Making a positive difference
for energy consumers

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

Email:RetailFinancialResilience@ofgem.gov.uk
20 June 2022

Dear Stakeholders,

Statutory consultation: Supplier control over material assets

1.1 In January this year we consulted on updating guidance accompanying the Financial Responsibility Principle (FRP) and on new guidance for the Operational Capability Principle (OCP)[1]. We decided to implement this guidance via our decision letter dated 23 May 2022.[2]

1.2 The FRP and OCP are both requirements in the existing supply licence (SLCs) that set out broad principles-based rules around the financial and operational arrangements suppliers must have in place.[3] Introduced in early 2021, the FRP (SLC4B) is an enforceable rule that requires suppliers to responsibly manage costs that could be mutualised, and to take appropriate action to minimise such costs. The OCP (SLC4A) obligates a supplier to ensure it has and maintains robust internal capability, systems, and processes to enable it to efficiently and effectively serve each of its customers.

1.3 The guidance informs suppliers on how they should comply with their obligations under the OCP and FRP, as well as information on how the principles are implemented and fit within our existing regulatory framework. The May 2022 update to the guidance confirms what is expected of suppliers in relation to ownership or control of the material assets needed to run their business.

[1] Proposed guidance on the Operability Capability and Financial Responsibility principles
[2] Decision on proposed guidance on the Operational Capability and Financial Responsibility principles
[3] Electricity Supply Standard Licence Conditions. Please see page 54 onwards for SLC 4A and 4B1-4B3 for electricity, which is replicated in gas.

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The issues we identified

1.4 In our January consultation[4] we explained that through our monitoring work and recent experience with supplier failures, we had identified that some licensed suppliers had structured their businesses in such a way (or were about to do so) that they did not own, control or have the economic or legal rights to their material assets. These assets can include premises, facilities, staff, equipment, IT system, brand name and other key agreements required for a supplier to serve its customers efficiently and effectively. We identified a number of arrangements where these assets were owned and controlled by a parent company or another company in the same group as the licensed supplier and it did not have any legally enforceable or clearly defined arrangements in place with that parent / group company in respect of those assets.

1.5 In our consultation on changes to the FRP guidance[5], we set out our view that this places an unfair and disproportionate risk on energy consumers. This is because the arrangement may give a parent or other group company the ability to retain assets that could otherwise have helped offset the contributions from consumers and taxpayers following a supplier's failure. We gave examples as to how this results in increased costs to the consumer, whether a supplier failure is managed through the special administration regime (SAR) or Supplier of Last Resort (SoLR) process.

1.6 We also noted our concern about the potential for situations in which direct action is taken prior to a supplier's failure to benefit a parent company or its investors at the expense of consumers or taxpayers. For example, where steps are taken to liquidate or terminate agreements for key supplier assets (such as a hedging contract), making the supplier insolvent but allowing unregulated parts of the group to retain the value of those assets. We stated that we consider this would place unacceptable and unjustified additional costs on consumers as well as other responsible suppliers and market participants. We explained that we think it is imperative that consumers are not unfairly penalised as a result of arrangements which mean a supplier's key assets cannot be relied on to offset or minimise mutualised[6] costs in the event of a supplier's failure.

The changes we made

[4] See footnote 1
[5] See footnote 3
[6] Mutualised is defined in the Electricity Standard Licence Conditions as "means one or more market participants other than the licensee bearing costs incurred by the licensee, which may include Customer Credit Balances and costs incurred by the licensee under government environmental and social schemes, by virtue of regulatory mechanisms."

1.7 The OCP places an obligation on a supplier to ensure it has and maintains robust internal capability, systems and processes to enable it to efficiently and effectively serve each of its customers. We created new guidance accompanying the OCP to clarify that we expect, in complying with the OCP, suppliers to own or have sufficient control over all material assets required to run their supply business.

1.8 Material assets, in the context of the OCP, are those relied on by a supplier to run its supply business and meet its obligations to customers. Whether a particular asset is material will therefore depend on the specific circumstances and we expect the suppliers will know which assets are material to running their business. However, to assist, in the amendments to the guidance, we provided a non-exhaustive list which are likely to be material (premises, facilities, staff, equipment, IT systems and brand name).

1.9 Sufficient control means that suppliers have direct ownership or legally enforceable rights over their material assets so that they are able to rely on them legally and enjoy the benefit of them.

1.10 The FRP is an overarching obligation on suppliers to act in a financially responsible manner. It requires suppliers to, at all times, manage responsibly costs that could be mutualised and take appropriate action to minimise such costs and to have adequate financial arrangements in place to its costs at risk of being mutualised.

1.11 We updated the FRP guidance to confirm that if a supplier uses an asset to meet its obligations under the FRP, it must either own this asset or have sufficient control over it so that it can rely on it legally and enjoy the benefit of it and that it should not liquidate, sell or dispose of such an asset if doing so increases the risk and amount of mutualised costs. This was in response to the unfair and disproportionate risk faced by consumers where arrangements enable a parent or other group company to retain assets used by a failed supplier which could otherwise help offset the costs of a supplier's failure.

The proposals in this consultation

1.12 We are now seeking to enshrine the key components of the updated OCP/FRP guidance in the supply licence. As explained in our January consultation and May decision on amending the FRP guidance and introducing OCP guidance, our amendments confirm how suppliers should structure their business in order to comply with the FRP and OCP. Where licenced suppliers do not organise their businesses as set out in the amended guidance, this has the potential to cause significant levels of

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detriment to consumers and other responsible marker participants. In the context of the OCP, where suppliers do not have sufficient control over material assets, this is likely to impede a SoLR or special administrator from being able to provide an effective and efficient service to customers in the event of supplier failure. In the context of the FRP, failure to have legally enforceable rights over any hedged position[7], or other asset a supplier relies on to meet the FRP, could increase the costs at risk of being mutualised, placing additional costs on other market participants that will be passed on to consumers through higher bills. Therefore, given the potential adverse consequences of failure to organise their businesses in a manner in accordance with the guidance, we consider that it is prudent, and supports our principal objective to protect the interests of consumers, to place the obligation to do so directly into the licence. This ensures suppliers are clear that there is a direct obligation to comply with these requirements and highlights to suppliers the enforcement action Ofgem can take in the event of a failure to do so. In feedback to previous consultations, stakeholders indicated that they would welcome this clarity.

Impact assessment

1.13 Under the Utilities Act 2005 (Section 5A) we are required to conduct an impact assessment, or publish a statement explaining why we do not think one is necessary, where we are proposing to do anything in connection with the carrying out of our functions and where that proposal is "important". Our guidance on impact assessment explains that a proposal is "important" for a number of reasons. In line with that guidance, this proposal would be considered as "important" were it to have a significant impact on suppliers. The guidance also explains that "significant impact" may include where implementing the proposal would have significant costs for industry participants.

1.14 As explained above, we have already implemented guidance[8] which confirms how we expect licensed suppliers to organise their businesses in compliance with the OCP and FRP. Therefore, we do not consider that taking the additional step of placing the requirements directly into the supply licence will have any impact on suppliers. Suppliers should already be adhering to these requirements.

1.15 We received stakeholder feedback to our consultation on the guidance where some suppliers indicated that, having considered the terms of the amended guidance, they

[7] Hedging contracts refers to arrangements entered into by suppliers to procure energy on the wholesale market at a set price – such arrangements prevent suppliers from being exposed to the risk of sudden wholesale price fluctuations. For more information, see chapter 6 of the accompanying policy consultation.
[8] Guidance on the Operational Capability and Financial Responsibility principles

expected that they would need to take certain steps to bring themselves into compliance with the OCP and FRP. To ensure that we work with suppliers to bring them into compliance, our decision letter[9] called on suppliers to contact us should they consider they needed time to bring themselves into compliance and to provide us with an action plan indicating how they would do so. We asked suppliers to respond to us by 6 June if they were in this position, with action plans to be provided by 20 June.

1.16 The feedback we received from suppliers did not indicate that any of the steps they considered they were required to take to come into compliance would cause any significant impact on them, nor cause them to incur significant costs. We have not therefore carried out an impact assessment in respect of these proposals because, as explained above, we do not consider that they will result in any significant impact on suppliers.

Next Steps

1.17 We welcome any comments on the draft supply licence conditions accompanying this document by close on 19 July 2022. If we decide to make the proposed modifications, we envisage the modifications taking effect 56 days after a decision is published.

Cathryn Scott
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[9] See Footnote 2

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