

Licensing Frameworks
Ofgem
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Sent by email to: licensing@ofgem.gov.uk

Dear Licensing Frameworks Team,

Supplier Licensing Review: Financial Responsibility Principle (FRP) guidance

A requirement for suppliers to protect 100% of potentially mutualised costs should they fail, ‘the 100% requirement’, will be the most effective means to meet the objectives of the supplier licensing review (SLR) including preventing the mutualisation of costs upon supplier failure.

Our strong economic arguments for the 100% requirement may be found in our submissions in January 2019¹ and December 2019² in response to Ofgem’s SLR consultations, as well as within the NERA report we submitted alongside our December 2019 response.

We look forward to the publication of Ofgem’s consultation on cost mutualisation phase two before the end of February 2021 and expect embedding the 100% requirement within licence conditions to be within scope of that consultation. Any other proposals brought forward by Ofgem should be thoroughly impact assessed so it is clear what degree of benefits they will deliver when compared to the 100% and 50% requirements that have been previously consulted on by Ofgem.

Ofgem has provided no evidence of how it expects suppliers, who operate unsustainable business models, to change their business practices in response to the FRP requirement. There is therefore no evidence that the FRP will prevent the mutualisation of costs upon supplier failure.

We are concerned that the FRP will fail to be a credible constraint on reckless supplier behaviours we have observed in recent years, therefore undermining the effectiveness of the SLR, to the detriment of consumers in the short and longer term. In the absence of the 100% requirement it is important that:

¹ Centrica response to Supplier Licensing Review consultation:

https://www.ofgem.gov.uk/system/files/docs/2019/04/centrica_response.pdf

² Centrica response to ‘Statutory Consultation – Supplier Licensing Review: Ongoing requirements and exit arrangements’:

https://www.ofgem.gov.uk/system/files/docs/2020/01/centrica_ongoing_requirements_and_exit_arrangements_response.pdf

- enforcement of the new Principle is viewed by suppliers as being a credible threat with Ofgem publicly stating that it is ready to take swift and robust enforcement action; and
- there is a common understanding across suppliers of behaviours that would likely result in enforcement action.

Such measures would send a very clear message to the supplier community that financially irresponsible behaviour by energy suppliers will no longer be tolerated, and that Ofgem is fully committed to addressing this destabilising feature of the retail market.

Financial Responsibility Principle (FRP)

The most effective way in which the new Principle will be viewed by suppliers as being a credible threat will be for Ofgem to be seen to take prompt action against suppliers who manage their finances irresponsibly, by opening enforcement action for breach of the FRP at the first opportunity. Enforcement action should include preventing a supplier from gaining any new customers until it can prove that it is acting in a financially responsible manner. This would send a clear message to the supplier community that such behaviour will no longer be tolerated, and that Ofgem is committed to addressing this destabilising feature of the retail market.

In the meantime, the introduction of specific measures in the guidance underpinning the FRP will also have a material impact on supplier behaviour. To be effective, the measures set out in the bullets below should be viewed as being “red lines” that suppliers should take care not to cross or face the likelihood of enforcement action. To build upon the FRP guidance, it is important that suppliers are put on notice that Ofgem intends to advance further proposals for prescriptive measures as soon as is practicable, and that a clear timetable is set out for when additional prescriptive licence conditions will be consulted upon and introduced.

We would expect the prescriptive measures within the FRP guidance to be targeted at those suppliers displaying behaviours suggesting they may be financially irresponsible and are therefore at greater risk of failure. We expect the guidance to clarify that Ofgem will investigate, and potentially take enforcement action against, any supplier that:

- Is pricing towards the bottom of the market and lower than most other suppliers, without clearly demonstrating it can finance the financial exposure such pricing entails. Unsustainable pricing strategies have been the cause of many supplier failures we have seen in the past few years.
- Has an average credit balance per customer significantly above other suppliers, without clear evidence justifying this level. This may be a sign a supplier is using customer money to finance its activities or is asking customers to pay for energy upfront – both market models that have the potential to be financially unstable and result in excessive mutualisation of costs should the supplier fail.
- Demonstrates a recent and significant decline in customer service. A sharp change in customer service levels can be indicative of a supplier cutting costs as it can no longer finance its activities.

In all the cases above Ofgem should investigate to determine whether that supplier can demonstrate it has the capital and resources to sustain its ongoing supplier activities and can pay any policy obligations when they come due – including the Renewables Obligation.

Currently Ofgem will only take enforcement action once a supplier misses the RO October late payment date, at which point it is often too late to prevent mutualisation of costs should the supplier fail. Ofgem, working with BEIS, should target financially irresponsible suppliers requiring them to demonstrate how they will meet their RO obligations several months before this date, taking enforcement action if these suppliers cannot demonstrate a credible ability to pay.

We are concerned that many enforcement activities on failed suppliers have lapsed as no action was taken while the supplier is failing, e.g. Extra Energy was under investigation for two years prior to its failure. For the FRP to be effective, enforcement action must be taken quickly - within weeks of a breach.

The additions to the FRP guidance we have proposed will ensure the FRP is somewhat effective at addressing the market failures we have seen from irresponsible supplier models that have subsequently failed and resulted in the mutualisation of costs. While the proposed bullets above will not be as effective as the 100% requirement, they will ensure the FRP provides a stop gap until further prescriptive licence conditions are brought in.

Any information requests relating to the FRP should be targeted at those suppliers where there is evidence of potential failure. Suppliers currently provide a significant level of reporting to Ofgem and the FRP should not result in an additional burden on financially responsible suppliers that are unlikely to fail.

Cost Mutualisation Phase Two

We support Ofgem considering whether further measures are necessary beyond the FRP to prevent mutualisation of costs. We consider that the 100% requirement is a necessity to prevent future mutualisation of costs from supplier failures.

Ofgem has stated it will consult in 2021 and we encourage this consultation to be published no later than end of February 2021 as the risk of mutualisation will increase in proportion to any delay to the publication of this consultation. Supplier failures are often unpredictable, and each passing month has the potential to result in supplier failures and a subsequent mutualisation of costs.

We also wish to seek assurance that this publication will be accompanied by a robust impact assessment, one that has more detailed analysis than the high-level version published in October 2019³.

We understand from Ofgem that the prescriptive consultation will be a policy consultation, and this is necessary when introducing any new proposals. Previous Ofgem consultations on the supplier licensing review have introduced new proposals at the statutory consultation phase without subjecting them to a rigorous impact assessment, as was seen with the introduction of the FRP in the June 2020 statutory consultation⁴.

A late introduction of a new policy initiative does not allow for enough consideration of its impacts, as was observed for the FRP, and so should be avoided at the statutory consultation phase. Though this would not be the case for placing the 100% requirement into licence as it has been consulted on before; provided it is supported by robust legal drafting of the proposed licence conditions.

Any new proposals from Ofgem must be accompanied by a robust impact assessment that clearly shows what the benefits of the proposal will be when compared to both the 50% and 100% requirements that have been consulted on before. A like for like comparison of benefits will demonstrate whether any new initiative can deliver the reduction in mutualised costs we have sought through our preferred 100% requirement.

³ Supplier Licensing Review – ongoing requirements and exit arrangements impact assessment: https://www.ofgem.gov.uk/system/files/docs/2019/10/191021_-_draft_impact_assessment_final_new_updated.pdf

⁴ Supplier Licensing Review – statutory consultation: <https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-supplier-licensing-review-ongoing-requirements-and-exit-arrangements>

While Centrica has not always agreed with past proposals in Ofgem's supplier licensing review, we will continue to engage constructively with Ofgem on the further development of prescriptive regulation.

If you have any questions or would like to discuss our response, please contact me on Tabish.khan@centrica.com or 07789 575 665.

Yours sincerely

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