

22 February 2022

Cathryn Scott  
Director of Enforcement & Emerging Issues  
Ofgem  
10 South Colonnade  
Canary Wharf  
London E14 4PU

Dear Cathryn,

**Re: Guidance on the Operational Capability and Financial Responsibility Principles**

Thank you for the opportunity to comment on the above consultation. As we have set out in our response to the parallel consultation on the *"Update to the action plan on retail financial resilience: supplier control over material assets"*, we welcome Ofgem undertaking critical review, consultation and considered reform to strengthen the energy industry and provide additional resilience.

Rather than restate the points here, we refer Ofgem to our submission in respect of the above document. These activities are of critical importance to the industry, but we urge that Ofgem's actions be measured and proportionate. While the work Ofgem is undertaking is both important and urgent, it is not so urgent that as an industry we cannot take time to ensure that the right actions are now taken. Those actions should include looking frankly and honestly at the causes of the issues and ensuring that these are addressed.

The Prepayment Charge Restriction and the Default Tariff Cap (together 'the price cap') are incontrovertibly causative factors in the current industry crises. Nearly thirty suppliers have failed, and this is, at least in part, due to regulatory failure to allow suppliers to recover their efficient costs and make a normal return on capital employed under the price cap.

In the consultation, Ofgem sets out its' requirement that suppliers bear 'an appropriate share of their risk'. While we would not normally dispute that this would be fair, it needs to be aligned to the allowance in the price cap. Where the price cap fails to make allowance for suppliers to manage risk, the inescapable conclusion is that consumers will bear the consequences through supplier failures. If Ofgem requires that consumers be held whole, then it should fund suppliers to enable them to adequately manage risk.

Under the relevant price controls, networks businesses receive an allowed return above the risk-free rate. Network businesses face a far lower risk profile than suppliers – they have an allowed revenue, captive customers and guaranteed payments with any bad debt being mutualised. Even with all these protections, Ofgem recognises that they need a return over and above the protections which is sufficient to provide investors with reason to invest.

Suppliers on the other hand are fully exposed to the vicissitudes of the market. They face robust competition, with no protection for bad debt and an assumed EBIT of 1.25% under the price cap. In the case of prepay specialists, they face an even more extreme position due to Ofgem's continuing support of a cross-subsidy, without mutualisation to credit customers and an explicit failure to allow recovery of the specialist suppliers' efficient costs.

As has been demonstrated beyond any doubt in the last months, Ofgem's price cap has forced all suppliers to supply energy below cost. This is clearly not consistent with a requirement to fund the levels of risk management Ofgem expects. Suppliers (and their investors) need to be rewarded for bearing risk in the same way as any other commercial entity – or price-controlled entity for that matter. Ofgem notes (paragraph 1.5) that *'We want to ensure that the costs of a supplier's business are borne by the business itself, rather than being subsidised, on its failure, by its competitors and ultimately by consumers.'*

We agree - but only in the circumstance where the supplier is being allowed appropriate risk management costs under the price cap, and Ofgem has met its duty to ensure that licensees can fund their regulated activities.

In terms of the specific changes proposed, we agree that they are generally self-explanatory. They are consistent with the preferred approach set out by Ofgem, but we do not believe that they are all realistic under the current price cap. We acknowledge that the April 2022 price cap makes progress in that it will allow suppliers to recover most of their costs for the next year, and a proportion of the cap period seven costs. However, it will not remediate the years of consistent underfunding by Ofgem and allow suppliers to rebuild their balance sheets.

In addition to the points above, we would like to understand in more detail Ofgem's views on the enforcement mechanisms and outcomes it envisages would be necessary to support enforcement of the additional requirements.

The current licence conditions on Operational Capability and Financial Responsibility are relatively new. It is not clear that the guidance has been tested and found wanting. Ofgem has not provided any evidence that the current provisions have not allowed actions that it would otherwise have taken. We believe that before introducing new arrangements, Ofgem should be able to demonstrate that existing guidance has gaps. We do not agree that the case for change has been made in this case.

On this basis, while we support the objectives underpinning the principles, we believe some of the proposals are not necessary, and if implemented a transitional period may be needed – for example to formally document relationships which may have been working effectively for years.

We also believe that a key element of applying the principles in these licence conditions is to recognise that suppliers will reasonably have variable business models and risk appetites, and that there will be a range of viable approaches.

Finally, we believe it is appropriate that the requirements set out in guidance are carefully considered alongside the Default Tariff Cap Framework to ensure that all are properly and fairly funded. The extensive requirements which are described in the proposed guidance are

likely to have costs associated for suppliers, and it is not clear that such additional costs are covered.

We hope that this submission has been useful, and we would welcome an opportunity to discuss the points made in more detail.

Kind regards

Alison Russell  
Director of Policy & Regulatory Affairs