

## Guidance on the Operational Capability and Financial Responsibility Principles

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This document provides suppliers with guidance on how they should comply with their obligations under SLC 4A (the Operational Capability Principle) and SLC 4B (the Financial Responsibility Principle), as well as information on how the principles are implemented and fit within our existing regulatory framework.

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## **1. Introduction**

1.1. The Operational Capability Principle (SLC 4A) obligates a supplier to ensure that it has and maintains robust internal capability, systems and processes to enable it to serve efficiently and effectively each of its customers. The Financial Responsibility Principle (SLC 4B) is a set of overarching rules requiring suppliers to take action to ensure that:

- They maintain Capital and Liquidity of sufficient amount and Quality so that they can meet their reasonably anticipated financial liabilities as they fall due on an ongoing basis;
- If they were to exit the market, that their operational and financial arrangements are such that any Supplier of Last Resort (SoLR) or special administrator appointed would be able to efficiently and effectively serve its customers and that any exit would result in minimised mutualised costs;
- They manage responsibly costs that could be mutualised and take appropriate action to minimise such costs at all times;
- They have adequate financial arrangements in place to meet their costs at risk of being mutualised at all times;
- They maintain Sufficient Control over any Material and Economic Asset used to meet their obligations under SLC 4B and;
- They do not dispose of said assets if doing so risks an increase in costs at risk of being mutualised.

1.2. SLC 4B also puts in place a requirement to notify the Authority before making certain non-essential payments, loans or asset transfers to third parties where any of the three Trigger Points have occurred.

1.3. While certain elements of SLC 4A and 4B apply only to domestic suppliers, this guidance is relevant for all domestic and non-domestic suppliers.

1.4. Ofgem<sup>1</sup> previously issued guidance under SLC 4B in May 2022, and updated this Guidance again in April 2023. This new Guidance supersedes any Guidance previously issued under SLC 4B and is issued to assist stakeholders in understanding and complying with these licence conditions. We remind all suppliers that this Guidance does not modify or replace the conditions in the gas and electricity supply licences. Suppliers should continue to refer to the conditions outlined in the most recent versions of the gas and electricity supply licences.

1.5. Save for any errata which we would expect to correct and reissue without consultation, the Authority may amend this Guidance from time to time in accordance with the licence.

1.6. Where defined words and expressions are used in this Guidance, they are capitalised and have the same meaning as in SLC 4B.

### **What is the Operational Capability Principle?**

1.7. The aim of the Operational Capability Principle (OCP) is to ensure that suppliers have the appropriate systems and processes to provide a quality service to their customers and meet their regulatory obligations.

1.8. It is a broad requirement on suppliers to ensure that they have and maintain robust capabilities, systems and processes to enable them to serve customers effectively and have the capability to meet all relevant legislative and regulatory obligations. We are providing additional Guidance on how suppliers should comply with this principle in relation to one specific area where we have identified risks to consumers. We are clarifying our expectations on the level of control we expect suppliers to have over the material economic and operational assets they use or need to run their businesses. We identified the need for this additional Guidance as part of the policy development we did in response to feedback on our consultation on Strengthening Financial Resilience.

### **What is the Financial Responsibility Principle?**

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<sup>1</sup> The terms “we”, “us”, “our”, “Ofgem” and “the “Authority” are used interchangeably in this document and refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority

1.9. The Financial Responsibility Principle (FRP) acts as an overarching obligation to ensure suppliers act in a financially responsible manner that is appropriate for their business specific risks. This means they properly manage risk, are well-capitalised, and able to withstand severe but plausible financial stress.<sup>2</sup> Ofgem may take enforcement action where we see irresponsible financial behaviour in the market which contravenes this principle.

1.10. To strengthen the financial resilience of the retail energy sector, we want suppliers to bear an appropriate share of risk. This includes adopting responsible financial management approaches and holding sufficient Capital and Liquidity to meet reasonably anticipated liabilities as they fall due such that they are resilient enough to withstand future shocks, and to minimise the extent of cost Mutualisation in the event of their failure.

1.11. Suppliers without sufficient Capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure. They are also more likely to pursue excessively risky strategies because they are less reliant on investor Capital. Features of the retail energy market mean that some supplier costs are at risk of being Mutualised upon failure if they are not managed responsibly while the supplier is trading. Customer credit balances, network charges and environmental and social scheme obligations are examples of this type of cost. This can give rise to very poor outcomes for consumers and systemic risks to the retail supply market, even in circumstances where the majority of suppliers do not rely on such unsustainable business models.

1.12. Our overarching objective is to protect existing and future consumers by developing a more resilient energy supply market. We want to remove incentives for excessive risk-taking with consumer money whilst enabling an environment for investment and sustainable competition, at the lowest overall cost to consumers. This will ensure that consumers, energy suppliers and investors can have confidence in the energy supply market going forward.

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<sup>2</sup> The interpretation of 'severe but plausible stress' will vary from supplier to supplier. These scenarios are situations that, while they seem unlikely to occur, if/when they do occur, they would result in high impact and significant disruption to suppliers' businesses.

## 2. Implementation

2.1. The Financial Responsibility Principle (FRP) and the Operational Capability Principle (OCP) were introduced into the gas and electricity supply licences in early 2021. We amended the FRP and OCP on 26 August 2022 to set out that suppliers must have sufficient control of their material and economic assets<sup>3</sup>. The FRP was modified again on 5<sup>th</sup> April 2023 to implement the proposals we consulted on in our Strengthening Financial Resilience statutory consultation<sup>4</sup> published on 25 November 2022. As set out above, the FRP sets out what suppliers must do to ensure that they are sufficiently financially resilient to survive market shocks and minimise costs at risk of being Mutualised where they do fail. These more specific requirements help suppliers by providing clarity around what they must do to ensure compliance with their financial responsibility obligations and helps protect consumers by ensuring that the Authority can intervene appropriately and early where there is evidence that a supplier is not meeting those obligations.

2.2. To allow for early intervention by the Authority where appropriate, the FRP as set out in Standard Licence Condition (SLC) 4B.7 requires that, if any of the Trigger Points have occurred (see paragraph 3.41 of this Guidance for further guidance on the Trigger Points), suppliers must notify the Authority (until the Authority has confirmed in writing that such notification is no longer required), 28 days before making any payment, providing any loan or transferring any asset to any third party unless that payment, loan or transfer is one that is essential to the licensee's operation as a supplier of gas and/or electricity to consumers. For the avoidance of doubt, this standard condition does not prevent any existing arrangements which would decrease costs for consumers, such as cash efficiency measures (which includes arrangements where the supplier loans excess cash back on a short-term basis to the centre/group treasury to manage). The requirement under SLC 4B.7 enables the Authority to work with a supplier in managing its financial outgoings where that supplier is not sufficiently financially resilient or, where appropriate and necessary, take enforcement action requisite to bring the supplier back into compliance with the FRP or other obligations.

2.3. The Authority has a range of statutory and licence-based information gathering powers which it currently uses to ensure that it has oversight of supplier compliance with

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<sup>3</sup> [Decision on statutory consultation on supplier control over material assets | Ofgem](#)

<sup>4</sup> [Statutory Consultation - Strengthening Financial Resilience | Ofgem](#)

the FRP and other obligations. The FRP includes additional proactive reporting requirements via the Annual Adequacy Self-Assessment (see paragraph 3.21 of this Guidance) and the Trigger Points framework (see paragraph 3.41 of this Guidance). To provide suppliers with a clear understanding of information that the Authority requires and when it requires it, this guidance sets out the details of these requirements from paragraph 3.20 onwards.



### **3. Expectation of suppliers**

#### **Guidance on the Operational Capability Principle**

3.1. The objective of SLC 4A is to ensure that a supplier has and maintains robust internal capability, systems and processes to:

- (a) efficiently and effectively serve each of its customers;
- (b) efficiently and effectively identify likely risks of consumer harm and to mitigate any such risks; and
- (c) comply with relevant legislative and regulatory obligations.

3.2. To achieve this, SLC 4A requires that a licensee must have Sufficient Control over all of its Material Economic and Operational Assets necessary to maintain robust internal capability, systems and processes, including but not limited to premises, facilities, staff, equipment, IT system and brand name, etc used or needed to run its supply business.

3.3. The requirement to maintain robust capability, systems and processes means that a regulated supply entity must either own or have Sufficient Control over all the operations used or needed to run their supply businesses. Sufficient Control means that a regulated supply entity has legally enforceable rights over the material assets it requires to operate its business, so that it can rely on those assets legally and enjoy the benefit of them. This means, for example, it does not rely on informal intra-group arrangements or the goodwill of third parties as such arrangements may be able to be terminated at will. Suppliers cannot efficiently and effectively serve their customers or identify and mitigate risks to those customers where they have insufficient control over their operational capacity.

#### **Guidance on the Financial Responsibility Principle**

##### **Holding sufficient Liquidity and Capital to meet liabilities as they fall due**

3.4. Under the FRP, all suppliers – domestic and non-domestic - are required to maintain Capital and Liquidity of sufficient amount and Quality that they are able to meet their reasonably anticipated financial liabilities as they fall due on an ongoing basis. It is the responsibility of a supplier to determine (and be able to justify to the Authority) what Capital and Liquidity they may need to be able to meet their reasonably anticipated

financial liabilities as they fall due in times of severe but plausible financial stresses and in light of its specific business strategy and risks.

3.5. A supplier should make its assessment of adequate financial resources on a fair valuation of both assets and reasonably anticipated financial liabilities, considering timing of cash flows under severe but plausible scenarios that the specific business could face. In carrying out this assessment, a supplier should consider whether it has sufficient Capital and Liquidity to cover the nature and level of risks to which it might reasonably anticipate being exposed. In doing this, it should consider which of at least the following risks are relevant to its business, and how these risks could impact its Liquidity and Capital needs considering severe but plausible stress. For avoidance of doubt, the list below is a non-exhaustive list, and it is the responsibility of the supplier to clearly identify all relevant risks to its business model which need to feed into its decisions on necessary Capital and Liquidity to remain compliant with the FRP.

- **Price risk:** The risk that financial losses may occur due to changes in commodity prices. Price risk can be considerably reduced by hedging, where suppliers purchase energy for delivery on future dates on pre-agreed pricing terms, protecting the supplier from the volatility of price fluctuations on the cost of wholesale gas and electricity. Conversely, where suppliers are contracted to sell energy at a fixed price to customers but do not have all volumes contracted, they may need to continue delivering lower prices even as the prices they pay for energy rise. Suppliers can also be affected by falling wholesale prices when they have future commitments to buy energy at fixed prices or can be exposed to market moves in either direction where trading speculatively.
- **Churn/volume/demand risk:** The impact of significant changes in customer numbers and/or customer demand. For example, unexpected weather conditions can leave suppliers over- or under-hedged to meet demand and require them to secure supply they did not anticipate needing, or leave them with excess supply. Customer churn can also affect the extent to which a supplier can recover operating costs, given that it might lose income from customers who leave before it sees any decrease in its operating costs as a result of the departing customers.
- **Counterparty credit risk:** Relates to the risk that a counterparty to a transaction could default before final settlement, which can result in losses. For example, in the event a hedge counterparty fails, a supplier may have to re-hedge – potentially at higher prices. This may have particular risks if, for

example, a supplier relies heavily on an external trading arm to procure supply and hedges, and that trading arm fails. Or, in the event a supplier has a Power Purchase Agreement (PPA) or Gas Supply Agreement (GSA) in place and the counterparty fails to deliver on that PPA and GSA.

- **Credit risk:** Consumers may not always be able to pay their bills in a timely manner, in which case suppliers will take on increasing levels of “bad debt.”
- **Liquidity risk:** Relates to the inability to meet payment obligations as they fall due. A major source of Liquidity risk is that in a stressed market, some suppliers will face increasing costs associated with posting collateral for trades.
- **Other market risks:** Beyond these major categories, there are a variety of other risks that could be associated with procuring energy, such as foreign-exchange risk and interest rate risk. Suppliers should also have regard for tail risk, which relates to the chance of a loss occurring due to a highly unlikely or rare event.
- **Operational risk:** risks associated with shortcomings in governance; reputational risk; business disruption and IT risks. Suppliers should also have regard to any risk related to its association with a group, for example if the firm may be adversely affected by its relationships (financial or non-financial) with other entities in the group or by risks which may affect the financial position of the whole group.

3.6. The supplier should consider how it intends to deal with each of the distinct risks its business is subject to and give appropriate consideration to the relationship between these risks (for instance where they may be correlated in extreme events). Where a risk is not obviously quantifiable – e.g., certain types of operational risk – a supplier should consider the best mitigation, and whether holding additional Capital or Liquidity could be an appropriate response until the risk is eliminated or reduced.

3.7. The supplier needs to consider the Quality of financial resources it has available to meet liabilities as they fall due. What this means is that the supplier needs to consider the loss absorbency of Capital it has available to draw on to absorb unexpected losses. In the case of Liquidity, a firm should consider the extent to which a resource can be converted to cash as soon as needed and with minimal loss in value.

3.8. The supplier also needs to consider the risks associated with any funding sources that are a form of debt, and those which are not held by the licensee itself. For example, to

the extent any of the sources of funding it anticipates having available to cover risks are not already drawn liabilities of the supplier, and rely on the parent or another entity within the group, the supplier should ensure there are no limitations on the ability to transfer capital to the specific licensee when needed, including in times of stress to the group, other entities to the group, or to the supplier itself. The supplier should also consider the impact of internal capital distribution in terms of any resources being ringfenced in the event of insolvency.

3.9. Suppliers are required to report on their financial and operational adequacy annually (the Annual Adequacy Self-Assessment, as set out in SLC 4B.10 and paragraph 3.21 below). Suppliers should also be aware on an ongoing basis of their Capital and Liquidity position against their risks and be able to demonstrate compliance with the FRP at any time. Whenever there is a material change to the supplier's business, the supplier is expected to carry out an evaluation to ensure that the level of Capital and Liquidity it holds to meet the FRP remains comprehensive, and proportionate to the nature, scale and complexity of the supplier's activities. For example, as a supplier plans to grow or introduce new products or new pricing strategies, its evaluation processes should evolve to ensure that they account for those in assessing FRP compliance.

3.10. We will consider, on a cumulative basis, a range of Supervisory Financial Reporting such as Market Compliance Reviews<sup>5</sup>, stress tests and other financial monitoring and Milestone Assessments<sup>6</sup> (where relevant) to complement the Annual Adequacy Self-Assessment and Trigger Points framework to inform our position on supplier resilience. This integrated picture of a supplier's resilience will underpin our assessment of a supplier's compliance with the FRP and any subsequent decision on how to respond.

3.11. When Ofgem makes an evaluation on compliance with the FRP, as well as using other pieces of evidence, it will consider a range of considerations regarding the supplier's own assessment informing their Capital and Liquidity levels, including but not limited to the following:

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<sup>5</sup> These are where the Authority gathers and analyses information from licensees regarding their compliance with particular obligations. Following this analysis, the Authority may publish its findings and the degree of compliance achieved by individual suppliers.

<sup>6</sup> Under Standard Licence Obligations 28C

- Whether the data and analysis informing the Capital and Liquidity assessment is sufficiently sophisticated considering the supplier business model and risks.
- The policies and processes a supplier has to identify, measure and manage the Material sources and effects of relevant risks.
- Whether the supplier sufficiently identified and considered the range of risks it is exposed to and interactions of those risks, how those risks are likely to evolve, and whether the supplier has considered the impact of severe but plausible stress scenarios on those risks.
- Whether the supplier has sufficiently considered and made reasonable assumptions about the risks associated with its identified sources of funding to meet the FRP.
- Whether the supplier has sufficiently considered how it is impacted by its association with a group or other entities in the group.
- The involvement of senior management in the process, and clear ownership of risks and mitigations amongst senior management.

### **Exiting the market, cost Mutualisation and asset control**

3.12. Under the FRP, suppliers are required to ensure that were they to exit the market, that their financial and operational arrangements are such that any Supplier of Last Resort (SoLR) or special administrator appointed on the supplier's exit would be able to efficiently and effectively serve its customers and that the exit would result in minimised Mutualised costs.

3.13. We would expect suppliers therefore to have sufficient systems and controls in place to identify, monitor and where practicable reduce potential harms that could result from the supplier's exit from the market, both to its own customers as well as to the wider Consumer Interest. Where no alternative actions are available to mitigate those harms, a supplier should consider whether they need to hold additional Capital or Liquidity to help mitigate those harms.

3.14. Closely connected to this is the obligation on suppliers to manage responsibly costs that could be Mutualised and to take appropriate action to minimise such costs.

3.15. To meet SLC 4B.3 and 4B.4, we would expect a supplier to have the ability to meet its financial obligations while not being overly reliant on Customer Credit Balances (CCBs) for its working capital. We expect a supplier to achieve this by:

- Being able to accurately determine the total amount of sums it holds in customer credit balances (the “Credit Balance Amount”) at any point in time.
- Having risk management controls, processes, and procedures in place to minimise the risk of the Credit Balance Amount being Mutualised. We would expect these to include arrangements for the management of a supplier’s business so that it is predominantly reliant on investor capital and does not put at risk the Credit Balance Amount. In any event, suppliers must at all times ensure that they comply with the other elements of the FRP including holding sufficient Capital and Liquidity in accordance with SLC 4B.1.

3.16 Without prejudice to the generality of the meaning and application of SLC 4B, we would expect a supplier to have, and to be able to provide evidence to us on request that it has, the following in place to demonstrate compliance:

- Plans to meet its financial obligations under government schemes by relevant dates and the ability to fulfil those plans.<sup>7</sup>
- Effective processes, that are consistent with existing licence requirements,<sup>8</sup> for example for setting direct debit levels and for checking and returning customer credit balances.<sup>9</sup>
- Sustainable pricing approaches that allow it to cover its costs over time, or if it is pricing below cost that the risk sits with investors and not consumers. We may require evidence to show that suppliers can finance their overall business plans.
- Robust financial governance and decision-making frameworks in place.

3.17 As set out in the licence, where a supplier uses a particular asset, mechanism or arrangement to meet its obligations under SLC 4B, the supplier must either own that asset,

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<sup>7</sup> The Financial Responsibility Principle covers both costs that could be Mutualised following supplier failure and those that may be Mutualised if paid late. For instance, any Renewables Obligation buyout fund payments that are not made by the end of October will be Mutualised whether or not the supplier has failed

<sup>8</sup> For example SLC 0 - “The Standards of Conduct”, SLC 31F/31I - “Informed tariff and consumption choices”, SLC 27.15 - “Setting Direct Debits”, and SLC 27.16 - “Refunding customer credit balances on request”.

<sup>9</sup> Under Standard Licence Obligations 27.15 and 27.16.

mechanism or arrangement, or have Sufficient Control over it so that it can rely on it legally and enjoy the benefit of it. For example, if a supplier uses hedging positions to procure energy on the wholesale energy markets to manage and mitigate the risks of insolvency it should either own those hedging positions, or, if those hedging positions are held by a different entity other than the supplier, the supplier should have robust, legally enforceable and clearly defined arrangements in place with the entity that owns the hedging positions that enable the supplier to rely on and enjoy the benefit of those hedging positions.

3.18 Furthermore, where a supplier uses a particular asset, mechanism or arrangement to meet its obligations under SLC 4B, the supplier must not liquidate, sell or otherwise dispose of that asset, mechanism or arrangement where doing so risks an increase in costs at risk of being Mutualised. For example, if a supplier uses hedging contracts to procure energy on the wholesale energy markets, it should not liquidate, sell or otherwise dispose of those hedging contracts in circumstances where doing so risks an increase in costs at risk of being Mutualised.

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

### **Reporting requirements**

3.20 As set out in SLC 4B.8 and 4B.10, the FRP includes requirements on suppliers to proactively report to Ofgem how they are meeting requirements for ongoing financial resilience. This includes, but is not limited to, the Annual Adequacy Self-Assessment and the Trigger Points. Suppliers are expected to report to Ofgem in writing as soon as reasonably practicable (but no later than 7 days) after they become aware that there is a Material Risk that any of the Trigger Points, set out in paragraph 3.44 of this Guidance and in SLC 4B.8, may occur or where any of the Trigger Points have occurred. Below we set out further detail on expectations for that supplier reporting.

### **Annual Adequacy Self-Assessment**

3.21 As set out in SLC 4B.10, to evidence their compliance with the FRP, suppliers must provide an Annual Adequacy Self-Assessment (the “self-assessment”), that sets out the analysis that underpins their evaluation of past and future compliance with the FRP requirements. The self-assessment should evidence how the supplier has met the FRP requirements, and has complied with the standard conditions 4B.1, 4B.2, 4B.3, 4B.4, 4B.5 and 4B.6 in the past 12 months and how it will continue to meet the requirements and comply with standard conditions 4B.1, 4B.2, 4B.3, 4B.4, 4B.5 and 4B.6 for the next 12 consecutive calendar months. This self-assessment, should include, but should not be limited to, providing information on how the supplier:

- Maintains Capital and Liquidity of sufficient amount and Quality to meet reasonably anticipated financial liabilities as they fall due.
- Ensures that were it to exit the market or have its licence revoked, that its financial and operational arrangements are such that any SoLR or special administrator appointed on the supplier’s exit would be able to efficiently and effectively serve its customers and that there would be minimised Mutualised costs upon exit.
- Responsibly manages costs at risk of Mutualisation and takes appropriate actions to minimise such costs.

3.22 Suppliers can choose to align their self-assessment reporting with their internal reporting cycles. As set out in SLC 4B.12, suppliers must submit their first self-assessment by 31 March 2024 at the latest. Thereafter, we expect reporting to be made at least once every 12 months. As set out in SLC 4B.13, suppliers must, within 28 days of SLC 4B.13 taking effect, notify Ofgem of the date they intend to submit their first self-assessment.

3.23 The submission date that a supplier notifies Ofgem under SLC 4B.13 will continue to apply unless the supplier notifies Ofgem of a change of date. A change of date is possible because we expect suppliers to review their self-assessment process at least once every 12 months.

3.24 If there is a significant change in the supplier’s business or operating model, the supplier may wish to carry out a review promptly before its next scheduled annual self-assessment. For example, if there is a merger between a supplier and another business entity, the supplier should, as part of its preparation for that event, analyse the impact on the supplier’s annual self-assessment process. Similarly, if a supplier’s business undergoes



a significant change due to external factors (for example, significant changes in the structure of a market sector), the supplier should consider the effects on its annual self-assessment process in a timely manner.

3.25 Suppliers should design their internal timetable for the review of their self-assessment process and the submission of their scheduled self-assessment in a reasonable way that reflects proper management of their internal risk.

3.26 While Ofgem has provided some flexibility by allowing suppliers to report according to their internal reporting cycle, we would expect suppliers to ensure that their proposed review and reporting timetable would result in Ofgem receiving the necessary information in an appropriate and timely manner.

3.27 With reference to SLC 4B.14, it is important to clarify that a supplier is not permitted to state a revised reporting date that would result in the supplier not submitting its self-assessment report to Ofgem for more than 12 consecutive months. For example, if a supplier has a submission date of 31 March each year and the supplier submits its self-assessment report on 31 March 2024, but on 28 February 2025, the supplier wishes to change its annual submission date to 31 December, this would not be permitted, as the next submission date would be 31 December 2025, which would be more than 12 months after 31 March 2024 (the previous submission date). However, the supplier could have notified Ofgem on, for example, 1 December 2024 that it intended to change its submission date to 31 December. This is because the next submission of its self-assessment report would then have occurred on 31 December 2024, which would be within 12 months of the previous submission on 31 March 2024.

3.28 Where a supplier changes the submission date of its annual self-assessment, we would expect the supplier to submit the self-assessment to Ofgem within 28 days of its senior management body having approved the annual self-assessment document resulting from that review. In addition, the supplier is expected to submit documentation of the review showing a clear explanation of any changes to the supplier's self-assessment process that have occurred following the review and the reasons for those changes, and an analysis of the effectiveness of the firm's risk management processes during the period covered by the review.

3.29 How a supplier completes its self-assessment, including the evidence it provides, will vary, as we recognise there is no one-size-fits-all approach to running a supply business. However, Ofgem will have consideration for:

- The quality of reporting in terms of its accuracy and whether any assumptions underlying reporting projections, stress testing, risks and mitigations are reasonable.
- The appropriateness of the internal processes for the analysis in the report and whether they are sufficiently sophisticated considering the supplier business model and risks.
- The policies and processes a supplier has to identify, measure and manage the Material sources and effects of relevant risks in the reporting.
- Whether reporting sufficiently identifies and considers the range of risks and interactions of those risks that the business is exposed to, how those risks are likely to evolve, and whether the supplier has considered the impact of severe but plausible stress scenarios to those risks.
- Whether the supplier has sufficiently considered and made reasonable assumptions about any risks associated with its identified sources of funding to meet the FRP.
- If reporting sufficiently explains how the supplier is impacted by its association with a group or other entities within the group, or with other third parties who can impact its financial situation or the availability of Capital and Liquidity.
- The involvement of senior management in the process, and clear ownership of risks and mitigations amongst senior management.

3.30 As set out in SLC 4B.15, the Annual Adequacy Self-Assessment must be accompanied by a signed declaration of financial and operational adequacy (“Certificate of Adequacy”) which has been approved by the licensee’s Chief Financial Officer, or senior official with equivalent responsibility. This ensures the supplier’s directors are responsible for properly assessing the supplier’s financial adequacy and compliance with the FRP.

3.31 We would expect the self-assessment to include an executive summary, focusing attention on distilling key messages of the drivers of performance and risk, and presenting key strategic insights regarding financial resilience. It should provide sufficient information to give Ofgem a clear view of the key drivers of business performance, including commentary on the risk appetite, and materiality of each factor.

3.32 Although we will not dictate or prescribe how suppliers should evaluate their financial adequacy and FRP compliance and how to report it, the self-assessment should cover:

- Business-specific arrangements and risks (paragraphs 3.33-3.35 below)
- Exiting the market, minimising Mutualisation Costs, asset control (paragraphs 3.36-3.37 below)
- Governance and internal capability, systems, and processes (paragraphs 3.38-3.40 below)

#### Business-specific arrangements and risks

3.33 Suppliers should explain how they have come to a view on the appropriate level of Capital and Liquidity needed to be compliant with the FRP. This should include an evaluation and explanation of the supplier's business plan and business-specific risks over the coming and previous 12-month period which the supplier uses to inform their Capital and Liquidity planning to remain compliant with the FRP. A non-exhaustive list of what we would expect to consider includes:

- How the supplier is funding any regulatory obligations.
- The supplier's risk appetite associated with its business strategy, e.g. tariff pricing, hedging strategy, purchasing agreements.
- Identification and explanation of all Material business-specific risks, having consideration for the range of risks set out in paragraph 3.5. This includes, for example, explaining how the supplier considers less quantifiable operational risks – such as exposure to risks associated with other entities within a group.
- Explanation and evaluation of the effectiveness of associated mitigation strategies.
- Reliance on the balancing market.
- Presence and conditions of purchasing agreements, and risks and mitigations associated with those conditions.
- Collateral requirements.
- Description of internal processes for identifying and mitigating risks.
- Explanation of how the supplier has subjected their business projections and risks to severe but plausible stresses consistent with their risk profile. We

expect suppliers to show reasonable assumptions when discussing how they will manage potential downside risk.

3.34 The supplier should explain how this internal evaluation of their business specific arrangements and risks informs their Capital and Liquidity planning to ensure compliance with the FRP.

3.35 The supplier should explain how it intends to deal with each of the risks its business is subject to, including how it has quantified the risk into a certain amount of Capital or Liquidity to mitigate it, or other ways that it intends to mitigate the risk that warrant not holding extra Capital or Liquidity against it. Where a risk is not obviously quantifiable – e.g. certain types of operational risk – a supplier should explain mitigations, and whether it has decided to hold additional Capital or Liquidity against that risk while working towards mitigation. The supplier should also explain the sources of funding they are relying on for their business specific Capital and Liquidity needs, and other risk mitigations.

#### Exiting the market, minimising Mutualisation costs and asset control

3.36 Suppliers should set out how they ensure that, were they to exit the supply market (due to insolvency, licence revocation or in any other circumstances), disruption to customers and the market would be minimised where possible, that their operational and financial arrangements are in order such that any Supplier of Last Resort or special administrator appointed would be able to efficiently and effectively serve the supplier's customers, and that there would be minimised Mutualised costs upon exit. It should be clear how ensuring these outcomes fits into their business, Capital and Liquidity planning.

3.37 Suppliers should explain how they are compliant with asset control requirements as set out in SLC 4B.5 and SLC 4B.6 including the requirement to ensure Sufficient Control over any Material Economic and Operational Asset, and the prohibition on liquidating, selling or disposing of Material Economic and Operational Assets it uses to meet FRP obligations where that would increase costs at risk of being Mutualised.

#### Governance and internal capability, systems, and processes

3.38 Suppliers should explain how they have established appropriate lines of defence to manage, monitor and assure their directors that they have embedded the internal capability and processes to monitor and mitigate business-specific risks within clear risk appetite levels. The process should incorporate the results of the self-assessment process that drives management accountability. They should explain how their governance process

takes these considerations into account in business planning, and Capital and Liquidity planning.

3.39 Suppliers should also explain any independent internal audit (i.e., an audit function, which is separate and independent from other functions and activities of a supplier's business) capability and how this is used in making judgements about business and Capital and Liquidity planning. For example, suppliers could explain the internal independent process they have taken to ensure that their risk management, governance, and internal control processes have operated and are operating effectively to meet their obligations under the FRP. Where internal audit capability is not present, suppliers should provide an explanation for its absence and how independent internal assurance is achieved, as well as consider annually whether there is a need for internal audit capability, including making recommendations to the board.

3.40 The self-assessment reporting should include a summary of relevant governance arrangements and processes around functions that own and manage risks (as well as ensure compliance) and the functions that provide independent assurance. Self-assessment reporting should also include an explanation of adequate entity level controls with an explanation of core business functions (including those outsourced) and how they will be resourced. This should include statements of responsibility for each core function, the names of those responsible for each area, the delegations of authority framework, how they are suitable to manage those responsibilities, as well as projected growth and the number of staff forecast for each function. The reporting should also include an overview of internal audit requirements and processes.

### **Trigger Points**

3.41 A Trigger Point is an indicator which, upon its occurrence or likely occurrence, requires a supplier to notify Ofgem of this occurrence or likely occurrence so that risks can be proactively managed. We have chosen the Trigger Points (set out in paragraph 3.44 of this Guidance and in SLC 4B.8) such that a supplier will notify Ofgem of risks and issues which may affect, or are affecting, the direction or future outcome of a suppliers' financial situation and its ability to meet the FRP. It is the intention that by proactively notifying Ofgem of expected or actual changes to a suppliers' financial position that the supplier and Ofgem can better mitigate that risk in the interest of consumers.

3.42 Suppliers must notify Ofgem in writing as soon as reasonably practicable (but no later than 7 days) after the supplier becomes aware that there is a material risk that a

Trigger Point may occur, and as soon as reasonably practicable (but no later than 7 days) once it becomes aware a Trigger Point has occurred. Suppliers should consider the full context of their business model and risks, and the impact of severe but plausible stress scenarios, as well as seasonality when assessing whether a change may have a sustained or Material impact on their financial situation and ongoing ability to meet the FRP, and on the likelihood of any Trigger Point occurring. For clarification, this reporting is separate from that of the regular financial monitoring via the monthly RFI.

3.43 The Trigger Points are not an exhaustive list of possible indicators that could imply financial deterioration but are designed to encourage suppliers to proactively report to Ofgem on risks and issues that may affect or do affect a suppliers' ability to comply with the FRP so that swift action can be taken to mitigate the risk or remedy the issue. As per SLC 5A, suppliers must be open and transparent with Ofgem and we therefore expect that suppliers notify the Authority at any point where there is a change to any aspect of their financial position that could materially impact their current or future ability to be compliant with the FRP.

3.44 The Trigger Points are:

- **Any reduction in the licensee's Access to Funds, where this may impact the licensee's ability to meet standard conditions 4B.1, 4B.2, 4B.3, 4B.4, 4B.5 and 4B.6:** As outlined in the licence conditions, Access to Funds means any legally binding agreement which provides the supplier with capital or access to funding to be utilised for their licensable activities. Examples of capital instruments include: unsecured shareholder loans, parent or group company working capital facilities and unconditional guarantees. Examples of other funds that provide access to funding include but are not limited to: parent company guarantees, loans (including senior and subordinated, third party and intercompany), mezzanine finance, working capital facilities, trade finance facilities (including letter of credit, guarantee, factoring and invoice discounting), securitisation facilities, and guarantees. Suppliers must notify Ofgem of any projected or actual reduction in Access to Funds that may impact their ability to meet the FRP, as this could significantly affect the financial standing of a supplier. This includes, but is not limited to, where suppliers identify scenarios where they may no longer have access to funds from an investor, parent company, bank, or other lenders, or if funds or borrowings have been, or will be, reduced. Upon being notified, Ofgem will consider next steps depending on the amount that the funding has reduced by and the financial position of the supplier before the event.

- **Any changes with respect to the licensee’s contractual arrangements with counterparties, where this may impact the licensee’s ability to meet standard conditions 4B.1, 4B.2, 4B.3, 4B.4, 4B.5 and 4B.6:** Suppliers must notify Ofgem when there is a change (or expected change) in contractual arrangements with counterparties such that it could have an impact on their ability to meet their obligations under the FRP. For example, a breach or likely breach of a covenant in a market borrowing agreement, as well as any change in counterparty agreements that enable access to wholesale markets to trade and hedge. For the avoidance of doubt, this does not mean that Ofgem should be notified every time a supplier makes a hedging transaction, but rather when, for example, counterparty contracts cease to exist or mature, as well as if there is a default or breach of covenant by a supplier within one, or a detrimental change in terms.
- **Any change that could have a Material adverse effect in respect to the cash position of the licensee:** Suppliers must notify Ofgem if there is any change that could have a material adverse effect (or expected effect) in the cash position of the licensee. For example, if the supplier expects that this change may impact their ability to meet their obligations under the FRP on an ongoing basis, they should inform Ofgem.

3.45 For the avoidance of doubt, suppliers should notify Ofgem of any change that affects their ongoing ability to meet the FRP if that change means, for example that they would:

- a) Notify their Board
- b) Notify their investors
- c) Notify their risk committee (in a case where a supplier has a risk committee)
- d) Have to issue equity/debt
- e) Have to get a loan from their parent company

3.46 Where a licensee supplies to both domestic and non-domestic customers, they should explain in their Trigger Point notification under SLC 4B.8, as well as their Annual Adequacy Self-Assessment (as set out from paragraph 3.21 in this Guidance and in SLC 4B.10), how they split assets between their domestic and non-domestic supply. This will help us understand the implications of the supplier’s Trigger Point notification and to make an assessment on the appropriate response.

#### *Consequences of the Trigger Points*

3.47 Once notified, we will consider the Trigger Point alongside the range of information we already collect on that supplier and make an assessment on further action. We may seek further engagement, and where appropriate may agree a suitable reporting arrangement. Any additional reporting would be proportionate and assessed on a case-by-case basis. Where we have concerns about a supplier's compliance following notification, we may decide to undertake further assessment and engagement, request an independent audit, and/or move to consider enforcement action where appropriate.

3.48 If any of the Trigger Points have occurred, the supplier must notify the Authority 28 days before making any payment, providing any loan or transferring any asset to any third party unless that payment, loan or transfer is one that is essential to the licensee's operation as a supplier of gas and/or electricity to consumers. The licensee must also continue to notify the Authority in respect of such payments until the Authority has confirmed in writing that such notification is no longer required. For the avoidance of doubt, this standard condition does not prevent any existing arrangements which would decrease costs for consumers, such as cash efficiency measures (which includes arrangements where the supplier loans excess cash back on a short-term basis to the centre/group treasury to manage).

3.49 Using our enforcement powers, we may consider enforcement action which includes restricting the supplier from extracting value from the business as appropriate if requisite to secure compliance with the FRP or other obligations. If a supplier does not hear from Ofgem within the 28 days ahead of the scheduled transaction, the supplier can then proceed with the transaction as planned.

3.50 However, if there is concern, Ofgem may seek to use the illustrative list of possible actions below, which includes the restriction of certain non-essential payments. The following are some examples of the potential responses that Ofgem would generally expect to make following a Trigger Point notification from the supplier, or where Ofgem has evidence from its monitoring data that a supplier may be at risk of meeting, or has met, any of the Trigger Points in paragraph 3.44:

- Request the supplier to report additional information to us.
- Request that the supplier cease making non-contractual payments.
- Request that the supplier cease taking on new customers.
- Request that the supplier's parent undertaking provides additional liquid assets for the supplier.
- Request to see the suppliers' contingency arrangements/alternative arrangements or plans to minimise the risk of disruption to the business. We would generally



expect that suppliers would have already considered other contingency arrangements or plans.

- Request to see the suppliers' recovery plan as it is expected that suppliers will be considering whether to take or will have already taken any relevant recovery actions.

3.51 The potential actions specified above (in paragraph 3.50) do not prevent Ofgem from taking alternative or additional actions in appropriate cases. The purpose of the potential responses in paragraph 3.50 is to provide greater clarity for suppliers on Ofgem's general expectations and approach to interventions, to assist suppliers' own planning and responses.

3.52 Overall, we want to be able to work with suppliers to take appropriate actions as Ofgem's intention is to work with suppliers to ensure the best outcome for consumers. In certain circumstances, however, we may move straight to enforcement action.

### **Financial monitoring**

3.53 In addition to supplier self-assessments, Ofgem also collects reporting through Supervisory Financial Monitoring. This includes stress testing, which Ofgem intends to carry out on a regular basis, as well as regular financial monitoring via the FRP RFI.

3.54 To ensure that the information we are asking for is as relevant as possible and can adapt to changing market conditions, the specific nature of the stress tests or information requests will be specified at each reporting juncture.

3.55 In the case of stress testing, Ofgem expects to send the supplier a notice setting out what information they will be asked to provide a minimum of four weeks ahead of the reporting deadline. A supplier should make sure that its Board is satisfied that the stress tests have been prepared with due care and skill.

3.56 For more regular financial reporting, suppliers are provided a timetable in advance. If there are changes to the questions, suppliers will generally be given notice a minimum of two weeks before the reporting deadline. These timings could be shorter in the case where Ofgem identifies a sudden and urgent need to change reporting requirements in line with our ability to request information from suppliers as part of SLC 5.

3.57 Suppliers must respond in full to any information requests made under SLC 5 or using other information gathering powers, in the timeframe and form set out in the

information request. If they are unable to respond to a specific question, they should provide a clear explanation in writing why. Where a supplier does not respond in full or on time or where we consider that the response evidences a contravention or likely contravention (or apparent contravention or likely contravention), we may consider taking appropriate enforcement action.

#### How different sources of financial resilience reporting are used

3.58 We will consider, on a cumulative basis, a range of Supervisory Financial Monitoring, such as Market Compliance Reviews<sup>10</sup> and Milestone Assessments<sup>11</sup> (where relevant) to complement supplier self-assessment reporting and enhanced financial monitoring under SLC 4B to inform our position on a supplier's resilience. This integrated picture of supplier resilience will underpin our assessment and decision on how to respond.

3.59 As highlighted above, we appreciate that there will not be a one-size-fits-all approach to how a supplier should run its business. However, where we see poor practice and potential risk, we would look to use our powers to intervene to protect consumers and reduce potential cost Mutualisation for the rest of the GB energy market.

3.60 If we have concerns regarding the arrangements a supplier has in place, we may seek further engagement, and if appropriate may agree a suitable reporting arrangement, noting suppliers' obligation to be open and cooperative when providing us with information. Any additional reporting would be proportionate to the risk of Mutualisation and assessed on a case-by-case basis. Where we have concerns about a supplier's compliance with these principles, we may decide to request and set the terms of reference of an external audit, request information, as well as conduct 'fit and proper' assessments for individuals with 'significant managerial responsibility or influence' as required under SLC 4C of the gas and electricity supply licences. Ultimately, the outcomes of the range of supplier reporting will inform our assessment and decisions/actions. We may also move immediately to consider whether enforcement action is appropriate.

3.61 A supplier's financial circumstances will fluctuate over time. To adhere to the Financial Responsibility Principle and other licence conditions, we expect all licensees to be

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<sup>10</sup> These are where the Authority gathers and analyses information from licensees regarding their compliance with particular obligations. Following this analysis, the Authority may publish its findings and the degree of compliance achieved by individual suppliers.

<sup>11</sup> Under Standard Licence Condition 28C

open and transparent with us on an ongoing basis. We expect suppliers to also regularly review and update their finance and growth plans and to set out the circumstances under which they will notify us as part of the Trigger Point reporting process. We also expect to be notified where suppliers identify current or potential future financial difficulties that are not included in the list of identified Trigger Points. We strongly encourage suppliers to engage with us early.<sup>12</sup>

3.62 Our enforcement guidelines set out the approach we take to enforcing against all licence conditions, including the Financial Responsibility Principle.

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<sup>12</sup> In accordance with our open and co-operative principle (SLC 5A) we would expect a financially responsible supplier to seek early engagement with us to communicate, and reassure us of, significant changes to its financial position or its approach to financial management