to the retail price cap), Ofgem acts with regard to policy direction from BEIS and its predecessors, as set out in its statutory duties:



In carrying out these functions the Authority must also have regard to... certain statutory guidance on social and environmental matters issued by the Secretary of State.<sup>137</sup>

This has both direct and indirect effects on the discharge of Ofgem's duties. The direct effects drive how Ofgem designs specific regulatory interventions, such as environmental levies that need to be recovered as part of retail tariffs. The indirect effects are also potentially important—and it is not always possible to disentangle Ofgem's regulatory philosophy from the direction of policy set by BEIS. For example, the emphasis on the promotion of competition as a means of protecting consumers and incentivising innovation to deliver the energy transition (e.g. see Ofgem's Strategic Narrative 2019–23)<sup>138</sup> is aligned with the corresponding focus of BEIS (e.g. see Energy Retail Market Strategy for the 2020s).<sup>139</sup>

Furthermore, the findings of the detailed and thorough Energy Market Investigation assessing the sector since liberalisation, which was undertaken by the CMA in 2014–16, played an important role in informing the perceived sources of market failure in the energy retail market. This highlighted the importance of reducing the dominance of the legacy players. A material conclusion of the CMA investigation—by which many of the regulatory philosophy and regulatory market design decisions of Ofgem were subsequently influenced—was the following:

Overall, we consider there to be a material customer detriment arising from the AECs [adverse effects on competition] that we have identified in retail energy markets. We have estimated that the customer detriment associated with high prices was about £1.4bn a year on average for the period 2012 to 2015 with an upwards trend. We also found evidence which is indicative of harm to customers from poor quality of service and restrictions on innovation, but by its nature this type of harm is less readily quantifiable.<sup>140</sup>

And:

We have investigated four broad areas in which we had concerns that domestic retail markets may not be working well for customers: (a) weak customer response and lack of engagement with domestic retail energy markets; (b) price discrimination and tacit coordination on the part of suppliers; (c) supply-side barriers to entry and expansion in the prepayment segments; and (d) the regulatory framework governing domestic retail market competition, notably the RMR [Retail Market Reforms] reforms and the settlement systems for gas and electricity.<sup>141</sup>

We note that market participants have raised material concerns about the robustness of the £1.4bn per annum customer detriment figure cited by the CMA.<sup>142</sup> Nonetheless, several stakeholders have referenced this headline as having substantiated the policy/regulatory concern to deliver competition as a means of reducing consumer detriment in the retail market. Moreover, the citation of harm to consumers from 'poor quality of service' and 'restrictions on innovation' has underpinned the regulatory focus on delivering competition and

<sup>137</sup> Ofgem (2013), 'Our powers and duties', 19 July, para. 1.9, accessed on 18 February 2022 at: <https://www.ofgem.gov.uk/publications/our-powers-and-duties>.

<sup>138</sup> Ofgem (2019), 'Our strategic narrative for 2019 – 23', July, pp. 14–15.

<sup>139</sup> Department for Business, Energy & Industrial Strategy (2021), 'Energy Retail Market Strategy for the 2020s. Helping consumers on their net zero journey', July, pp. 4–5.

<sup>140</sup> Competition and Markets Authority (2016), 'Energy market investigation: Final report', 24 June, p. 48.

<sup>141</sup> Competition and Markets Authority (2016), 'Energy market investigation: Final report', 24 June, p. 30.

<sup>142</sup> For a detailed critique, see Oxera (2017), 'CMA Energy Market Investigation—critique of CMA consumer detriment analysis', March.

higher rates of switching as a means of incentivising higher quality standards and rates of innovation in the industry.

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## **A3 The Supplier Licensing Review**

### **A3.1 Ofgem's assessment of policy options at the Supplier Licensing Review**

In its 2018 Supplier Licensing Review entry arrangements consultation, Ofgem set out its overall case for change across the three stages of the supplier lifecycle. Important motivation and context for the review, set out at the time by Ofgem, included:

- the need to manage a much larger number of players (growing from 27 domestic suppliers in December 2014 to 73 domestic suppliers by June 2018);
- a greater proportion of customer book value held by non-legacy suppliers (more than 24% of market share by 2018);
- greater customer engagement and switching levels, indicating improved competition in the market;
- instances of poor customer service from non-legacy suppliers;
- a growing number of supplier failures that had to be managed through the SoLR process.<sup>143</sup>

Given this context, the key aims of Ofgem's Supplier Licensing Review were to raise standards around financial resilience and customer service through a strengthening of the regulatory regime. It highlighted the need to balance, on the one hand, protecting consumers against suppliers' financial instability and poor customer service, and, on the other, ensuring that arrangements do not create undue barriers to innovation and competition.<sup>144</sup> As an overall set of strategic aims for the review, we note that this approach is broadly aligned with relevant statutory objectives for the retail market.

Ofgem considered three broad policy options for potential reform in the sector, set out in the table below, in terms of its consultation stage assessment of benefits and risks against the overarching aims set out above.

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<sup>143</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, pp. 13–14.

<sup>144</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, p. 14.

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**Table A3.1 Ofgem's assessment of broad policy options in the 2018 Supplier Licensing Review on entry arrangements**

Broad approach	Benefits	Risks
<b>Option 1</b> Current requirements (status quo)	<ul style="list-style-type: none"> <li>• Lowest barrier to new entrants/competition</li> <li>• Short assessment time period/route to market</li> <li>• No misleading signals re Ofgem 'approved' plans [sic]</li> </ul>	<ul style="list-style-type: none"> <li>• Licences could be granted to under-prepared or under-resourced companies, which exposes consumers to customer service and supplier failure risks</li> <li>• Companies can bypass assessment (if entering the market via an 'off the shelf' licensed company)</li> <li>• Limited basis to reject applications</li> </ul>
<b>Option 2 preferred</b> Increased information requirement with qualitative assessment criteria	<ul style="list-style-type: none"> <li>• Enables Ofgem to prevent unprepared or purely speculative applicants from gaining a licence</li> <li>• Raises barrier without stifling competition or discriminating against new business models</li> <li>• Brings forward key elements of existing compliance/monitoring framework and gives us earlier insight</li> <li>• Not unduly onerous on either the applicant or Ofgem, and therefore a proportionate response</li> </ul>	<ul style="list-style-type: none"> <li>• Entry assessment is no guarantee of future standards or financial stability</li> <li>• Potential for misinterpretation that we are making judgements on prospects of success</li> </ul>
<b>Option 3</b> Detailed information requirement with financial scrutiny and/or specific capital requirements	<ul style="list-style-type: none"> <li>• Arguably lowest exposure of customers to risks associated with financial instability (but risk reductions likely to be short-lived without further interventions)</li> </ul>	<ul style="list-style-type: none"> <li>• Not flexible for all potential entrant types</li> <li>• Disproportionate resource/effort—no test at entry can guarantee ongoing standards/stability</li> <li>• Financial projections beyond year 1 are highly speculative</li> </ul>

Source: Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, Table 1: Assessment of broad policy options, p. 21.

Ofgem proposed three criteria for how it might assess future supply licence applications if it moved towards requiring more information from suppliers (i.e. Option 2 or 3), as follows.<sup>145</sup>

- **Criteria 1:** The applicant has the appropriate resources for their proposal to enter the market—that they understand the costs they will face, propose a pricing model based on reasonable assumptions, have made sufficient provision for necessary human resources capabilities, and understand key risks of operating in the market.
- **Criteria 2:** The applicant understands their regulatory obligations and has appropriate plans in place to meet these—requiring prospective entrants to demonstrate their awareness of obligations and describe the practical steps that they are taking to comply with these.
- **Criteria 3:** The applicant is fit and proper to hold a licence—introducing additional questions requiring the disclosure of information from the

<sup>145</sup> Ofgem (2018), 'Consultation – Supplier Licensing Review (Entry Requirements)', 21 November, Table 1: Assessment of broad policy options, p. 23.

prospective entrant on previous insolvency, involvement in previous SoLR events, and compliance/enforcement history.

Finally, Ofgem proposed measures for the removal of the 'off the shelf' or 'supplier in a box' model of market entry under which the eventual suppliers would avoid engagement in the market entry processes. To achieve this, Ofgem proposed moving its entry assessment closer to the point of market entry.

On the basis of its assessment and with support from the majority of stakeholders, Ofgem selected Option 2 and the introduction of requirements for prospective entrants to disclose more data. A paper summarising this was tabled and discussed at GEMA's meeting on 27 February 2019. The proposed recommendations were agreed and published in Ofgem's April 2019 decision paper on entry requirements, to come into effect in June 2019. Overall, although Ofgem did not introduce capital requirements, the changes to the entry process represented a substantial tightening—taking the scrutiny of entrants back to levels not seen since 2003.

### **A3.2 Measures introduced in the ongoing arrangements and exit requirements section of the Supplier Licensing Review**

Besides the measures described in sections 2.4 and 2.5, Ofgem introduced a broader package of measures as part of the Supplier Licensing Review.<sup>146</sup> Specifically, in the ongoing arrangements section of its review, Ofgem introduced the following measures.

- Under the **operational capability** section of its review, Ofgem introduced a new principle for suppliers to ensure that they have—and can demonstrate that they have—the capability, systems and processes in place to enable them to effectively serve their customers and comply with their regulatory obligations.
- Under the **milestone assessments** section of its review, Ofgem introduced a requirement that suppliers inform Ofgem when reaching thresholds of 50,000 and 200,000 domestic customers, enabling Ofgem to carry out dynamic assessments where it might have concerns about a supplier's financial stability or ability to serve its customers.
- Under the **ongoing fit and proper requirement** section of its review, Ofgem introduced a new licence condition stating that suppliers must have robust systems, processes and governance in place to ensure that relevant individuals who hold a position of Significant Managerial Responsibility or Influence (SMRI) are fit and proper to occupy that role.
- Under the **supplier openness and cooperation** section of its review, Ofgem introduced a new principles-based requirement for suppliers to be open and cooperative with Ofgem.
- Under the **customer continuity plans** (formerly, living wills) section of its review, Ofgem introduced a new licence condition requiring all suppliers to produce and maintain a Customer Supply Continuity Plan, which sets out the supplier's strategy for safeguarding the continuity of supply for its customers in the event of its exit from the market.

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<sup>146</sup> Ofgem (2020), 'Supplier Licensing Review: Ongoing requirements and exit arrangements – Decision', 26 November.

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- Under the **independent audits** section of its review, Ofgem introduced a new licence condition allowing Ofgem to request that a supplier undertake an independent audit where it has specific concerns regarding supplier financial health or customer service capabilities.
- Under the **monitoring and reporting requirements** section of its review, Ofgem introduced a new licence condition requiring suppliers to notify Ofgem in the event of specific changes that might arise in the course of running their business. These include changes to certain business contact details, changes to any merger, acquisition or divestment plans (including trade sales and purchases), and any changes in ownership or in persons with SMRI in respect of the business.

In the exit arrangements section of its review, Ofgem introduced the following measures.

- Under the **customer interactions with administrators** section of its review, Ofgem introduced a requirement for suppliers to include references in customer contract terms and conditions to the effect that activities relating to debt recovery will be executed as outlined in the relevant licence condition, to ensure consistency between the way in which insolvency practitioners and a licensed energy supplier pursue debt.
  - Under the **customer books sales** section of its review, Ofgem introduced (i) a new requirement for suppliers to notify Ofgem when they are planning to undertake a commercial transaction that would result in the transfer of customers; and (ii) a licence condition that prevents licensees from engaging in commercial transactions that are likely to subvert or distort the SoLR process and/or make it more likely that costs will be mutualised.
  - Under the **SoLR commitments** section, Ofgem clarified the requirement for suppliers to take all reasonable steps to honour the terms of the bid that they provide as part of the SoLR selection process.
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## **A4 Renewables Obligation and industry levies**

There are a number of other regulatory mechanisms or tools relevant to the incentives faced by suppliers that we set out in this section. We consider:

- the RO, which obliges suppliers to source an increasing proportion of their generation from renewable sources, purchase Renewables Obligation Certificates (ROCs), or pay into a buy-out fund;
- other industry levies and policy costs payable by suppliers once they reach certain customer size thresholds.

### **A4.1 The Renewables Obligation**

The RO provides incentives for large-scale renewable electricity generation by making UK suppliers source a proportion of their electricity from eligible renewable sources. The annual obligation level on suppliers is published on 1 October. Thereafter, eligible renewable electricity generators report their monthly renewable electricity generation. Ofgem issues ROCs based on the type of technology that is used and the amount of electricity generated. Generators sell ROCs (for the wholesale electricity price plus a premium) to suppliers or traders.

All suppliers have to present ROCs corresponding to the amount of energy supplied, and suppliers that do not present enough certificates pay a penalty. This is called the 'buy-out price'. The money that has gone to Ofgem from the buy-out price or late payment funds is redistributed to all suppliers that have presented their ROCs pro rata.<sup>147</sup>

Suppliers that choose to pay into the RO must do so in August, which means that they are able to use customer money intended to cover the RO (which is collected throughout the year) as a form of temporary working capital. Moreover, suppliers are able to defer late RO payments for six months, at which point they will collect half of the next year's customer bills (implicitly including RO contributions).

Taken in combination with the use of customer prepayments as a form of working capital and the absence of regulation on capital requirements, this may have enabled some suppliers to operate in the market without committing large amounts of their own capital or necessarily securing sufficient lines of funding. This may have contributed to the costless entrance/'free bet' hypothesis as discussed in section 2.5, and the resulting adverse incentives from the perspective of the consumer interest.

### **A4.2 Other industry levies and policy costs**

There are a number of other industry levies and policy costs that may lead to the same 'free bet' effect for suppliers that enter through a different mechanism. They are as follows.

- The Feed-in Tariffs that are paid by suppliers with a domestic customer base of over 250,000.<sup>148</sup>

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<sup>147</sup> Ofgem (2015), '2010 to 2015 government policy: low carbon technologies: Appendix 5: the Renewables Obligation (RO)', 8 May.

<sup>148</sup> Ofgem (2021), 'Feed-in Tariff Annual Report 2020-2021', 13 December.

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- The Energy Company Obligations that are paid by suppliers with more than 150,000 customers (this was more than 250,000 before March 2019).<sup>149</sup>
- The Warm Home Discount that is paid by suppliers with a customer base of over 150,000.<sup>150</sup>

The relative cost advantage that exemption from these levies granted to new entrants and smaller suppliers may have led to an uneven playing field between them and larger suppliers. All else being equal, this may have enabled such companies to undercut larger rivals without financial cost, and contributed to the costless entrance/'free bet' hypothesis as discussed in section 2.5. However, we note that larger suppliers may have benefited from offsetting advantages such as access to cheaper financing.

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<sup>149</sup> Ofgem, 'Energy Company Obligation (ECO)', accessed on 23 March 2022 at: <https://www.ofgem.gov.uk/environmental-and-social-schemes/energy-company-obligation-eco/energy-suppliers>.

<sup>150</sup> Ofgem (2018), 'Warm Home Discount: Guidance for Suppliers (Version 6.1)', 10 August.

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## A5 Additional data on financial resilience

This section shows additional data on financial resilience relating to the analysis in section 3.

### A5.1 Current ratio during the pandemic period

Figure A5.1 ✂

✂

Note: ✂

Source: ✂

Figure A5.2 ✂

✂

Note: ✂

Source: ✂

### A5.2 Customer credit balance for small suppliers during the pandemic period

Figure A5.3 ✂

✂

Note: ✂

Source: ✂

### A5.3 Deferred income as a percentage of total assets

Figure A5.4 ✂

✂

Note: ✂

Source: ✂

Figure A5.5 ✂

✂

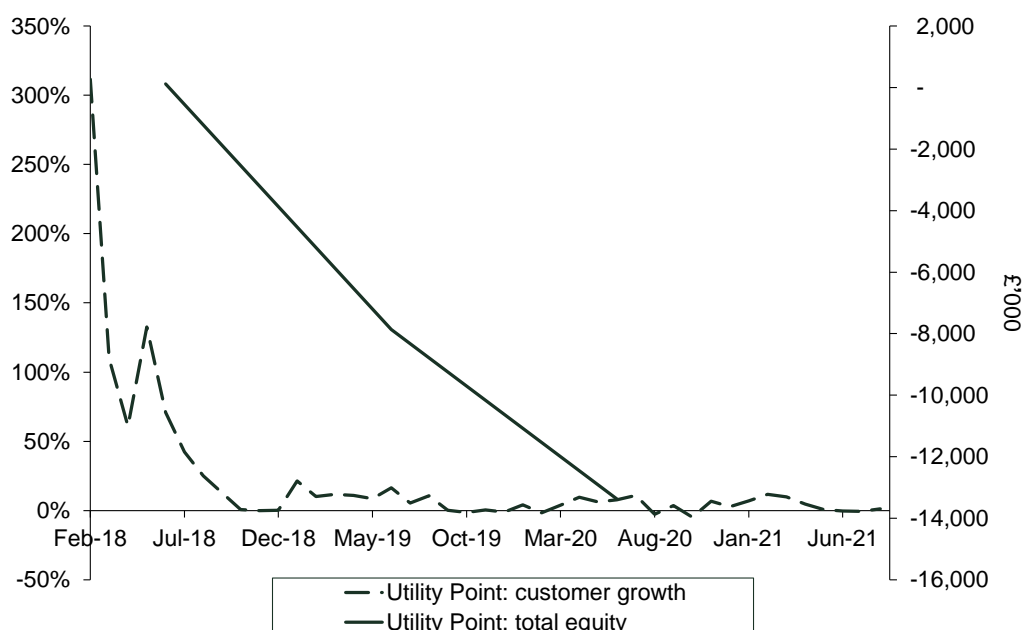
Note: ✂

Source: ✂

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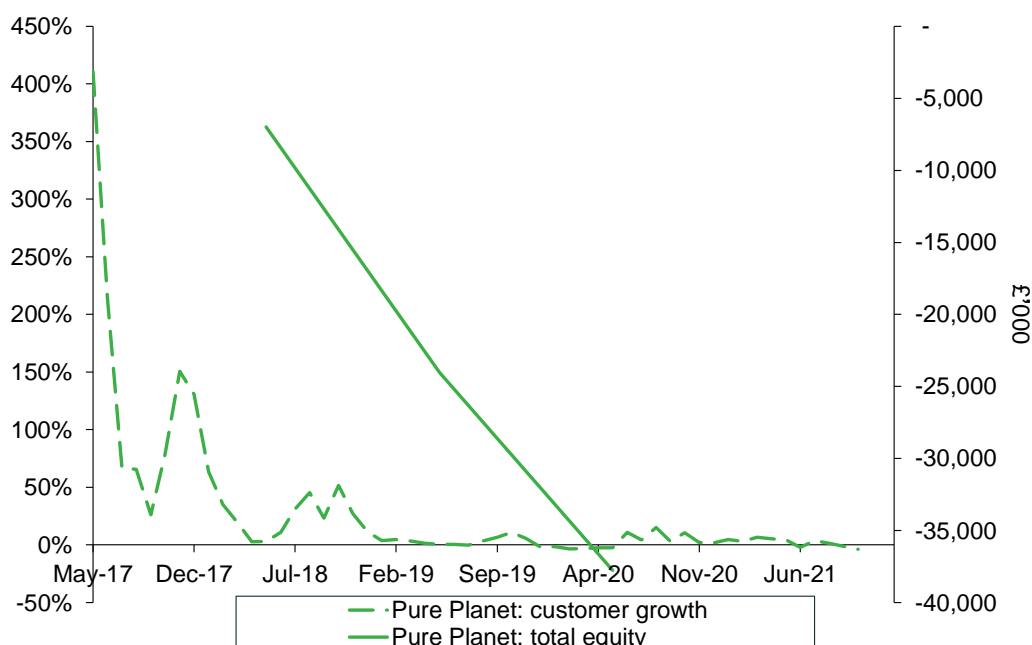
#### A5.4 Correlation between customer growth rates and total equity for failed companies in our sample

**Figure A5.6** Customer growth rates (dashed line, left axis) and total equity (right axis) for Utility Point



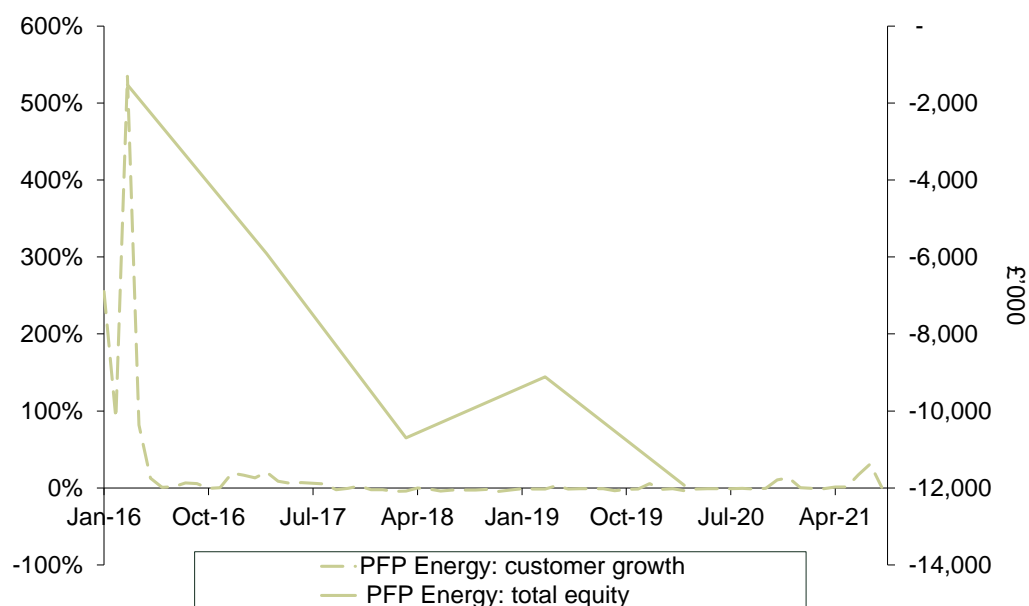
Source: Oxera analysis based on Ofgem data and company financial statements from Companies House.

**Figure A5.7** Customer growth rates (dashed line, left axis) and total equity (right axis) for Pure Planet



Source: Oxera analysis based on Ofgem data and company financial statements from Companies House.

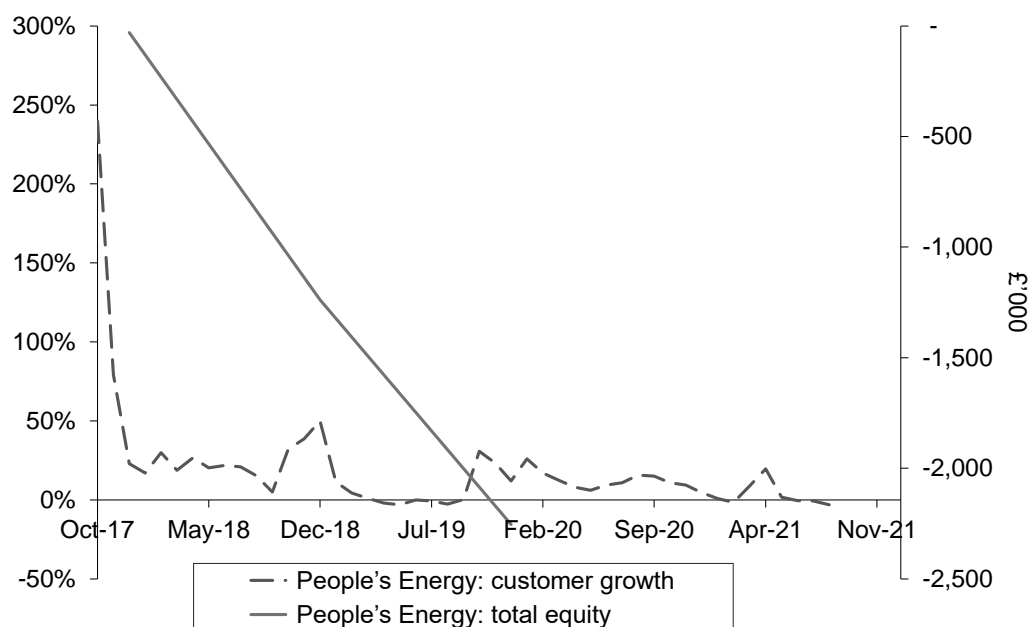
**Figure A5.8 Customer growth rates (dashed line, left axis) and total equity (right axis) for PFP Energy**



Note: The increase in the equity line for PFP Energy in the period shown is due to a £5m equity issuance that occurred in 2019.

Source: Oxera analysis based on Ofgem data and company financial statements from Companies House.

**Figure A5.9 Customer growth rates (dashed line, left axis) and total equity (right axis) for People's Energy**

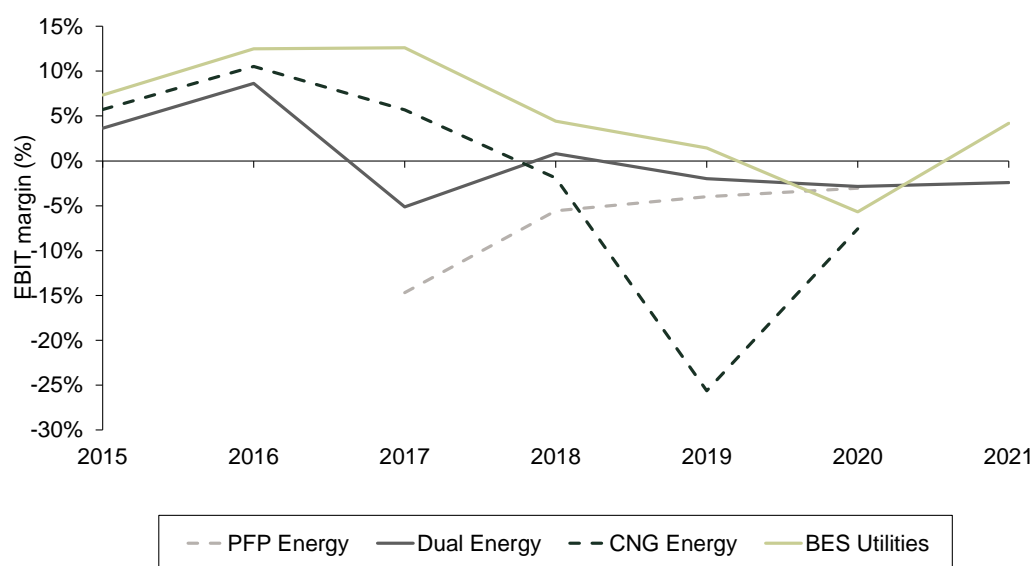


Source: Oxera analysis based on Ofgem data and company financial statements from Companies House.

We have not plotted the correlation chart for CNG Energy because customer growth data is not available; we have not plotted the chart for Avro because only the combined company accounts for FY2017 and FY2018+HY2019 are available; and we have not plotted the chart for Green Supplier due to a lack of sufficient data points for total equity.

## A5.5 Profitability for small suppliers

**Figure A5.10 Profitability for small suppliers, combined electricity and gas 2015–21**



Note: The supply margins shown in this chart are the ratio of a company's EBIT to its total revenues. A supplier's margin is calculated by subtracting from a company's total revenue its total direct costs, total indirect costs (such as operating costs), depreciation and amortisation. Green Supplier is not reported because values are not available.

Source: Oxera analysis based on companies' annual statements.

## A6 Supplier hedging arrangements

In this appendix, we set out our analysis of the hedging arrangements of retail energy suppliers, based on Ofgem's monthly RFIs to suppliers since the beginning of the pandemic. At a high level, our analysis reveals that there is overall poor compliance on the disclosure of hedging arrangements, with only 60% of suppliers disclosing the horizon and levels of their hedging position during the period between June 2020 to November 2021. Some failed suppliers also displayed a level of mistrust in how their information would be used, and/or inadequate knowledge of their financial positions, in their responses to Ofgem's RFIs on hedging arrangements (some examples are shown in the box below). Note that hereafter we use the shorthand 'active' for those suppliers that continued to operate in the market.

### Box A6.1 Disclosed information on hedging arrangements

Before Ofgem specified its questions on hedging arrangements and mandated disclosures on the levels of hedging over the next three quarters from April 2021 onwards, few suppliers disclosed useful information on their hedging arrangements. For example, one failed supplier, Green Supplier, stated in its June 2020 disclosure that:

Green's hedging strategy is commercially sensitive information which we are unable to share for this RFI.<sup>1</sup>

It was later revealed in July 2021 that Green Supplier had 0% of its customer demand hedged for Q4 2021, Q1 2022 and Q2 2022.<sup>2</sup>

Another failed supplier, Utility Point, continued to refuse to disclose its hedging arrangements even after Ofgem specified its questions on hedging, and in turn began to question Ofgem. In an Ofgem document dated August 2021, Utility Point was asked for:

As of today, the percentage of your customers' expected electricity and gas usage over the remainder of the financial year that has been hedged. Please provide separate figures for each quarter: Q3 2021, Q4 2021, and Q1 2022.

In response, Utility Point wrote:

I suspect responses to this will only be of note for suppliers with a stable base. For example a supplier who is forecasting growth / losses will provide significantly varied answers. Naturally companies all have different financial years to I assume we mean something like tax year?

In response to another specific request from Ofgem:

Your general approach to hedging, including a description of how far into the future you purchase energy, and in what proportion (e.g. x% of expected demand is hedged y months in advance).

Utility Point responded:

Again this will be impacted by forecasted growth / losses. Further you cannot purchase 100% of electricity requirements (realistically you can only purchase peakload and baseload). Are you expecting the report to focus on % of demand that can be hedged, or % of demand regardless of whether it is possible to hedge it? As it stands suppliers may give varied answers on this as well.

Utility Point ceased trading on 14 September 2021 and entered into the SoLR process.<sup>3</sup>

For those failed suppliers that disclosed detailed hedging arrangements, four (Simplicity Energy, Together Energy, PFP Energy and Orbit Energy) had relatively

high levels of hedging (i.e. >50% of customer demand hedged) over a horizon of longer than six months.

It is worth noting that Simplicity Energy failed in January 2021, before the energy crisis worsened, and its disclosure of hedging arrangements was made in June 2020 without any further updates. It is possible that either Simplicity's disclosed hedging arrangements had changed and/or that its hedging position had deteriorated prior to its failure.

Together Energy issued an update on hedging arrangements following the initial April 2021 disclosure presented in Table A6.1, which stated that the rising wholesale costs had 'a dramatic impact on the available margin for the SVT segment of its portfolio under the Default Tariff Cap'.

Specifically, it explained that the demand visible for SVT customers is low, and that its hedging strategies would lead to negative gross margins for each new customer signing up:

While with our fixed tariff customer base we have a reasonable expectation of demand and are able to hedge accordingly, our SVT customer base does not have a reasonable expectation of demand. Customers can leave this tariff at any time with no exit fees, so we think it is inappropriate to hedge this volume too far in future. Our current SVT hedge profile steps down over 6 months, 100% of SVT volume hedged in the month ahead, to 20% in month 6. This creates a delta between the margins set in the Default Tariff Cap and the margins we can actually achieve, and in a rising market as we have seen over the last 8 months, this delta can severely impact margin on this portfolio. A customer signing up to our SVT today will produce negative gross margins for Together Energy.<sup>4</sup>

Based on the information provided above, it appears that, despite owning a relatively well-hedged portfolio, the combination of demand uncertainties and rising wholesale costs contributed to the insolvency of Together Energy.

Note: <sup>1</sup> Ofgem (2020), '06-June-2020\_Suppliers\_RFI\_data'. <sup>2</sup> Ofgem (2021), '07-July-2021\_Suppliers\_RFI\_data'. <sup>3</sup> Ofgem (2021), 'Ofgem protects customers of failed suppliers Utility Point and People's Energy', 14 September, accessed on 10 April 2022 at: <https://www.ofgem.gov.uk/publications/ofgem-protects-customers-failed-suppliers-utility-point-and-peoples-energy>. <sup>4</sup> Ofgem (2021), '07-July-2021\_Suppliers\_RFI\_data'.

Source: Suppliers' RFI data provided by Ofgem.

It is worth noting that, before Ofgem specified its questions on hedging arrangements and mandated disclosures on the levels of hedging over the next three quarters from April 2021 onwards, even fewer suppliers disclosed useful information on their hedging arrangements.

Notwithstanding the significant non-disclosures from suppliers, our analysis reveals that, of those that did report on hedging arrangements, seven out of the 15 failed suppliers were either unhedged or only hedged over less than six months/two quarters. Three companies (Ampower, Avro and GOTO) hedged more than nine months but had relatively low levels of hedging at the longest horizon (i.e. less than 50% of demand hedged nine months out). The levels of hedging that CNG Energy had are unclear from its disclosures to Ofgem. However, at least four failed suppliers (Together Energy, PFP Energy, Simplicity Energy and Orbit Energy) had relatively high levels of hedging (over 50% of demand hedged over nine months or more). This is shown in Table A6.1 below, which summarises key information for those failed suppliers that disclosed their hedging arrangements.

**Figure A6.1** ✂

✂

Source: ✂

**Table A6.1 Hedging arrangements for failed suppliers**

Company	Customers as of July 2020	Failure date	Hedging horizon	Customer demand hedged 3 months out (%) <sup>1</sup>	Customer demand hedged 9 months out (%) <sup>1</sup>
Ampower UK	3,312	Nov-21	More than 9 months	0% electricity, 100% gas	0% electricity, 100% gas
Avro	519,138	Sep-21	More than 9 months	20%	15%
✂	✂	✂	✂	✂	✂
CNG Energy	39,331	Nov-21	More than 9 months	Fully hedged for fixed contracts; limited information on overall level	Fully hedged for fixed contracts; limited information on overall level
Entice Energy	2,024	Dec-21	3 months	50% electricity, 100% gas <sup>3</sup>	0% electricity, 100% gas <sup>3</sup>
GOTO Energy	16,014	Oct-21	More than 9 months	88%	6%
Green Supplier	47,795	Sep-21	n.a.	0%	0%
Igloo Energy	122,941	Sep-21	3 months	19% electricity, 40% gas	0%
Orbit	57,765	Dec-21	More than 9 months	100%	100%
PFP Energy	48,766	Sep-21	More than 9 months	91% electricity, 91% gas	73% for electricity, 69% for gas
Pure Planet	136,763	Oct-21	3 months	100% for fixed tariffs; 100% for SVT for 3 months	100% for fixed tariff; 0% for SVT
People's Energy	186,298	Sep-21	6 months	67%	0% <sup>4</sup>
Simplicity Energy	28,490	Jan-21	9 months	100%	66%
Together Energy	84,869	Jan-22	More than 9 months	87%	95%
Yorkshire Energy (DESL)	77,923	Dec-20	3 months	100% for fixed tariffs; 100% for SVT for 3 months	0%

Note: Detailed hedging arrangements for most suppliers were reported between April 2021 and July 2021, after Ofgem specified its questions on hedging arrangements and mandated disclosures on the levels of hedging over the next three quarters in April 2021. The only exceptions in this table are Yorkshire Energy (DESL) and Simplicity Energy, which reported their hedging arrangements in June 2020 and provided no subsequent updates (as both companies failed over the period December 2020 to January 2021). The hedging horizon and levels recorded in this table represent the first detailed disclosure from suppliers. Updated disclosures from the following months are not presented.

<sup>1</sup> The levels of hedging presented are the summary of responses to Ofgem's request 'As of today, the percentage of your customers' expected electricity and gas usage over the remainder of the financial year that has been hedged. Please provide separate figures for each quarter: Q3 2021, Q4 2021, and Q1 2022.' Most suppliers appear to reduce their levels of hedging as they are further out in their hedging horizon (e.g. they hedge 90% exposure for Q3 2021, 80% for Q4 2021, and 70% for Q1 2022). ✂ <sup>3</sup> Based on a long-term agreement with CNG. <sup>4</sup> Hedged 46% of demand over a 6 month time horizon.

Source: Ofgem RFI data.

✂

**Table A6.2** ✂

✂

Note: ✂

Source: ✂

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