Consultation Response

Statutory consultation: Strengthening Financial Resilience (second stage)

Office of Gas and Electricity Markets (Ofgem)

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About this consultation

Ofgem launched this consultation to collect stakeholder views on renewed proposals to introduce a common minimum capital requirement and powers to direct energy suppliers to ringfence customer credit balances. Alongside wider reforms these policies are designed to strengthen the financial resilience of the energy supply market.

Key points and recommendations

- Ofgem's recent decisions regarding supplier financial resilience mean that consumers are better protected against a repeat of the market turmoil of 2021/22.
- Ringfencing supplier Renewable Obligation (RO) commitments and implementing the enhanced financial responsibility framework are excellent steps forward.
- We strongly recommend that independent audits of supplier progress towards adequate capitalisation be a mandatory component of Ofgem's plans.
- Age UK is also supportive of the regulator's capital floor and target proposals although we suggest several improvements.
- Implementation from March 2025 means two more winters of uncertain supplier stability – Ofgem should begin a phased introduction this summer instead.
- While we are unable to comment on the appropriateness of Ofgem's exact figure for what adequate capitalisation looks like, we are keen to ensure the final value is highly sensitive to differential supplier risks and consumer profiles.
- Ofgem's lack of appetite for enforcement could derail these plans – the regulator needs to prove it is capable of appropriately sanctioning non-compliant providers.
- To ensure suppliers fulfil their obligations Ofgem must shift away from its heavy reliance on self-reporting to assess compliance, offering more proactive oversight.
- Ofgem must assess capital adequacy based on a definition which favours supplier's holding greater levels of liquid assets, as these can be more readily mobilised.
- We support Ofgem's renewed proposals for protecting customer credit balances (CCBs) but recommend the regulator make credit balance practices more transparent and address the hurdles to accessing CCBs or adjusting Direct Debits.

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

Having responded to the initial energy supplier financial resilience consultation in December[1], we welcome this second opportunity to feed into Ofgem's efforts to improve market stability[2]. In 2021/22 the failure of 30 energy suppliers[3] brought the retail energy market to the brink of collapse. Regulations which improve financial resilience are extremely important and with this further timely and much needed intervention, we remain optimistic that Ofgem's reforms will lead to improved market stability.

Improving the retail energy market is a key focus for Age UK because of the importance of heat and power to our older population. Our research in January showed that more than half (57%) of those aged 60+ were worried about being able to pay their household energy bills[4]. It also indicated that around 4.7 million people aged 60+ felt that their home was too cold most or all the time and 800,000 reported that they had had to recently leave their home to keep warm[5].

There is no doubt that supplier failures have a severely negative impact on affordability and consumer confidence, making a bad situation worse for consumers facing spiralling prices. 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[6], the last thing older people need is a further wave of costly insolvencies.

We are optimistic that Ofgem's recent decisions regarding financial resilience will significantly reduce the risk of the market turmoil of 2021/22 repeating itself. As a proponent of ringfencing supplier Renewable Obligation (RO) commitments we welcome the regulator's decision to add this to supplier licence conditions[7]. Implementation of the enhanced financial responsibility framework (EFRF), which includes improved capital adequacy requirements, is also welcome[8]. While we remain sceptical of Ofgem's appetite for enforcement action and its reliance upon supplier self-reporting to assess compliance, inclusion of the EFRF within licence conditions will go a long way towards enshrining these principles across the market.

We also welcome the regulator's capital floor and target proposals. While we have specific recommendations for improvements (see responses to questions one, two, three, and six) we are confident that this approach will help safeguard against future supplier failures.

Q1. Do you agree with our proposed approach of the Capital Target and the Capital Floor?

Ofgem propose a target capital level for suppliers which will be equivalent to £130 per domestic dual fuel customer (set as the same value of £65 for an electricity and gas customer) alongside a capital floor of £0 adjusted net assets per domestic dual fuel customer. The target will act as the benchmark all suppliers should aim to meet while the floor will act as a minimum threshold. This allows suppliers to draw down on assets during an emergency with a view to gradually returning to the target benchmark after the crisis has subsided. Ofgem's proposal is to implement this from March 2025.

We agree that this proposal will help stabilise the energy supply market and reduce the risk of suppliers being undercapitalised in times of crisis. We therefore welcome Ofgem's proposal but recommend several changes to ensure it is as effective as possible.

Ofgem needs to make it more explicit that the capital target is the benchmark, and any supplier with capital below this level is only permitted to do so on a temporary basis during a crisis. The regulator will need to clearly define what constitutes a crisis to ensure suppliers are not regularly dropping below the target for inappropriate reasons. Ofgem will also need to better consider what action it will take if a supplier falls below the floor. Improved enforcement capabilities will be key to the regulator providing a proactive and proportionate response (see response to question 3). The regulator should also consider whether and, if so, how the figure should be adjusted in future, for example by index-linking it.

While we are unable to comment on the appropriateness of the exact figure Ofgem land on for what adequate capitalisation looks like, we are keen to ensure the final value is sensitive to market conditions and differential supplier risks. We discuss this in greater detail in response to question 11.

Ofgem must be mindful that this policy could also create unfair competition if some suppliers do not follow the rules. It is important that compliant suppliers who are responsible with their capital and regularly achieve the expected target do not face being undercut by other suppliers routinely dropping below the target. This could create unfair pricing and lead to a repeat of the unsustainable competition practices which exacerbated 2021/22's litany of supplier failures[9]. This will require proactive oversight from Ofgem (see response to question 3).

As part of this, issuing a new supply licence must be subject to an assessment of the market entrant's capital adequacy. Ofgem's present capital target is based on customer numbers, but newly established suppliers do not have any. When assessing new market entrants Ofgem should therefore base its capital adequacy requirements on an appropriate alternative assessment (e.g. prospective growth estimates). If Ofgem provides a licence to a market entrant who does not have sufficient capital then they should be mandated to meet staging posts to ensure they reach the capital target as soon as practical.

Q2. Do you agree that 31 March 2025 is a reasonable time period for introducing the Capital Target and Capital Floor? If you disagree, what would be a more reasonable time period and why?

Implementation from March 2025 means two more winters of our older population not knowing if they are being supplied by a white elephant – an undercapitalised, mismanaged supplier, susceptible to failure at any time. Given the precedent for supplier failures since 2021 Ofgem needs to begin a phased regime this summer instead.

In our previous response we agreed that a gradual move towards capital adequacy is preferred as it would ensure that any associated costs were not imposed on consumers at a time of already high prices[10]. However, our support for this position was based on the understanding that suppliers would be gradually moved towards stronger liquidity as soon as possible. Delaying the implementation of the capital adequacy regime until March 2025 without clear intermediary staging posts represents the regulator offering a deadline extension on malpractice for undercapitalised suppliers.

Instead, we want Ofgem to undertake a phased introduction of its staging post approach beginning from summer 2023. This would gradually shift suppliers towards the proposed capital target and will mean that undercapitalised suppliers have already started developing a safety net against any unexpected price shocks this winter.

This is particularly important for the older population. Energy bills are generally higher over the winter as demand and prices increase during the colder months[11]. This makes it incredibly important for older people to have confidence in the stability of their supplier over this period, as market uncertainty can compound the existing issues of higher prices and lower temperatures. Waiting until March 2025 will mean two more winters of our older population facing uncertainty.

Q3. Do you agree with the Capitalisation Plan process for those suppliers meeting the Floor but not the Target?

Ofgem have proposed that once a supplier falls below the target, they will be subject to default transition controls. These controls will prescribe specific expectations and requirements for suppliers to return them to the target level. Once a supplier submits its own bespoke capitalisation plan, and the plan receives Ofgem approval, this then supersedes the default transition controls.

The default controls include two key sanctions. Firstly, a supplier cannot engage in customer acquisition. This would include taking on new customers, upgrading existing customers to a dual fuel contract, or undertaking marketing activity. Secondly, they will be subject to payment controls for any non-essential payment to a third party (e.g. transferring assets, providing loans, or making transactions which are deemed unessential to supplier operations). Part of this may also include ringfencing customer credit balances (CCBs). Ultimately, Ofgem reserves the right to revoke supply licences if providers fail to make their way back towards the target.

While the default transition controls entail significant sanctions for non-compliant suppliers, there are potential flaws. Firstly, we are concerned that while these controls are prescriptively defined and represent a significant penalty for non-compliant suppliers many providers will secure an effective opt out if they successfully submit a less restrictive capitalisation plan. Ofgem must carefully scrutinise these plans with input from independent external organisations and consumer representatives to ensure suppliers do not inappropriately water down the consequences of falling below the capital target.

Secondly, adequate enforcement is essential to ensure suppliers return to the capital target as quickly as possible. While it is good Ofgem is leaving all enforcement options on the table, including revoking supply licences, we fear that it is unlikely that any more severe action will ever be undertaken even in the most egregious cases of licence breaches. The experience of 2021/22 exposed Ofgem's lack of appetite for enforcement activity, and there has been an absence of necessary investment in this component of the regulator's role[12]. This is despite Ofgem's core commitment to both deterring malpractice and delivering consequences for non-compliance[13]. We are keen to avoid supply licences being revoked without significant justification, however Ofgem must be prepared to take this action and proactively transfer customers to a more stable supplier when consistent malpractice is uncovered.

Finally, Ofgem will need to ensure it engages in more proactive oversight and avoids being overly dependent on supplier self-reporting. Suppliers can remain between the capital floor and capital target temporarily if they have had to draw down on capital during a crisis. This makes sense and would trigger transition controls if they fall below the floor or linger below the target for lengthy periods. However, this approach only works so long as Ofgem is proactive in monitoring compliance, and means the regulator's heavy dependence on self-reporting is problematic.

Relying on suppliers to self-report as the main oversight mechanism could lead to them selectively reporting data which downplays the risk of them falling below the capital target. We welcome Ofgem's suggestion of potentially including independent supplier audits as a means of shoring up the process, but we strongly recommend that this be a mandatory component of Ofgem's plans.

Q6. In this section we have set out our position as to which accounting metrics and financial instruments count towards Capital. However, we are aware that in other industries, such as banking, there are other debt instruments that count as capital when regulators test for financial resilience. Are there any other debt instruments available in the market that we should consider including in our definition of Capital?

In defining what it means by 'capital', Ofgem's focus is on ensuring the balance is struck between suppliers being able to meet their capital adequacy requirements while mitigating the risk to consumers of making the definition so broad that it includes inappropriate assets which are of little use during a crisis. We support the regulator's attempts to balance these two factors but reinforce the importance of weighting this complex equation towards the risk consumers face. This will better ensure they have confidence in their provider's resilience in the face of market volatility.

When defining what constitutes capital Ofgem must be mindful of the original purpose of the minimum capital threshold – ensuring sufficient resources are available so that suppliers can rapidly draw down on reserves during a crisis. Age UK is keen to ensure Ofgem pursues a definition which focuses on suppliers holding liquid assets to meet the vast majority of their capital adequacy requirements wherever possible. This will ensure they can quickly stabilise their business and support their customers during periods of market uncertainty.

There are two primary asset classes relevant for measuring liquidity – fixed assets and current assets. Fixed assets can be tangible (e.g. property, vehicles, equipment) or intangible (e.g. trademarks, brand recognition, goodwill). Current assets include resources which are generally more readily available (e.g. cash in hand, cash at the bank, money owed by debtors).

Ofgem's determination of what constitutes capital is key because many suppliers are under capitalised or hold intangible assets which are unlikely to be of use during a crisis.

In 2021/22 nine suppliers (out of 25 reviewed) held no meaningful fixed assets, and a further 9 relied on intangibles for most of theirs[14].

To shore up Ofgem's definition it must ensure that what is considered an asset for the purposes of meeting the minimum capital threshold is weighted towards readily accessible forms of capital which are better able to rapidly shield consumers against the risk of supplier failure, for example cash. Beyond the most liquid asserts, Ofgem should then consider wider assets on a sliding scale.

We agree with Ofgem's determination that the definition of capital used must ensure there is 'skin in the game' for shareholders. Because of a lack of sufficient capital requirements financial backers generally face little risk when they invest in an energy supplier because they must only devote a small amount of exposed capital to keep the company afloat. This is compounded by the investment failsafe delivered by the Supplier of Last Resort (SoLR) process and special administration regime, as investors know that if the supplier fails it will effectively be bailed out by consumers or the taxpayer. Mandating that a supplier holds liquid assets for use in an emergency means investors must initially stump up the cash to keep the company afloat and are exposed to associated risks if the supplier is mismanaged. We agree that this keeps shareholders focused on ensuring company directors are attentive to sustainable business practices and longer-term solvency.

Q10. Do you agree with our changed position the Capital Target to be on a 'per electricity and gas customer', rather than 'per dual fuel customer', basis? If you disagree, please provide an alternative approach and supporting evidence.

We agree with this approach.

Q11. Do you agree with splitting the Capital Target of £130 equally between electricity and gas in line will recent price cap typical bill values? If you disagree, please provide an alternative approach and supporting evidence.

While we are unable to comment on the appropriateness of the exact figure Ofgem land on for what adequate capitalisation looks like, we are keen to ensure the methodology for determining the final value is established based on market risk, consumer exposure, and what is deemed adequate to avert supplier failures during a crisis. We are concerned that the capital adequacy target being set as the same value (£65) for an electricity and gas customer will not adequately reflect the differential volatility of these two commodities.

It will also fail to appropriately reflect the composition of different suppliers' customer bases. For instance, since 2021 natural gas prices have proved incredibly volatile. This means a supplier with a customer base skewed towards single fuel gas customers may be more exposed to risk than a supplier who delivers primarily to single fuel electricity consumers. Similarly, suppliers with very high fixed-tariff customer volumes would be overexposed to price volatility when prices climb, as was the case for many suppliers in 2021/22[15].

Ofgem should focus less on setting a fixed figure for the capital target and instead tailor its capital adequacy requirements to fit the circumstances. This will ensure the degree of capitalisation each supplier attains will better reflect its exposure to market volatility.

Q12, 13, 14, and 15. Ringfencing of customer credit balances.

While we have previously expressed reservations about Ofgem's customer credit balance (CCB) proposals[16] and remain sceptical of the regulator's decision not to completely ringfence them, we accept that wider reforms and new capital adequacy arrangements should help reduce the risks associated with over reliance on CCBs or their misuse. While Ofgem's appetite for enforcement remains a concern (see response to question three) its continued commitment to enact bespoke ringfencing under specific conditions is welcome. We therefore support Ofgem's renewed proposals but suggest the regulator better account for consumer sentiment regarding CCBs when determining what is 'appropriate use'.

CCBs represented around 3.6% of the mutualised costs passed onto consumers because of supplier failures since September 2021[17]. 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[18]. With this in mind, we encourage Ofgem to also weigh the impact of consumer sentiment towards CCBs and supplier billing practices. One of the biggest frustrations customers face in the energy market is a perception that their supplier is overbilling them beyond what is reasonable or cost reflective. Direct Debits often do not reflect actual energy use. Much of this is legitimate – with suppliers smoothing customer costs throughout the year instead of directly billing for higher use over the winter. However, many older people have got in touch with Age UK since 2021 as they feel unable to challenge this process when they need to, and they feel there is a lack of transparency.

It cannot be understated what a devastating impact reports of suppliers using credit balances to fund their growth[19] has had in a context where millions of consumers have been struggling to heat and power their homes. Alongside the risk of CCB misuse, there is a tangible sense that this practice has undermined consumer trust in suppliers and Ofgem's ability to regulate them.

Ofgem should be mindful of this as it undertakes its proposed reforms and provides consumers with greater reassurance. Ofgem's commitment to strengthening the rules around setting Direct Debits is welcome, but it must support this by commissioning an independent inquiry into how difficult it is to request a cost reflective Direct Debit, and the return of credit balances upon request. This is particularly important given the poor customer service practices of suppliers[20]. Improved supplier transparency is key to this. If suppliers want to restore confidence in the market, they need to be far clearer about why their bills often do not appear to be reflective of customer energy use.

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