Consultation Response

Statutory consultation: Strengthening Financial Resilience

Office of Gas and Electricity Markets (Ofgem).

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About this consultation

Ofgem launched this consultation to seek the views of stakeholders on a range of proposals including the introduction of a capital adequacy regime, improvements to its Financial Responsibility Principles and ringfencing of domestic supplier Renewables Obligation receipts. These measures are designed to strengthen the financial resilience of the domestic energy supply market and reduce the risk of consumers footing the bill for supplier failures.

Key points and recommendations

- Retail energy market regulations have let older people and other consumers down, with inadequate regulatory oversight playing a key role in catalysing the consumer energy crisis.
- Unexpected increases in wholesale prices were exacerbated by ineffective regulation, scant enforcement, and unsuitable standards for market entry.
- Capital controls, the ringfencing of Renewables Obligation (RO) commitments, and the Enhanced Financial Responsibility Principle (EFRP) represent promising improvements.
- We strongly support Ofgem's proposal to strengthen supplier capital adequacy requirements and we are hopeful this will reduce the risk of supplier insolvency.
- Where suppliers fail to meet key milestones Ofgem must be prepared to review practices, mandate improvements, and take pre-emptive enforcement action.
- Ofgem's proposals for a pillar 1 market capitalisation baseline followed by pillar 2 requirements based on specific supplier circumstances are very welcome.
- We remain sceptical of Ofgem's proposal for Customer Credit Balances (CCBs) but welcome the commitment to review progress and adapt their approach if needed.
- We support Ofgem's commitment to ringfencing RO payments as this will mitigate the risk of consumers being forced to cover supplier mismanagement of RO funds.
- Age UK will seek to amplify Ofgem's request for the Government to legislate for more regular supplier RO contributions.
- Age UK supports efforts to introduce an Enhanced Financial Responsibility Principle (EFRP) – alongside wider reforms this will help reduce the risk of supplier failures.
- We are nonetheless concerned that Ofgem lacks the appetite for proactive enforcement required to address any breaches to EFRP – we urge Ofgem to provide an assurance that they are prepared to act in a timely manner.
- We strongly recommend Ofgem invest more money in its enforcement teams to ensure that where rules are not followed suppliers can be held to account.
- EFRP is also overly reliant upon supplier self-assessment – we encourage Ofgem to proactively conduct audits of supplier data to better assess compliance.

About Age UK

Age UK is a national charity that works with a network of partners, including Age Scotland, Age Cymru, Age NI and local Age UKs across England, to help everyone make the most of later life, whatever their circumstances. In the UK, the Charity helps more than seven million older people each year by providing advice and support. It also researches and campaigns on the issues that matter most to older people. Its work focuses on ensuring that older people: have enough money; enjoy life and feel well; receive high quality health and care; are comfortable, safe and secure at home; and feel valued and able to participate.

Introduction

Retail energy market regulations have let older people down, with inadequate regulatory oversight playing a key role in catalysing the consumer energy crisis. Unexpected increases in wholesale prices were exacerbated by ineffective regulation, scant enforcement, and unsuitable standards for market entry. We therefore warmly welcome the opportunity to respond to this consultation on strengthening the financial resilience of energy suppliers as we move into 2023[1].

Around three-in-ten older households in England are fuel stressed[2], up from just one-in-ten only last year[3]. More than two thirds (67%) of people aged 60+ in Britain are worried about being able to heat their home when they want to, and more than half (54%) are worried about the impact of energy prices on their health[4]. Concerns about the knock-on impact of living in a cold home on wellbeing and the ability to pay for other essentials like food have become recurring concerns for older people[5].

Age UK is supportive of reforms which would help alleviate the issues older people face in the energy market. While we have enjoyed constructive dialogue with Ofgem's retail market team during key points of the energy price crisis we remain concerned that fundamental consumer-centric reform has been lacking from Ofgem's agenda. Thus far the regulator's recent decisions regarding consumer protections have fallen far short of what is needed. Of greatest concern was Ofgem's rapid introduction of a January price cap adjustment, representing a major threat to the wellbeing of older people during the coldest and most expensive period of the energy crisis[6].

Nevertheless, Ofgem heeded our warnings regarding default tariff exit fees[7] and its retail team have worked constructively with us this year to address specific issues faced by our clients and older people. Ofgem's latest plans for capital controls, ringfencing of Renewables Obligation (RO) contributions, and the Enhanced Financial Responsibility Principle (EFRP) represent promising steps on the road to improving the domestic energy market. A repeat of the 30 supplier failures witnessed over autumn and winter 2021/22[8] would only further worsen the situation for older consumers and we are cautiously optimistic that Ofgem's proposed reforms to enhance supplier financial resilience will lead to improved market stability.

Response

After 30 suppliers failed over autumn and winter 2021/22 Ofgem commissioned Oxera to conduct a comprehensive review of the energy market regulatory framework and the role it played in market failures[9]. Oxera proposed several interventions that Ofgem could have implemented to stave off the worst of the crisis or mitigate its impacts on consumers. These included minimum capital adequacy requirements, avoiding the misuse of credit balances, and protections for Renewables Obligation (RO) commitments[10].

Below, we discuss the progress Ofgem has made towards these recommendations based on their renewed reform proposals. We also discuss the broader Enhanced Financial Responsibility Principle Ofgem has put forward[11].

Capital Adequacy requirements:

We strongly support Ofgem's proposal to strengthen supplier capital adequacy requirements and we are hopeful this will reduce the risk of supplier insolvency. With the combined costs associated with supplier failures and bailing out Bulb rising to a staggering £9.1bn – with £2.6bn added to consumer bills and a further £6.5bn in costs to the taxpayer[12] – capital controls have never been more warranted.

The insufficient capitalisation of many failed suppliers was a key factor in their demise[13]. The risks that suppliers took are ultimately paid for by consumers. It is unacceptable for firms operating within an essential service market like energy to have a business model which places undue risk at the foot of customers.

In response, Ofgem have proposed that in the short-term all domestic suppliers be required to hold net assets of between £110 and £220 per domestic customer by Q2 2025[14]. This gradual short-term goal is designed to reduce the immediate impact on the market of any requirement for suppliers to reach this threshold earlier.

Ofgem's capital adequacy regime proposals are a welcome addition which we hope will reduce the risk of supplier failures. While we are unable to comment on the appropriateness of the exact figure Ofgem land on for what adequate capitalisation looks like, we agree with Ofgem's overall focus that suppliers be required to maintain sufficient levels of capital to ensure they survive market shocks[15].

We encourage Ofgem to focus on three key metrics in determining capital adequacy: does the supplier truly have sufficient funds to withstand significant destabilisation in the market; what impact would the failure of this supplier have on its customers, consumers more broadly, and the stability of the energy market; how can the introduction of capital adequacy requirements be successfully balanced against the need to minimise associated costs to consumers.

Ofgem's proposals for a pillar 1 standard market capitalisation baseline followed by pillar 2 requirements based on specific supplier circumstances[16] are welcome additions in this regard. Different suppliers have very different market practices, customer bases, and degrees of exposure to risk. We believe that pillar 2 will afford Ofgem the flexibility to implement more stringent capital controls in cases where suppliers pose a greater risk to the market or vulnerable consumers.

As part of implementation, Ofgem must ensure better oversight of how suppliers are preparing for uncertain costs. This must include improved data sharing to ensure the regulator can adequately audit accounts and estimate whether a supplier is overexposed to market volatility. This should include direct access to suppliers' trading practices, including data on whether suppliers have sufficiently hedged for increased wholesale energy prices. In this regard, we support Ofgem's proposal to monitor supplier progress towards the capital adequacy requirements through incremental 'staging posts'[17]. Where suppliers fail to meet key milestones, Ofgem must be prepared to review practices, instruct suppliers to make improvements, and take pre-emptive enforcement action if standards are consistently being missed.

Ofgem must continue to put prospective suppliers, new entrants, and incumbent providers through stress testing, simulating a range of scenarios to estimate their market viability during times of crisis. If suppliers fail these tests, they should be provided with support to improve performance, and if they are found to be consistently undercapitalised then all enforcement actions, including removal of operating licences, must be considered. Using the Supplier of Last Resort (SoLR) process, customers could be pre-emptively moved to efficient suppliers while minimising any negative impact on consumer bills.

Customer credit balance protections:

Ofgem have chosen not to implement market wide Customer Credit Balance (CCB) ringfencing, arguing that this may have led to greater costs being passed onto consumers without allowing suppliers the working capital they need to run effectively[18]. Instead, Ofgem propose keeping CCB regulations under review and allowing for intervention when supplier circumstances warrant bespoke ringfencing[19]. The hope is that wider reforms, including capital adequacy and improved regulations around direct debit collections, will mitigate CCB issues and reduce customer exposure to mutualisation costs – the costs added to consumer bills because of supplier failures.

CCBs represented around 3.6% of the mutualised costs passed onto consumers because of supplier failures since September 2021[20]. Customers of many failed suppliers had credit balances well in excess of what was required, with some suppliers reportedly using them as a mechanism for funding their growth[21].

Misuse of CCBs to finance supplier operations must be addressed[22]. To avoid further CCB costs being borne by vulnerable households, appropriate protections must be implemented and enforced by Ofgem. The regulator must also use its data request powers to gain better oversight of how suppliers are using CCBs and if customers are being treated fairly.

We remain sceptical of Ofgem's decision not to completely ringfence CCBs. However, we do welcome the regulator's commitment to review the progress of CCB regulations and adapt their approach if required. Bespoke ringfencing may also prove sufficient to reduce the risk to consumers but at this point it remains too early to tell, and we would welcome the opportunity to engage with Ofgem's future review of these regulations.

Governance of Renewables Obligation commitments:

Levies are imposed on suppliers to contribute towards renewable energy programmes, with the largest of these being the Renewables Obligation (RO). While RO payments are collected from consumers on a monthly basis, required payments are only sent to Ofgem annually[23].

This presents significant market risk in cases where suppliers utilise their customer's contributions to renewables payments as working capital and expend the funds, rendering them unable to pay their obligation when it falls due. Since 2018 there have been a string of RO defaults, with early estimates suggesting £218 million of 2022 mutualisation costs to consumers will comprise RO payments alone[24].

We welcome Ofgem's commitment to ringfencing RO payments as this will mitigate the risk of consumers being forced to cover supplier misuse. We also support Ofgem's call for the Government to legislate for more regular supplier contributions[25].

Enhanced Financial Responsibility Principle

Age UK supports Ofgem's efforts to introduce an Enhanced Financial Responsibility Principle (EFRP). We agree that alongside wider reforms this improvement could help mitigate the risk of supplier failures and related costs to consumers, however we are concerned that the EFRP will lack data oversight and the strong enforcement backing required for its principles to become actionable industry best practice.

Ofgem already has a Financial Responsibility Principle (FRP) in place. It is designed to ensure suppliers responsibly manage any costs which could be passed onto consumers through the mutualisation process and minimise these costs wherever possible[26]. While Ofgem claims powers are already in place to ensure the FRP is followed the precedent of 30 supplier failures over autumn and winter 2021/22[27] and the systematic regulatory failures which exacerbated this[28] represent a stark reminder of the FRP's inadequacies.

EFRP will however entail more explicit financial resilience protocols and requirements for responsible business practices. This will include a commitment from suppliers to maintain sufficient liquidity to cover business-specific liabilities based on the bespoke circumstances of the supplier and its customer base.

As outlined, we support Ofgem's efforts to introduce the EFRP and improve the standards expected of suppliers. Our main concern is that Ofgem lacks the appetite for proactive enforcement of existing rules, let alone pursuing suppliers within the context of this new framework. Implementation of the EFRP is also overly reliant upon supplier self-assessment. Suppliers are likely to provide the absolute minimum amount of monitoring data required and we are concerned that Ofgem is effectively delegating its oversight duties to suppliers. It is therefore essential that Ofgem, if it wants to be considered a fit and proper organisation to regulate this essential (and complex) marketplace, should invest more money in its enforcement teams and proactively conduct audits of supplier data at regular intervals to assess compliance.

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