Making a positive difference
for energy consumers

Domestic gas and electricity suppliers

Email:
retailfinancialresilience@ofgem.gov.uk

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Dear CFO,

Open letter on financial distributions from retail energy suppliers

The volatility we have seen in wholesale energy markets has had a profound effect on the retail sector: challenging its business models, practices, and approach to risk. It has also had a very negative impact on consumers struggling to afford the energy they need.

To move the sector to a more financially resilient place, we are reforming our retail market to better withstand this volatility. This is aimed at ensuring both that suppliers are less likely to fail and that if suppliers do fail, costs to consumers are minimised.

We are improving our financial monitoring, compliance and enforcement activities, moving quickly to improve the capitalisation of retailers, but also providing reasonable plans for transition to allow companies to make the necessary changes.

The retail market overall has seen a significant period of losses, during which the bulk of suppliers have not paid dividends. This has been a financially responsible response to the gas price crisis. But a resilient market must be investable which in turn requires prospects for reasonable profitability. The purpose of today's updated EBIT proposal is to set an EBIT allowance that is high enough for the notional supplier to finance their activities, but customers pay no more than necessary to ensure this financeability and promote market stability. Suppliers are collectively projecting a return to profitability this year.

There is a diversity of financial positions in the supply market. We expect all suppliers to be considering their financial responsibility obligations when deciding on whether to distribute returns to shareholders, including the enhanced financial responsibility principle (EFRP) which comes into effect from 31st May 2023. This letter sets out our current expectations under these obligations. Those expectations take into account current and projected capital positions, the level of uncertainty around wholesale energy prices, and market conditions. Weighing those considerations, and consistent with our view that distributions are important and necessary for the investability of the market, we judge that there may be conditions where some suppliers could recommence distributions should their boards choose to do so. Any distribution must be within an appropriately responsible framework and must not, of course, place the supplier in breach of their regulatory or other obligations (including the EFRP).

Under this framework, supplier boards will be responsible for making distribution decisions subject to the standard constraints of the regulatory framework. Those include the positive obligation on all suppliers to evidence that they have sufficient business-specific financial resources so that their liabilities can be met on an ongoing basis. This may include meeting a prospective common minimum capital requirement, subject to the Authority approving the modification of supply licence conditions over the summer of 2023 following our consideration of responses to the April statutory consultation.

In relation to 2023 and 2024 financial results, suppliers should not make distributions to shareholders if, after the distribution their capital position is below the level of capital judged sufficient by their board. In judging the sufficient capital position, the board should take into account the supplier's credible trajectory to meet prospective quantitative regulatory capital requirements that exist at that time, such as a common minimum capital target with a future 'live' date. That credible trajectory can include the prospective transition period – it is not Ofgem's purpose to bring forward the live date for quantitative regulatory capital requirements via the back door. Suppliers in a negative net asset position should not make distributions and should retain profits to build resilience.

We will expect to be satisfied that any distributions would not create excess vulnerabilities to stress for a given supplier, impair its ability to treat customers fairly, or impede its ability to manage responsibly costs that could be mutualised. This is consistent with Ofgem's objective to protect energy consumers, and in line with licence conditions. It is the responsibility of suppliers' boards to make distributions which are consistent with this objective. Accordingly, if any supplier wishes to make shareholder distributions outside of this framework, it should engage initially with their account managers and expect a high bar for justifying any exceptions. We are publishing this statement now in order to give supplier boards time to take it into account as they approach those decisions in coming months.

The expectations outlined above are likely to be superseded by future licence obligations and/or guidance (such as the introduction of a common minimum capital requirement, which is currently subject to consultation). Until any such conditions are implemented, or we issue further communication, we expect suppliers to make distributions only in line with their obligations including as outlined in this letter.

Yours sincerely,

Rohan Churm
Director – Financial Resilience and Controls