

Consultation

Policy Consultation – Strengthening Retail Financial Resilience

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We want an energy market where retail suppliers are financially resilient, and where risks are not inappropriately passed to consumers. This will ensure that consumers, energy suppliers and investors can have confidence in the energy supply market going forward.

We are consulting on policy options for protecting customer credit balances and money collected to meet Renewables Obligation payments. We expect this to reduce the costs directly incurred by consumers when a supply fails. It should also mean that suppliers do not have access to free working capital that could encourage them to take excessive risk.

Building on our existing programme of work to improve supplier resilience, we are also consulting on our proposal to introduce specific capital adequacy requirements for suppliers. We plan to develop an adaptive framework to ensure the right level of resilience, while minimising unnecessary burden and barriers to innovation. In addition, we are seeking views on initial proposals aimed at reducing the costs associated with hedging when a supplier fails. Alongside this consultation we have published a statutory consultation on proposals relating to the control of assets and changes to direct debit rules.

We welcome views and request stakeholder feedback on our proposals by 19 July 2022 to RetailFinancialResilience@ofgem.gov.uk.

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Executive summary

Recent events in the energy market have exposed that retail businesses have too often had insufficient capital to manage the business of supply, and some supplier business models have been overly reliant on customer credit balances and money collected to meet Renewables Obligation (RO) payments for working capital.

Under the current market arrangements, suppliers can accrue and use credit balances and RO payments as free, and risk-free, working capital. This has encouraged suppliers with insufficient capital and poor business models to enter the market and grow unsustainably. As Oxera¹ identified in the lessons learned report commissioned by Ofgem's Board, such models do not incentivise good operational performance or good customer service, as suppliers are able to attract new customers based not on their service offering, but rather with non-cost reflective (and ultimately unsustainable) pricing, driving some suppliers to accumulate more and more customers simply to stay afloat.

Suppliers without sufficient capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure. Further, under present market conditions, the costs of failures borne by customers have far exceeded the costs of refunding the credit balances and RO payments of individual suppliers. 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.

We want an energy supply market where energy suppliers are financially resilient, and where suppliers bear the appropriate cost of risk-taking so that costs are not inappropriately passed on to consumers. Suppliers should have sufficient capital and sustainable business models to ensure they are sufficiently resilient to market shocks. This will ensure that consumers, energy suppliers and investors can have confidence in the energy supply market going forward.

Our proposals

The proposals set out in this consultation document seek to ensure that suppliers bear the appropriate cost of the risk-taking so that they are more resilient to market shocks, and that

¹ [Ofgem publishes report into its regulation of the energy market | Ofgem](#)

customers are shielded from the impacts of supplier failures as far as possible. These proposals are:

- **Protecting consumer credit balances and RO payments:** we consider there is a good case for insuring or otherwise protecting customer credit balances and RO payments, so they are available to the customers' new supplier if and when a supplier fails. Not only will this reduce the mutualisation costs directly associated with credit balances and RO payments, but it will mean that suppliers do not have access to free, risk-free working capital that incentivises them to take excessive risk and pursue risky business models. We set out these proposals in Chapters 2-4.
- **Protecting the value of hedges for consumers:** a significant proportion of the costs that all consumers were exposed to as a result of recent supplier failures were due to the new supplier having to purchase gas and electricity on wholesale markets that were much higher than the price allowed under Ofgem's Default Tariff Cap. Although some failed suppliers had 'hedged' (i.e. bought wholesale energy in a way that reduced their exposure to price risk between their selling price to customers and movements in the wholesale energy market), the value of those hedges could not be transferred to the new supplier along with the customers. In Chapter 5, we set out some initial thinking on regulatory options for preserving the value of an insolvent supplier's hedge for the benefit of their customers. The aim is to reduce mutualised costs following a supplier's failure and/or to ensure that owners of failed energy supply companies cannot extract value from such assets at the expense of future bill payers when the company becomes insolvent or is wound up.
- **Capital adequacy:** we consider suppliers should be required to maintain sufficient minimum levels of capital to survive market shocks and incentivise robust risk management. While our current rules already enable us to set capital adequacy expectations, we believe that more specific requirements and a greater level of regulatory oversight will be needed to increase supplier resilience and incentivise more robust risk management. Our emerging thinking is that suppliers should be expected to maintain a minimum capital buffer, with the possibility of additional, bespoke capital requirements for higher risk suppliers that do not take appropriate steps to manage risk, and we are seeking views on key design aspects of such a regime.

These proposals are just one component of Ofgem's wider work to build an energy market that is fair and works for everyone. Related work includes the changes we are making to the price cap to make it more flexible and adaptable, new measures to ensure only fit and proper

persons are able to start and run energy companies, and more rigorous stress testing, to those companies are more resilient to the sort of extreme market conditions we have seen in the past year. In developing our regulatory proposals, it will be important for us to consider their interactions with this related work. For example, price cap adjustments and reform, including quarterly cap reviews, backwardation, market stabilisation charge and review of supplier profitability/returns on capital, will all interact with the policy proposals. We are working across Ofgem to ensure that the cumulative effects of these measures are assessed, benefits and costs are not double counted, and that the sequencing of introducing these measures is carefully planned and communicated.

We need an energy market that is sufficiently resilient to market shocks such as the one we have been experiencing, but as the Oxera report notes it is important that Ofgem does not reactively swing from one end of the competition-resilience spectrum to the other. Any new regime must be designed to enable a sustainable, innovative, and competitive market, to promote our transition to net zero. Getting the balance right will be important and in order to do so we will need a dynamic and flexible regulatory framework that will enable us to tighten or loosen regulatory obligations over time, to adapt to changing market conditions. We will be developing new licence conditions with that adaptive framework in mind, and plan to hold workshops with suppliers over the coming weeks to get feedback on draft license changes to protect credit balances and RO payments.

Impact Assessment

In Chapter 7, we set out our analysis of the impacts of our proposals to protect credit balances and RO payments. We commissioned NERA to produce a report detailing and quantifying the potential impacts our proposed interventions on CCB and RO, and this analysis is published as a separate document alongside this consultation.

The impact assessment indicates that these proposals should lead to an overall net benefit to consumers in the long term, with higher savings for disengaged consumers (those less likely to switch), who are also often in vulnerable circumstances. We welcome views on our methodology and analysis.

Transition

We recognise the need to provide appropriate time for suppliers to transition to new arrangements. As part of our transition and implementation proposals we are assessing the

interactions with the price cap, and whether adjustments will be needed to ensure an efficient supplier is able to finance its activities.

We recognise that some suppliers do currently use customer credit balances as an important source of working capital. Although we have concerns about this practice, and the existing regulatory requirement is for suppliers not to be 'overly reliant' on credit balances as working capital, we are considering whether transitional arrangements are necessary, and would welcome stakeholder views on this.

We are also considering the transitional arrangements that need to be put in place for our RO proposals. Our view is that suppliers should protect their full Renewables Obligation on a quarterly basis from the Renewables Obligation Period starting April 2023. We want to put a policy in place as soon as practicable to begin to deal with the issue of mutualisation, though we recognise the need to provide suppliers with enough time to put new arrangements in place. We are seeking views and supporting evidence on our RO proposals being effective from April 2023. To improve protections in the meantime, we intend to implement enhanced monitoring arrangements to more fully understand how suppliers currently plan to meet their RO obligations.

Related proposals

Alongside this policy consultation, we publish a statutory consultation on control of assets,² as well as, a statutory consultation on updating the direct debit Licence Condition.³

Next steps

We welcome further stakeholder views on the proposals set out in this document, and on the content of the Impact Assessment set out in Chapter 7, by **Tuesday 19 July**. Subject to the responses received to this consultation and feedback received via our engagement with stakeholders, we intend to issue a statutory consultation on our proposals to ringfence CCB and RO payments in the Autumn. The responses to our proposals on capital adequacy and to preserving the value of an insolvent supplier's hedges for the benefit of their customers will inform how we phase our work in these areas.

² <https://www.ofgem.gov.uk/publications/statutory-consultation-strengthening-fixed-direct-debt-rules>

³ <https://www.ofgem.gov.uk/publications/statutory-consultation-supplier-control-over-material-assets>

1. Introduction

Summary

In this chapter we provide the context and our previous consultations on financial resilience. We are seeking stakeholder responses by 19 July 2022.

Questions

Question 1: Do you think that the measures we are proposing sufficiently and proportionately address our objectives? Are there other measures that you think we should consider to better meet our objectives?

Overarching context

1.1. Recent events in the energy market have exposed that retail businesses have too often had insufficient capital to manage the business of supply, and that some supplier business models have been overly reliant on customer credit balances (CCBs) and money collected to meet Renewables Obligation (RO) payments for working capital. Whilst we recognise that, given the scale, pace, and duration of the price shock in the gas market, there would have been some supplier failures, too many suppliers operated with insufficient risk management practices and capital to manage their commercial risks and protect consumers.

1.2. We want an energy supply market where energy suppliers are financially resilient, and where suppliers bear the appropriate cost of risk-taking so that costs are not inappropriately passed to consumers. Suppliers should have sufficient capital and sustainable business models to ensure they are sufficiently resilient to market shocks. This will ensure that consumers, energy suppliers and investors can have confidence in the energy supply market going forward.

1.3. In December 2021, we announced an Action Plan⁴ with a package of measures to boost financial resilience in the energy retail market. Since then, we have introduced stress testing to assess whether suppliers are robust to a range of market scenarios, requested

⁴ [Open Letter to domestic energy suppliers - Financial Resilience | Ofgem](#)

assurance on suppliers' management control frameworks for financial risk, undertaken compliance action under our current rules to address concerns identified by the stress testing and assurance exercises, strengthened Ofgem's ability to intervene at milestone assessments and provided further guidance on the financial risk controls and fit and proper person assessments, in licence entry checks. We have also consulted on⁵ and implemented⁶ changes to the Financial Responsibility Principle (FRP) guidance to ensure suppliers have sufficient control of their material assets.

1.4. Our Action Plan also signalled our intention to consult on detailed policy options tackling mutualisation risks associated with RO payments and CCBs, and on a wider review of the regulatory framework for supplier financial resilience. Since the initial Action Plan was shared, we have issued an update to the Action Plan in April 2022⁷ with more details about the CCB and RO proposals and welcomed views from suppliers. We have also hosted a series of workshops and supplier bilateral sessions to share further details on the CCB and RO policies as well as presented options for approaches to capital adequacy regulation.

1.5. In our December Action Plan and January update, we set out key outcomes that would help us deliver our objective of a more resilient energy market, which continue to guide the development of our proposals:

- **Robust minimum standards:** regulation provides robust minimum standards, to ensure commercial risk is well managed. For example, suppliers need to be adequately hedged or hold sufficient capital to manage a wide range of market scenarios. Within this, suppliers are responsible for their own commercial strategy but must have a robust management control framework in place to support it and manage their risks;
- **Protecting customer money:** suppliers should not pass inappropriate risk to consumers, e.g., through use of customer monies or levy payments to fund wider business activity. Socialisation of losses when suppliers fail must be minimised (in line with firms in the broader economy);

⁵ [Update to action plan on retail financial resilience: supplier control over material assets](#)

⁶ [Decision on the proposed guidance on the Operational Capability and Financial Responsibility principles](#)

⁷ [Open Letter to domestic energy suppliers - Financial Resilience](#)

- **Accountability:** there should be minimum requirements for staff in significant leadership or executive roles and board members, (e.g. fit and proper person test and capability requirements), and appropriate board governance;
- **Proportionality:** we should regulate as necessary, and no more than needed. The regulatory burden of data exchange should be minimised through use of data and digitalisation techniques, for data provision and monitoring;
- **Transition:** any regime must be designed to enable a sustainable, innovative, and competitive market, to promote our transition to net zero; and
- **Control:** suppliers need to have ownership or sufficient control⁸ over all material economic and operating assets used and/or needed to run their business.

Problem definition

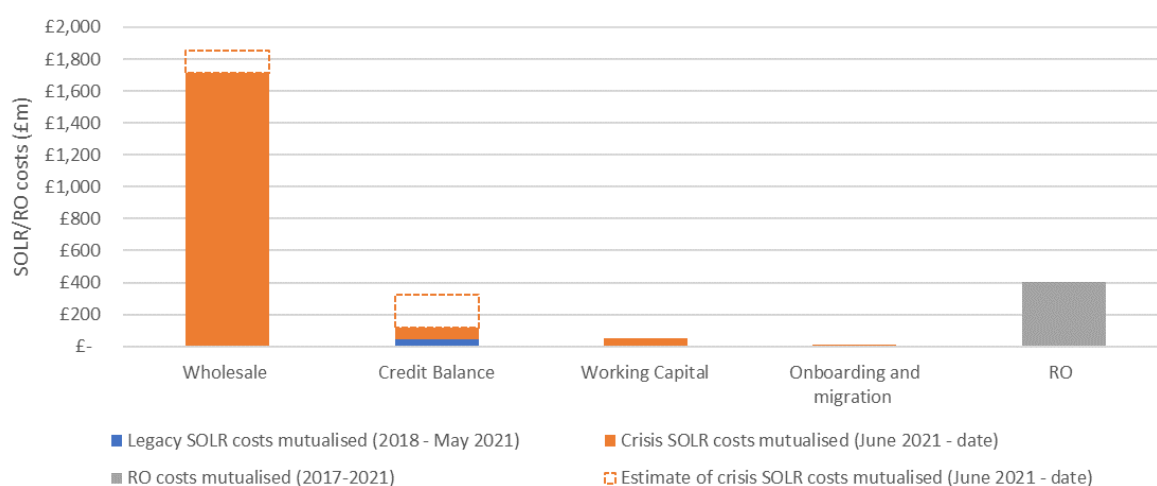
1.6. Under the current market arrangements, suppliers can accrue and use CCBs and money collected to make RO payments as free, and risk-free, working capital. On failure, CCBs and RO payments are effectively insured through mutualisation, meaning that suppliers are not exposed to this downside risk. Because they have less equity capital tied up in the business, investors have lower opportunity costs of exit. This has encouraged suppliers with insufficient capital and poor business models to enter the market and grow unsustainably. Such models do not incentivise good operational performance or good customer service, as suppliers are able to attract new customers based not on their service offering but rather with non-cost reflective (and ultimately unsustainable) pricing, driving some suppliers to accumulate more and more customers simply to stay afloat.

1.7. Suppliers without sufficient capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure. And under present market conditions, the significant costs of failures borne by customers have far exceeded the costs of refunding CCBs and RO payments of individual suppliers (see Figure 1). This can give rise to very poor outcomes for consumers and systemic risks to the retail supply market, even in

⁸ Sufficient control means that a regulated supply entity has legally enforceable rights over the material economic and operational assets needed to run 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.

circumstances where the majority of suppliers do not rely on such unsustainable business models.

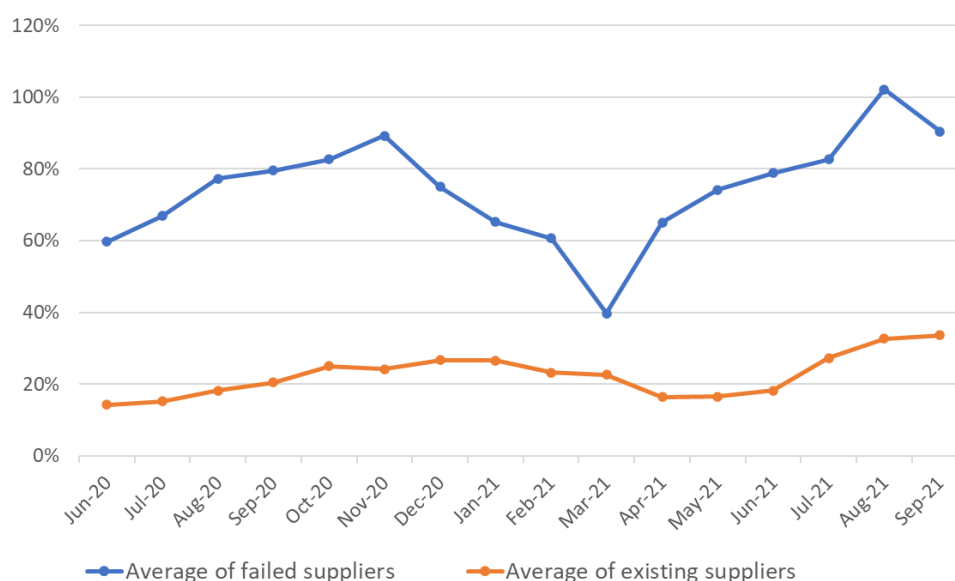
Figure 1: SoLR and RO costs mutualised (2018-present)



Source: Ofgem analysis

1.8. The Oxera lessons learned report identified that a number of suppliers that would go on to fail had the following common characteristics: (i) negative equity balances in the years leading up to their failure; (ii) poor liquidity and low levels of working capital; (iii) over-reliance on customer credit balances to finance their operations; and (iv) either unhedged, or not substantively hedged, positions. It concluded that these factors limited suppliers' ability to absorb shocks amid demand uncertainties and rapid and sustained increases in wholesale energy prices.

1.9. In addition to Oxera's findings, our own monitoring shows that there is strong evidence that failed suppliers generally had a much higher reliance on CCB for their working capital (see Figure 2).

Figure 2: Customer Credit Balances as a proportion of forecast total assets

Source: Ofgem analysis of COVID RFI

1.10. As Oxera indicates in its report, a requirement to maintain minimum levels of equity capital (as opposed to relying on 'free, risk-free' capital) has important incentive properties. First, the injection of shareholders' private capital into a business means that the owners have money at risk in the event of insolvency, or 'skin in the game'. This reduces the risk of moral hazard (i.e. incentives to take excessive risk). Second, the act of raising capital prior to entry, and/or on an ongoing basis, incentivises scrutiny and due diligence of a firm's business plans, as investors will want to assure themselves of its prospective and ongoing viability.

1.11. Oxera found that the systemic risks were exacerbated by a lag in the pass-through of wholesale fuel costs in retail energy prices (which we are addressing through our reforms to the Default Tariff Cap) and by the ability of owners of energy supply companies to extract in-the-money financial derivatives (or other assets) and then declare the supplier insolvent. Ensuring that owners of energy supply companies cannot extract value from such assets at the expense of future bill payers when the company becomes insolvent (or benefit from the value of such assets after the company is wound up) will also be an important factor in ensuring owners face the right incentives.

Objectives of and interactions between proposals

1.12. The proposals set out in this consultation document seek to ensure that suppliers bear the appropriate cost of their risk-taking so that they are more resilient to market shocks and that customers are shielded from the impacts of supplier failures as far as possible. **Our overarching objective is to develop a more resilient energy supply market in which consumers, energy suppliers and investors can have confidence going forward.** We will achieve this through measures to increase the financial resilience of suppliers, thereby reducing the likelihood and costs of future supplier failures for the benefit of consumers.

1.13. Our proposals have a number of inter-related strands as follows:

- **Ringfencing of CCBs and RO payments:** we consider there is a good case for insuring or otherwise protecting ('ringfencing') CCBs and RO payments so they are available to the relevant supplier of last resort (SoLR) if and when a supplier fails. Not only will this reduce the mutualisation costs directly associated with CCBs and RO payments, but it will also mean that suppliers do not have access to free, risk-free working capital that incentivises them to take excessive risk and pursue risky business models. We set out our proposals on ringfencing CCBs in **Chapter 2** and RO payments in **Chapter 3**. In **Chapter 4**, we set out a menu of mechanisms that we believe would ringfence or otherwise protect RO funds and CCBs, and ensure they are as 'insolvency remote'⁹ as possible to minimise the impact of cost mutualisation on consumers. Our Impact Assessment in **Chapter 7** and NERA's report, published alongside the consultation, indicates that this will deliver net benefits to consumers over the longer term.
- **Hedging:** in **Chapter 5**, we set out some early thinking on regulatory options for preserving the value of an insolvent supplier's hedge for the benefit of their customers, in order to reduce mutualised costs following the supplier's failure.
- **Capital adequacy:** we consider suppliers should be required to maintain sufficient minimum levels of capital to survive market shocks and incentivise robust risk

⁹ Insolvency remote is where funds are held or covered by a protection mechanism (see chapter 4) designed to ensure that those funds, upon supplier failure, do not form part of the supplier's insolvent estate but instead are preserved for the benefit of Ofgem (or its nominee(s), such as an incoming Supplier of Last Resort) to meet a suppliers' costs at risk of being mutualised such as its renewables obligation liability or the customer credit balances it held at the time of failure.

management (e.g. around hedging behaviour). While Ofgem's Financial Responsibility Principle¹⁰ requires that suppliers must have adequate financial arrangements in place to meet costs at risk of being mutualised, and our Default Tariff Cap is based on a profit margin for an assumed level of capital per consumer, we think more specific requirements and a greater level of regulatory oversight are required to address these risks effectively. In **Chapter 6**, we invite views on our proposed overarching approach to a capital adequacy regime, and on specific elements that will underpin it – including considering what risks regulatory requirements should cover, the level of resilience that a notionally efficient supplier should be expected to have, and how “capital” should be defined. Our emerging thinking is that suppliers should be expected to maintain a minimum capital buffer, with the possibility of additional, bespoke capital requirements or other mitigations for higher risk suppliers. Development of our proposals will be aligned with our work on the appropriate level of return under the price cap, and will need to strike an appropriate balance between resilience and competition/innovation, to optimise outcomes for consumers.

1.14. In developing our regulatory proposals, it will be important for us to consider their interactions and potential cumulative impact. For example, there are likely to be important interactions between our ringfencing and capital adequacy proposals. While ringfencing of CCBs and RO payments limits access to free, risk-free capital, reducing the incentives to pursue risky business models, a similar outcome might be achieved through hard-edged capital adequacy requirements underpinned by a strong and potentially intrusive supervisory regime in the long term. We prefer to deploy ringfencing in the first instance as it presents a lighter touch, more proportionate approach, is likely to be deliverable more quickly and should directly reduce CCB and RO mutualisation costs by protecting the funds through an insolvency remote mechanism. Similarly, if we were able to ensure that the value of in-the-money financial derivatives (hedges) were transferred to a SoLR instead of remaining an asset of the insolvent company such that mutualised wholesale costs were significantly reduced or avoided altogether, that would in turn reduce the costs of supplier failure and allow us to adapt our approach in the future if necessary.

1.15. We will examine costs and benefits holistically, to ensure there is no “double-counting” across these different strands of the proposals and that we take account of wider work on returns and supplier risks (see the “scope, holistic approach & wider interlinkages” section

¹⁰ Standard Licence Condition 4B of the Gas and Electricity supply licences

below). For example, the net benefits identified in the Impact Assessment are incremental to those arising from the proposed reforms to the Default Tariff Cap (inc. quarterly reviews). However, our work on Capital Adequacy, along with reforms to the Default Tariff Cap, may result in our taking a view on the amount of capital that a notionally efficient supplier should hold per consumer, and will need to take account of the impact of the Ringfencing proposals.

1.16. We need an energy market that is sufficiently resilient to market shocks such as the one we have been experiencing, but as the Oxera report notes it is important that Ofgem does not reactively swing from one end of the competition-resilience spectrum to the other. Any new regime must be designed to enable a sustainable, innovative, and competitive market, to promote our transition to net zero. Getting the balance right will be important and in order to do so we will need a dynamic and flexible regulatory framework that will enable us to tighten or loosen regulatory obligations over time, to adapt to changing market conditions.

Scope, holistic approach & wider interlinkages

1.17. Our focus in this consultation is on domestic retail suppliers. Domestic suppliers carry the highest risks around cost mutualisation and we want to directly reduce the costs and impacts borne by domestic consumers of supplier failure. We recognise there is a need to ensure financial resilience for non-domestic supply, however, we need to consider what is proportionate given the differences in the risks of mutualisation¹¹ and how non-domestic customers engage with the market. We are closely monitoring the non-domestic market and considering the need to extend any of our proposals to these suppliers. This will include making specific adjustments to reflect the different market and risk. For example, we expect non-domestic suppliers to be handling security deposits appropriately, and will consider intervention if we have concerns that this is not the case.

1.18. In addition to the interactions between the policy proposals set out in this consultation document, we are mindful of key interactions with other financial resilience initiatives (such as stress testing and strengthened financial risk controls) and with other policy areas as follows:

¹¹ Credit balances of non-domestic customers are not recovered through Last Resort Supply Payments, and tend to be proportionately lower than domestic balances.

- Government has announced that all domestic electricity customers will now receive a £400 universal grant from October 2022. We will need to give careful consideration how this support interacts with the implementation of our CCB proposals;
- As part of our transition and implementation proposals we are assessing the interactions with the price cap, and whether adjustment will be needed to ensure an efficient supplier is able to finance its activities;
- Price cap adjustments and reform, including the proposed move to quarterly cap reviews, updating the wholesale methodology to include backwardation costs, market stabilisation charge and review of supplier profitability/returns on capital will all interact with the policy proposals. We are working across Ofgem to ensure that the cumulative effects of these measures are assessed, benefits and costs are not double counted, and the sequencing of introducing these measures is carefully planned and communicated;
- We have launched a programme of stress testing on domestic and non-domestic suppliers and are monitoring the financial viability and resilience of gas shippers. Through this engagement, we are setting clear expectations to suppliers that we expect them to be building resilience where we see risks, and this programme will directly inform our proposals.

1.19. These proposals will be considered in the context of our Future Retail Strategy work and as part of our strategy to strengthen the regulatory regime for the energy retail market going forward, in response to the independent review carried out by Oxera.

1.20. We also are aware of the need to consider how to get the best information from supplier reporting to underpin any policy on supplier financial resilience, and to ensure that we develop an efficient approach to any new monitoring or reporting requirements. Over the coming months, we plan to consolidate and streamline our overall financial monitoring framework to ensure that we collect all (and only) the information that we require to undertake our analysis and avoid any duplication or redundancy, with a view to minimising the burden on suppliers.

Previous consultations and recent engagement

Previous consultations

1.21. Ofgem had been strengthening its approach in retail financial resilience, for example introducing higher standards for new entrants in 2019.¹² As part of our package of proposals for 'ongoing requirements' on suppliers operating in the market and 'exit arrangements' to mitigate the negative effects of supplier exit,¹³ we consulted on a requirement for suppliers to protect 50% of their RO and CCBs through a 'menu' of protection mechanisms. Due to stakeholder feedback, which raised a number complex issues, we decided we needed more time to consider analysis on the proposals,¹⁴ but we implemented new licence conditions in early 2021 to ensure that our broader expectations of suppliers were sufficiently clear.¹⁵

1.22. These new licence conditions comprised an operational capability requirement, the Financial Responsibility Principle (FRP) and ongoing fit and proper requirements. The FRP requires suppliers to responsibly manage costs that could be mutualised, to take appropriate action to minimise these costs and to have adequate financial arrangements in place to meet such costs. The guidance sitting alongside the FRP includes a requirement for suppliers not to be overly reliant on CCBs for their working capital.

1.23. Some of the stakeholders who opposed our original proposals have now exited the market and events over the last nine months have demonstrated both that the risks and costs involved with mutualisation are significant and the need for us to deliver more specific financial resilience requirements at pace.

1.24. In March 2021 we consulted on two new proposals specifically targeted at CCBs. These proposals were a) a requirement for suppliers to auto-refund all surplus customer credit balances at the end of a 12-month period, and b) a proposal to set a threshold on the amount of surplus CCBs suppliers can hold, with an obligation to protect all balances above the threshold.

1.25. Many of the respondents to the consultation expressed the view that the proposals would not appropriately deliver our objectives and that the introduction of the auto refund

¹² [Supplier Licensing Review: Final Proposals on Entry Requirements | Ofgem](#)

¹³ <https://www.ofgem.gov.uk/publications/supplier-licensing-review-ongoing-requirements-and-exit-arrangements>

¹⁴ [Update on timing and next steps on the Supplier Licensing Review | Ofgem](#)

¹⁵ [Decision on the Supplier Licensing Review: Ongoing requirements and exit arrangements | Ofgem](#)

policy would not be in the interests of consumers. Some stakeholders suggested that our model for the threshold policy was too simplistic to be completely effective. There were also concerns that the costs may outweigh the benefits of the proposal. Suppliers expressed concerns that the cost of protection mechanisms may pose a barrier to market entry, and potentially force some suppliers to leave the market, thereby reducing market choices available for consumers. There were also concerns the proposals would have a disproportionate effect on smaller suppliers.

1.26. We have now undertaken further work and analysis (outlined in Chapter 2) taking into consideration the changes in the retail market due to the high gas prices and number of supplier exits. We set out a number of options to ensure CCBs are adequately protected to reduce risks of mutualisation.

1.27. We consulted jointly with BEIS on addressing supplier payment default under the RO in August 2021. BEIS decided not to proceed with changes to RO legislation and is considering longer term reform on the RO and the potential to move to Fixed Price Certificates. We understand that BEIS is planning to issue a call for evidence later this year.

1.28. Responses from stakeholders, set out in further detail in Chapter 3, demonstrated a clear desire for change, and a preference for the option of Direct Legislative Reform, with some support for license-led change. In the absence of forthcoming legislative change, we are consulting on changes to the licence to address the issue of cost mutualisation under the RO scheme.

Recent stakeholder engagement

1.29. We are now consulting on the changes to RO and CCBs together to ensure policies can be considered holistically and impacts considered jointly. There are also similarities in our proposals across the two areas, where we propose suppliers will be required to protect or ringfence an amount of money using a insolvency remote Approved Protection Mechanism. Under our proposals these mechanisms should ensure money is either held separately or equivalent amounts will be provided if a supplier were to exit the market. These arrangements should ensure that these assets or money will not be available to creditors if the supplier were to become insolvent, but will instead be provided to the SoLR to reduce mutualisation costs. Chapter 4 explains the types of mechanisms and how they could work in more detail.

1.30. We set out proposals in our open letter of 14 April and held two rounds of workshops with stakeholders between February and May to discuss the developing policy and the emerging proposals. In addition, we held a significant number of bilateral meetings with individual suppliers to understand their views on our proposals. In response to this informal consultation, we received a range of stakeholder responses across the proposals. On CCB ringfencing proposals, supplier views were varied. A majority of the suppliers we have engaged with agreed with the proposal of protecting gross credit balances net of unbilled consumption, with some urging us to move as quickly as possible to put in protections this winter. Others were concerned about the impact on smaller and independent suppliers and requested we share our analysis of the impacts of the proposals and provide details of transition arrangements. There was general support for our proposals to require suppliers to ringfence RO payments collected from customers, though concerns were raised about the transition to these new arrangements. Some suppliers request that we share how we have assessed the overall combined impact on working capital, and consider alongside reforms to the Default Tariff Cap.

1.31. A number of stakeholders agreed on the importance of capital adequacy requirements but commented that our approach needs to consider the interaction with our proposals to ringfence CCBs and RO payments. Some stakeholders questioned the need for capital adequacy requirements, and many provided views on the range of issues that need to be considered, for example in relation to assessing risk.

1.32. Stakeholders also emphasised the importance of Ofgem considering the impact that all the proposals taken together will have on suppliers. This includes the impact of monitoring compliance with the proposals (for example through requests for information “RFIs”). They consider that it is important that Ofgem understands the administrative costs and timeline pressures these measures could have on suppliers so that, if the measures are implemented, Ofgem can include ways to make sure suppliers can manage implementation sensibly. Chapters 2, 3 and 4 set out in more detail stakeholders views on each of the policy areas.

1.33. We have reviewed our Ringfencing, Capital Adequacy and Hedging proposals in the light of the feedback received to date, to ensure we are creating a market where energy suppliers are financially resilient and that risks are not inappropriately passed to consumers.

Responses and next steps

1.34. We welcome further stakeholder views on the proposals set out in this document, and on the content of the Impact Assessment set out in Chapter 7, by **Tuesday 19 July**. Please

send your response to RetailFinancialResilience@ofgem.gov.uk. We will publish the non-confidential responses we receive alongside any further consultation on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

1.35. Subject to the responses received to this consultation and feedback received via our engagement with stakeholders, we intend to issue a statutory consultation on our proposals to ringfence CCB and RO payments in the autumn. We will review the responses to our proposals on capital adequacy and to preserving the value of an insolvent supplier's hedges for the benefit of their customers and these will inform how we phase our work in these areas.

2. Customer Credit Balances

Summary

In this chapter we summarise the issues associated with customer credit balances and why we think change is needed. We set out the scope of our current work; describe the policy options we have assessed; and explain why we propose to pursue our preferred approach. We set out options around the key design features of our preferred approach; comment on the need for transitional arrangements; and describe our initial thinking around monitoring, reporting and compliance activities.

Questions

Question 2: (For suppliers) What impact would ringfencing customer credit balances have on your business and to what extent could this be mitigated through transitional arrangements? Please explain your response and provide supporting evidence where possible.

Question 3: Do you agree that we should apply the Gross Credit Balance net of Unbilled Consumption definition for the purpose of ringfencing CCBs? Please explain your response and provide supporting evidence where possible.

Question 4: Do you agree with our view that the Protection Amount Calculation should be updated quarterly and based on backward-facing data, forward-facing projections, or a combination of the two? Please explain your response and provide supporting evidence where possible.

Background

2.1. Many domestic consumers choose to pay for their energy using fixed Direct Debit or standing order, paying the same amount of money to their supplier at regular agreed intervals (usually monthly) irrespective of how much energy they have consumed. Using these payment methods, we understand that consumers typically build up customer credit balances (CCBs) on their account over spring and summer when they use less energy for heating during these warmer periods. This balance is then drawn upon during the colder autumn and winter periods when more energy is consumed.

2.2. As set out in Chapter 1, our objectives in relation to our CCB proposals are to remove incentives for suppliers to take excessive risk and to reduce the mutualisation costs directly associated with CCBs. To protect the interests of existing and future consumers, we want to ensure suppliers entering and operating in the market have sufficient capital available from sources other than CCBs and are prevented from adopting risky business models that depend on the use of CCBs as part of the supplier's pool of working capital. We also want to ensure that CCBs are protected so that should a supplier fail, the cost of these CCBs can be transferred to the SoLR to reduce mutualisation costs. This chapter sets out the scope of our proposals, the approaches we have considered for meeting our objectives, why we are proposing that CCBs be ringfenced, and how we think this could be achieved.

2.3. We have identified and defined the following key terms which are used throughout this chapter.

Table 1: Key Terms for Chapter 2

Key term	Definition (Applies only to domestic customers with fixed Direct Debit and standing order payment methods in all cases)
Gross Credit Balance	The total payments made by each customer to the supplier less the total cost of energy billed to date by the supplier. Includes only customers who have a credit balance once this calculation has been made.
Gross Credit Balance net of Unbilled Consumption	The total payments made by each customer to the supplier less the total cost of energy billed to date by the supplier, and less the value of energy used by that customer since their last bill was issued.

	Includes only customers who have a credit balance once this calculation has been made.
Net Credit Balance	<p>The total payments made by each customer less the total cost of energy billed to date by the supplier, and less the value of energy used by that customer since their last bill was issued.</p> <p>This includes both customers who are in credit and customers who are in debt.</p>
Unbilled Consumption	The value of energy used by a customer since their last bill was issued.

Scope

Payment types

2.4. The proposals in this consultation apply to payment types that allow consumers to build up CCBs. These include fixed Direct Debit and standing orders.¹⁶ Both fixed Direct Debit and standing order payment types allow the customer to spread the cost of their energy across equal payments throughout the year, rather than paying variable amounts which are likely to be higher in the autumn and winter months and lower in the spring and summer months depending on the amount of energy used.

2.5. Payment types that are out of scope for this consultation are those that cannot or do not typically result in a build-up of enduring credit on the customer account. These payment types include variable Direct Debit, payment by the consumer on receipt of the bill, and prepayment meters.

2.6. Variable Direct Debits occur where the customer authorises the supplier to collect the full bill amount directly out of their bank account when payment is due. We understand that there is no CCB in these circumstances.

¹⁶With fixed Direct Debits the customer authorises the supplier to collect a fixed amount of money directly out of their bank account at agreed regular intervals. A standing order is an instruction that a customer gives to their bank to pay a fixed amount to the supplier at regular intervals.

2.7. There may be some limited CCB involved when a consumer pays the supplier on receipt of a bill. This is because the customer pays the amount shown on the bill that reflects their actual or estimated energy use in the relevant billing period, rather than paying a fixed amount throughout the year.

2.8. While the use of prepayment meters can result in the build-up of credit, prepayment meter balances are typically smaller than seen with fixed Direct Debit and standing order payment methods and tend to mirror usage patterns. Prepayment meters are not credited with a fixed sum on a regular basis, so are not subject to the same seasonality effect as a fixed Direct Debit or standing order, where significant CCBs can often be accrued over the spring and summer months.

Our proposal

2.9. In determining how CCBs could best be protected, we have assessed two potential approaches against the following criteria: (i) likely effectiveness in meeting our objectives to remove incentives for suppliers to take excessive risk and pursue risky business models and reduce the mutualisation costs directly associated with CCBs; (ii) deliverability (speed, implementation and ongoing administration costs); (iii) likely impact on existing business models (including impacts on financial stability, innovation, competition) and (iv) wider consumer impacts.

Approach 1: Ringfencing

2.10. Based on the assessment criteria above, we propose that suppliers insure or otherwise protect an amount of money using an 'Approved Protection Mechanism' (described further in Chapter 4). While some of these mechanisms protect an amount equivalent to CCBs rather than formally ringfence a supplier's CCBs, we refer to this approach generally as 'ringfencing' for ease of reference.

2.11. Although some of the proposed mechanisms do permit access to CCBs for working capital (specifically, letters of credit, third party guarantees or surety and some parent company guarantees), we believe that a provider of the letter of credit or guarantor would be likely to set terms designed to deter unsustainable growth and the inappropriate use of CCBs. Such investors would be expected to scrutinise a firm's business plans to assure themselves of its prospective and ongoing viability. While we recognise that some of the proposed mechanisms may not be fully insulated from insolvency action by an administrator in the case of a supplier failure, we believe they would be highly effective in reducing the risks of cost

mutualisation. As part of this proposal, consequential changes would be made to the SoLR licence condition to make clear that the amount of any SoLR levy claim would be reduced by (or could not include) the Protected Amount transferred to the SoLR.

2.12. As urgent change is needed, we believe this approach should be pursued based on it being both more effective in protecting CCBs than some previous proposals, such as an annual auto-refund, and less complex to manage than a client account-based approach (assessed in more detail below).

2.13. While this new requirement should deter new entrants with insufficient capital and poor business models from entering the market and growing unsustainably, efficient suppliers will receive an appropriate return on capital. As such, we do not consider this proposal will deter efficient new entry or innovation, or competition in the market. Our Impact Assessment suggests that this proposal, along with the proposal to ringfence RO payments will have a net benefit for consumers (see Chapter 7).

Approach 2: Client Account

2.14. A client account is a bank account that a person, business, or organisation keeps for a customer in order to keep the customer's money separate from their own. This method of protecting client monies is used in a number of sectors; for example, solicitors are required to keep client money in separate accounts. Implementing such an approach in the retail supply market would likely require a unilateral change to customer contracts to reflect the way payments made by customers are processed.

2.15. If we implemented a client account approach to protect Gross Credit Balances net of Unbilled Consumption, suppliers would be required to collect all payments from customers into a client account with any money held in the account belonging to the customer and not the supplier. Payments received from the customer for energy they have used would be regarded as the supplier's money and would be transferred into the firm's own business account rather than the client account.

2.16. Under this approach, a client account would be managed by the supplier, strictly in accordance with rules set by us. To ensure this mechanism offers effective protection, the supplier would also be required to set up a trust for the account. A trust is a means of securing funds for specific beneficiaries and would ensure that the money in the client account was protected. The supplier would be trustee and hold the funds in trust for its customers. The beneficiaries would be the supplier for defined draw down purposes (such as

bill reconciliation), the SoLR and the customer. In the event of supplier insolvency, the funds would be paid to the incoming SoLR to be held in trust for the customers transferred to it from the failed supplier. To prevent an insolvency administrator delaying payments from the trust, the supplier would grant a security power of attorney in favour of Ofgem.

2.17. If the client account, with the addition of a trust, was managed in accordance with the rules set by Ofgem, the risk of unsustainable supplier growth through the use of CCBs would be reduced. This is because CCBs would be inaccessible for working capital and protected from the risk of being mutualised upon supplier failure.

Why we are not recommending the client account approach

2.18. Using the criteria set out earlier in this chapter, and considering stakeholder feedback we received, including through recent stakeholder workshops and bilaterals, we have discounted the client account approach for the following reasons:

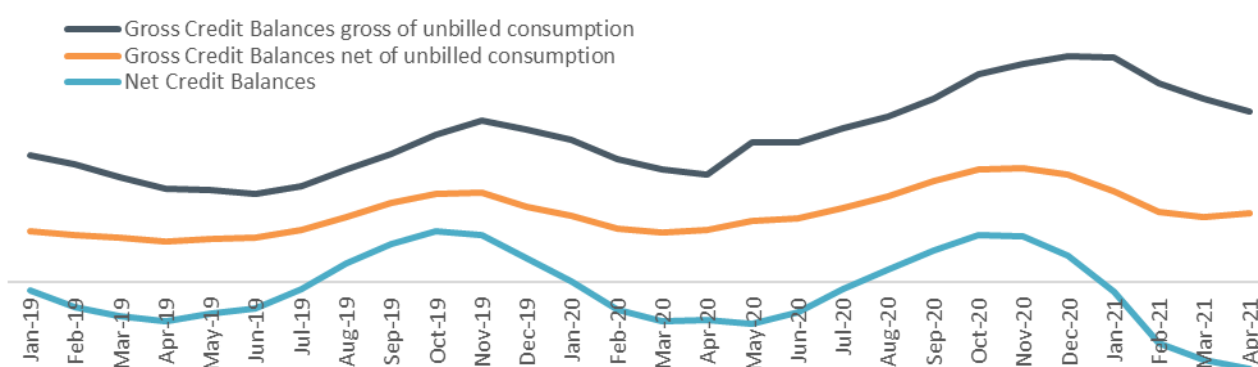
- While we understand that a client account could be set up quickly, we consider that the addition of a trust would add complexity and need to be reflected in the customers' terms and conditions. We consider that the rules determining how a supplier could withdraw and use the funds would need to be detailed and embedded in supplier business processes to ensure authorised withdrawals, for example for billing or customer refund, could be facilitated without undue delay or inconvenience to the customer or the supplier. Ongoing operation would be subject to monitoring by both the supplier and by Ofgem and this is likely to be time-consuming.
- Any requirement for a client account is also likely to have a significant impact on suppliers with less agile systems. In addition, there are likely to be considerable administrative overheads associated with this approach.
- The level of protection against the use of CCBs for risk strategies provided by this approach would depend on the total amount protected, the detailed mechanics, and compliance with the approach. This may be difficult to monitor.

Detailed policy design for ringfencing approach

2.19. We envisage using a Protection Amount Calculation to determine the amount of money a supplier would be required to ringfence. There are several key features of the calculation that would need to be determined. These include:

- the definition of the value to protect (where there is a trade-off to be made between Gross Credit Balance net of Unbilled Consumption and Net Credit Balance – see Figure 3)
- the frequency of updates to the calculation (daily/monthly/quarterly/annually) and;
- the nature of the calculation (based on actual backward-facing data or forward-facing forecast data).

Figure 3: Seasonal profiles and relationship between credit balances



Defining the value to be protected

2.20. In our 14 April 2022 Open Letter¹⁷, we set out how we could see the benefits of defining CCBs for the purpose of a ringfencing requirement as Gross Credit Balance net of

¹⁷ <https://www.ofgem.gov.uk/publications/open-letter-domestic-energy-suppliers-financial-resilience>

Unbilled Consumption¹⁸. We also recognised that an alternative to this is to use the Net Credit Balance definition¹⁹.

2.21. We have received mixed views from respondents regarding the suitability of these definitions.

2.22. The majority of stakeholders support applying the Gross Credit Balance net of Unbilled Consumption definition. They believe it strikes the right balance between protecting a suitable amount of CCBs and the costs of protection. These stakeholders have also noted that only protecting Net Credit Balances would not be sufficient to protect CCBs in the event of supplier failure²⁰.

2.23. A minority of stakeholders are either opposed to any form of CCB ringfencing, or favour applying the Net Credit Balance definition. These stakeholders have noted their concern that significant costs would be passed to consumers were the Gross Credit Balance net of Unbilled Consumption definition used. They have noted that applying the Net Credit Balance definition (factoring customer debit balances into the equation) would reduce the total balance requiring protection and hence the cost of ringfencing arrangements.

2.24. Some stakeholders have also suggested that when the full package of measures described in our Open Letter (including for example restricting the payment in advance model commented on later in this chapter) are considered as a whole, ringfencing applied to 'Net Credit Balances' would suffice.

2.25. We currently remain of the view that Gross Credit Balance net of Unbilled Consumption is the more suitable of the two definitions for prospective ringfencing arrangements. This is primarily because this approach would protect a meaningful²¹ amount of CCBs in the event of supplier failure throughout the year. It is therefore more likely to inhibit the use of CCBs as risk-free working capital and disincentivise excessive risk taking

¹⁸ Gross Credit Balance net Unbilled Consumption, is the accrued credit balance minus the amount of energy a consumer has used since their previous bill date. This is calculated for each customer and positive customer credit balances totalled for the supplier.

¹⁹ Net Credit Balance is calculated in a similar manner to Gross Credit Balance net Unbilled Consumption, however when total, a supplier will include negative customer credit balances (i.e. debt balances).

²⁰ Debit balances generally become the responsibility of an appointed administrator rather than passing to an appointed Supplier of Last Resort in the event of a supplier failure.

²¹ Due to the seasonal variance of energy use, there will be periods throughout the year where a supplier would be required to protect zero credit balances for 'Net Credit Balance', as debt balances are netted off against credit balances.

and poor business models. We also recognise debit balances will ordinarily be pursued by the administrator and not be recoverable by the SoLR in the event of supplier failure, which means that the Net Credit Balance approach may not reduce CCB cost mutualisation materially when a supplier fails. However, we would like to gather further views and evidence on the impacts of the different approaches²².

Frequency of updates to the calculation

2.26. We currently envisage all suppliers being required to update the calculation at the same point on a quarterly basis. This would allow suitable consideration for the seasonal variation of CCBs while preventing undue regulatory burden that may occur with more frequent calculation periods. We consider a quarterly update would also represent a simple and well-understood approach that would align with other financial obligations a supplier may have, such as the proposed quarterly price cap update²³.

2.27. More frequent updates (e.g. monthly) would provide a more accurate view of the necessary protection level but come with increased burden, which on balance may be disproportionate. Conversely, less frequent updates (e.g. bi-annually) carry the risk that protected amounts may be significantly under/overestimated.

2.28. We recognise that, depending on the Protected Amount Mechanism chosen and the nature of individual products, suppliers may need to agree new or amend existing arrangements each time the calculation is updated. This presents another factor for consideration when determining the optimum frequency for updating the calculation.

Nature of the calculation

2.29. We are considering whether ringfencing should be backward facing (using actual data based on billing and consumption records), forward-facing (forecast energy consumption) or a combination of both actual and forecast data.

2.30. Our current preference is that the Protection Amount Calculation would use forward-facing data, forecasting the peak CCBs during the defined period (e.g. quarterly). This would

²² We intend to issue a Request for Information (RFI) to suppliers, alongside this consultation, to gather additional information.

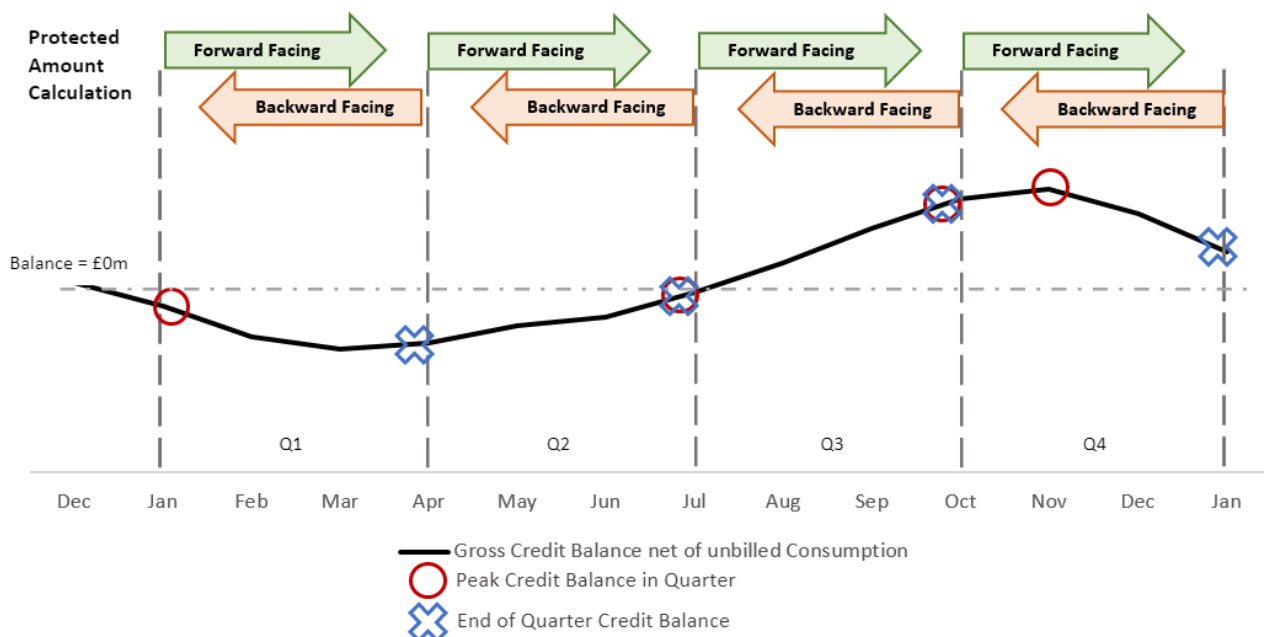
²³ <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology>

provide the highest level of CCBs protection for that period yet does not over-protect balances during periods where seasonality would typically mean that CCBs are low²⁴.

2.31. We recognise that by its nature, forecasting relies on projections that may turn out to be inaccurate, and we would need to consider what guidance suppliers might benefit from to shape their approach and maximise the accuracy of their forecasts. This may be especially true in particular scenarios – for example, for those suppliers with volatile customer numbers.

2.32. An alternative option is a backward-facing approach, where the CCB would be protected at the beginning of the quarter, for the forthcoming quarter. This removes any potential forecasting inaccuracies as it would be based on actuals (likely using data as the books close on the previous month) but may under-provision for one of the key risk periods (Q3 as per Figure 4 below, where the CCB at the start of the quarter is low but increases significantly – this is key as this quarter has typically seen a number of SoLR events, therefore exposing the market to the mutualisation risk this policy is designed to minimise).

Figure 4: Nature of Credit Balances



²⁴ The frequency of the annual curve, as seen in Figure 4, illustrates that we would expect two quarters with higher protection, usually following summer period of low energy use, and two quarters of lower protection requirement, as customers use their credit balances to offset increased winter energy use. If annual period, rather than quarterly, was used then the supplier would be overprotecting a credit balance amount which would be higher, and unrepresentative, of the lower winter period credit balance amount.

2.33. A backward-facing approach might lead a supplier to under-protect if their CCBs amount rose after the calculation was updated, reducing the effectiveness of the measure in protecting CCBs. Conversely, a backward-facing approach could lead to a supplier over-protecting if their CCBs fell after performing the calculation, resulting in efficient cost for the supplier.

2.34. Another option is to use a combination of backward-facing and forward-facing data. This could maximise the benefits and minimise the drawbacks associated with both approaches, but also increase the complexity of the calculation.

Transitional arrangements

2.35. We are considering whether transitional arrangements are necessary and welcome stakeholder views on this.

2.36. We are minded to introduce protections as soon as possible (likely to be the end of the year), particularly as CCBs are expected to rise throughout the summer and with the Government's Energy Bills Rebate²⁵ expected to be implemented from 1st October. However, we recognise that some suppliers use CCBs as an important source of working capital. While we reserve the right to pursue enforcement action where over-reliance on CCBs gives rise to significant risks to consumers,²⁶ we wish to better understand the magnitude of any risks to supplier business models of requiring 100% of CCBs to be ringfenced from the outset. Where the risk exists, we wish to understand the implementation timeframe impacted suppliers believe would be required, and the evidence to support such a timeframe.

2.37. We regularly monitor suppliers' financial condition using information received via our fortnightly Financial Responsibility request for information (RFI), an additional monthly RFI, and a forward-looking stress-testing exercise for 2022/23. We have looked at the CCBs suppliers have told us they expect to hold throughout the rest of the year in relation to their expected current assets, credit condition and access to funding. Our assessment is that domestic suppliers could be able to accommodate ringfencing at least 30% of their Gross Credit Balance net of Unbilled Consumption by Winter 2022.

²⁵ [Millions of most vulnerable households will receive £1,200 of help with cost of living - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/news/millions-of-most-vulnerable-households-will-receive-1200-of-help-with-cost-of-living)

²⁶ There is an existing requirement on suppliers not to be 'overly reliant' on CCBs as working capital (see <https://www.ofgem.gov.uk/publications/decision-proposed-guidance-operational-capability-and-financial-responsibility-principles>)

Monitoring, reporting and compliance

2.38. We propose introducing rigorous reporting and monitoring arrangements to verify and ensure compliance with any new CCBs ringfencing requirements.

2.39. In line with our initial thinking that suppliers would need to update the Protected Amount Calculation quarterly, we currently anticipate issuing a recurring RFI to suppliers on a quarterly basis.

2.40. We anticipate the return would need to demonstrate that the Protected Amount Calculation is accurate. It would also need to provide evidence the Protected Amount has been ringfenced using a Protection Mechanism meeting the relevant supply licence definition and any accompanying guidance, including that the ringfencing is continuously effective (no gap in protection of funds).

2.41. We are also considering whether we would need to obtain further information regarding the financial arrangement or institution providing the Protection Mechanism. For example, we are considering what additional evidence may be required where a letter of credit is provided by a financial institution to confirm the credentials of the institution as being fit for purpose for this specific requirement.

2.42. We could also consider other information such as the solvency of a third-party holding funds, the suitability of a parent company/group structure in providing a guarantee, the presence of an Anticipated Default Notice, and existing or previous enforcement action.

Ancillary proposals

2.43. Alongside our core proposal for a ringfencing mechanism, we recognise that other steps can be taken to prevent the excessive build-up of CCBs in the first instance.

Strengthening existing Direct Debit rules

As part of this consultation package, we have issued a statutory consultation on strengthening existing Direct Debit rules. This consultation can be found on our website alongside this document.

Payment in advance models

2.44. In our 14 April Open Letter, we described how we were considering banning certain 'payment in advance' tariffs (the practice of requiring more than a month's payment from customers before any energy is supplied.). We intend developing our thinking on this area further with a view to publishing a future consultation on potential changes.

3. Renewables Obligation

Summary

In this chapter we set out the issues associated with the Renewables Obligation (RO) and why we think change is needed. We describe the policy options we have assessed and explain why we intend pursuing the proposal we have set out. We are seeking views on the key design features of our proposed approach; comment on the need for transitional arrangements; and comment on our proposed approach to monitoring, reporting and compliance activities.

Questions

Question 5: Do you agree that option 3 ('protect RO payments or discharge through ROCs' obligation) is the best approach for addressing supplier payment default under the RO - and if not, what is your preference and why?

Question 6: How, and to what extent, would a requirement to protect your RO impact your business and the way you currently interact with the scheme? If we were to ask suppliers to create a trust in favour of Ofgem over the proceeds of sale of ROCs, do you foresee any challenges with this and would it disincentivise you from buying ROCs?

Question 7: How, and to what extent, do you think a requirement to protect your RO would impact the ROC market?

Question 8: Do you agree the proposal should be effective from April 23? Do you see any issues or concerns with the transitional phases we have laid out?

Question 9: What, in your view, would be the appropriate frequency of the reporting requirement: once an obligation period or quarterly?

Background

3.1. The Renewables Obligation (RO)²⁷ supports the generation of renewable electricity through a system of tradable green certificates called Renewables Obligation Certificates (ROCs)²⁸. Ofgem, the scheme administrator, issue ROCs to accredited generators for the amount of renewable electricity generated in a given period. Generators sell the ROCs to suppliers or traders, which gives generators a premium in addition to the wholesale price of their electricity. Designated Electricity Suppliers (suppliers) are under an obligation to present a certain number of ROCs to Ofgem or make a fixed payment into a buy-out fund in lieu of each ROC in order to discharge its RO. Cash payments are recycled to suppliers who met their obligation with ROCs, giving ROCs additional value. The cost of the RO to suppliers is passed on to consumers through electricity bills.

3.2. Under the current arrangements, suppliers accrue an obligation (the RO) over a 12-month obligation period (1 April - 31 March) and have 5 months to settle their obligation either by paying into the buy-out fund by 31 August, presenting ROCs by 1 September or a combination of both. Suppliers are also allowed a 2-month late payment period between 1 September and 31 October in which daily interest rates are charged. In total, this adds up to the maximum of 19 months' worth of obligation that an insolvent supplier can default on (or a supplier who, for example due to cashflow difficulties, can default on due to a failure to pay). Recently, there has been an increasing number of electricity suppliers exiting the retail market and defaulting on their RO. Defaults manifest as shortfalls in the buy-out fund. The GB schemes feature a 'mutualisation' mechanism which seeks to recover shortfalls once a certain threshold has been reached, from other electricity suppliers, once they exceed a threshold. The threshold in England and Wales was recently increased to make mutualisation less likely to be triggered. This change may reduce the instances of mutualisation being triggered but the underlying causes of payment default remain. Unless these are addressed, mutualisation remains a cost passed to other suppliers in the market (which is ultimately passed on to consumers, as described in more detail below).

3.3. Consumers pay for the RO as part of their electricity bill. Therefore, as set out in Ofgem's open letter dated 14 April 2022²⁹, under the current arrangements outlined above,

²⁷ Where "RO" is used in this document it denotes the Renewables Obligation (RO) Order and the Renewables Obligation (Scotland) (ROS) Order. The separate Orders are individually referenced where necessary.

²⁸ Where "ROC" is used it denotes certificates issued under all three Orders (ROCs, SROCs and NIROCs).

²⁹ Open Letter to domestic energy suppliers – Financial Resilience | Ofgem

suppliers are able to use money collected from consumers to pay for the RO as risk-free working capital rather than setting it aside to meet their RO. On failure, payments due under the RO scheme, above a threshold, are effectively insured through mutualisation. This means that the cost of a supplier failing to meet their RO due to insufficient funds and / or supplier failure, is borne by other suppliers - who pass the costs on to consumers in the form of higher electricity bills.

3.4. To address the underlying causes of payment default under the RO, Ofgem proposes to make changes to the Standard conditions of electricity supply licence (SLCs) that place a requirement on licenced electricity suppliers to protect their RO liabilities/payments. Further details are set out later in this Chapter.

Previous proposals on the RO Payments protection

3.5. As set out in chapter 1 on the RO, we consulted jointly with BEIS in 2021³⁰ on options to reduce the risk of mutualisation under the scheme. As explained in the joint response³¹, due to significant changes in the energy market with many suppliers exiting the market following a spike in gas prices, which made continuing to operate unviable for many, BEIS decided not to proceed with changes to RO legislation. BEIS wanted to take the time to consider the wide range of complex issues affecting the market, longer-term reform of the RO and the potential to change the RO to a Fixed Price Certificates (FPCs) scheme. We understand that BEIS is aiming to issue a call for evidence on FPCs later in the year.

3.6. BEIS also issued a call for evidence on a revised approach to the way in which the mutualisation amount is calculated once mutualisation has been triggered³². The responses to this call for evidence will be considered in the round, alongside both the short and long-term interventions listed in the joint response³³.

3.7. In addition, the Scottish Government published a consultation in November 2021³⁴, where they consulted on aligning mutualisation arrangements for the Renewables Obligation (Scotland) (RO(S)) with the RO, increasing the frequency of the RO(S) settlement, making

³⁰ Consultation on addressing supplier payment default under the Renewables Obligation(RO) | Ofgem

³¹ BEIS/Ofgem joint response to the Consultation on addressing supplier payment default under the Renewables Obligation (RO) | Ofgem

³² Renewables obligation: changes to mutualisation arrangements | BEIS

³³ BEIS/Ofgem joint response to the Consultation on addressing supplier payment default under the Renewables Obligation (RO) | BEIS

³⁴ Renewables Obligation (Scotland) scheme changes: consultation | Scottish Government

changes to the SLCs or continuing with the existing policy. The Scottish Government have not yet published their decision on this consultation. However, when they do, we will ensure we work closely with them and adjust our proposals if needed.

3.8. The proposals on the RO outlined in this policy consultation are intended to address the risks described above. We are consulting on changes to the RO and CCBs together to ensure the policies can be considered holistically and the impacts considered jointly.

3.9. Ofgem has engaged with stakeholders through bi-lateral meetings and workshops between February and May 2022. It also circulated an open letter in April 2022 to which stakeholders had the opportunity to respond.

Stakeholder views

3.10. The responses to the joint consultation with BEIS and to the Supplier Licensing Review (SLR) Consultations, coupled with the feedback obtained from more recent stakeholder engagement and informal consultation have helped us to develop the proposals on which we are now consulting.

3.11. Stakeholders who responded to our SLR consultation were generally supportive of the intention behind the measures proposed (to minimise mutualisation in the event of supplier failure / non-payment). However, views differed on what protections should be put in place. There was strong support amongst stakeholders for a phased implementation with the protection being set lower initially but then rising to 100% following review in year 2 or 3. Stakeholders argued that this would allow suppliers time to adjust their business plans, and that moving too quickly could push suppliers out of the market. Stakeholders were also keen that, for the RO, we explore options with BEIS for increasing the frequency of RO payments to quarterly in order to prevent the build-up of the RO debt as the year progresses and mitigate the risk of cost mutualisation in this area. On protection mechanisms, stakeholders had some concerns on the availability of protections, and how quickly these could be put in place. In addition, some stakeholders (specifically, larger suppliers) suggested that Ofgem should be taking a risk-based approach to the imposition of these measures, focusing on suppliers at risk of failure / payment default.

3.12. Responses from stakeholders to our joint consultation with BEIS demonstrated a wide range of differing views on how best to address supplier payment default under the RO. Responses to the consultation were mixed and whilst they indicated a preference for change via Legislative Reform, the detail provided in some cases explained that moving to more

frequent settlement would have a negative effect on some supplier businesses. Furthermore, whilst some suppliers highlighted the positive impacts of more frequent settlement, others showed support for Ofgem introducing a licence-based requirement. For the reasons outlined in paragraph 3.5, BEIS does not consider that introducing a legislative requirement in the short-term to move to more frequent settlement is the right approach.

3.13. Stakeholder responses to more recent workshops, bilaterals and our April open letter were consistently supportive of aligning the obligation to protect the accruing RO (i.e., a cumulative quarterly assessment of accruing RO throughout the obligation period) and using a backward-facing basis for the protection. There was also unanimous support for suppliers being able to discharge the obligation to protect by demonstrating that they hold purchased ROCs. Not allowing such an approach would risk disincentivising ROC purchase and overall engagement with the ROC market. Most stakeholders said they would be supportive of in-year reviews of the amount protected to take into account significant changes.

3.14. A small number of stakeholders again raised concerns around the approach to both CCBs and the RO, arguing that policy should be targeted at certain suppliers and based on a risk assessment of each supplier's position. They argued that the risk of mutualisation lay firmly with only a small number of suppliers, and that many suppliers had robust strategies to avoid cost mutualisation as demonstrated through their ability to withstand recent volatility in the market, and the steps they take to ensure sums due under the RO are secure (for example, through ring-fencing in their balance sheets).

3.15. Stakeholders agreed that it would be important to think about implementation timelines and a sufficient transition period, in whichever policy was taken forward to allow suppliers sufficient time to put in place funding and to make the necessary adjustments. Stakeholders also explained that they think that it is important that Ofgem consider the impact that all the proposals taken together (i.e., CCB protection measures, capital adequacy requirements, RO protection measures etc) will have on suppliers. This includes the impact that monitoring compliance with the proposals (for example through requests for information) will have. They consider that it is important that Ofgem understand the administrative costs and timeline pressures these measures could have on suppliers so that, if the measures are implemented, Ofgem can include ways to make sure suppliers can manage implementation sensibly.

3.16. The majority of stakeholders did not anticipate unintended consequences arising from the RO policy as set out (see Proposed Policy section below). However, one stakeholder raised concerns over the collateral coverage (i.e., where a supplier uses assets in order to secure a

loan) that would be required, and the impact on potential investment and profit margins. One stakeholder also raised concerns over the interaction with the price cap (the cap on prices that suppliers can charge customers - this is set by Ofgem).

3.17. On the question of transition, stakeholder views were mixed. A number of stakeholders said transition periods should be the same for all suppliers. One stakeholder argued that RO should come before CCBs in the transition sequence, and another stakeholder said RO transition should be quick to target winter 2022. Conversely one stakeholder said that RO and CCBs should move together.

Our views

3.18. Our joint consultation on addressing supplier payment default under the RO underlined for us the importance of taking action to address the issue of RO mutualisation. Suppliers were, in the majority, strongly in favour of taking swift action in this area. Mindful of both our desire to address the RO mutualisation risk, and support from suppliers to do something in this area, we are proposing to implement a regulatory solution through changes to the SLCs.

Assessment of licence-based options

3.19. In determining how to address the risks of RO cost mutualisation by regulatory means, we have assessed three potential options against the following criteria: (i) likely effectiveness in meeting our objectives to remove incentives for suppliers to take excessive risk and pursue risky business models and reduce the mutualisation costs directly associated with the RO; (ii) deliverability (speed, implementation and ongoing administration costs); (iii) likely impact on existing business models (including impacts on financial stability, innovation, competition) and (iv) wider consumer impacts.

Option 1: A 'report or protect' obligation

3.20. A 'report or protect' obligation would be a reporting framework requiring a supplier to provide evidence on a quarterly basis (with the first quarter beginning on 1 April) of their strategy to meet their RO obligations, failing which they would be required to protect the RO payments using an agreed mechanism that is as insolvency remote as possible. Suppliers would have the option to protect the RO payments voluntarily as an alternative to reporting requirements.

Pros of Option 1

- This option would provide us with early sight of supplier risk of insolvency, allowing us to take action to address and mitigate mutualisation risks as issues arise – primarily by requiring RO payments to be protected.
- It is anticipated that there would be minimal impact on working capital for those suppliers able to report on their ability to comply.

Cons of Options 1

- For those suppliers choosing to report, this option could leave the whole of their RO unprotected. At the point at which we identify a potential problem through our monitoring, it may be too late to require the supplier to find the necessary resources to protect the RO payments without pushing the supplier into insolvency. As such, there may be a significant risk that this option would not be effective in removing incentives for suppliers to pursue risky business models.
- There may be a risk that mutualisation could still occur as the option would not require all suppliers to protect funds.
- There could be an uplift in reporting requirements for suppliers.
- For those suppliers protecting their RO, or those suppliers who are unable to provide compliant reports, there could be an impact on working capital.

Option 2: A 'protect' obligation

Note: This option has now been discounted given that we consider the impact on the ROC scheme and the supplier's financial resilience render it unviable

3.21. Suppliers would be required to protect the amount of their RO liabilities using a mechanism that is as insolvency remote as possible, regardless of whether they have purchased ROCs.

Pros of Option 2

- This would be effective in the sense of providing protection that is as insolvency remote as possible / a way in which to protect against payment default.
- Over time consumers should face reduced risks and costs of mutualisation under the RO.
- As suppliers will no longer be able to rely on the RO amounts collected from consumers as a source of free working-capital it should help ensure suppliers are more financially resilient and consumers are less likely to be exposed to the risks of supplier failure.

Cons of Option 2

- This option could have a significant negative impact on suppliers' engagement with the ROC market, and the viability of the RO scheme. If suppliers had to ringfence or otherwise protect a sum equivalent to their RO obligation that did not take account of ROCs purchased, that could disincentive them from purchasing ROCs. As a result, consumers would be paying for a jeopardised renewable electricity scheme.
- To the extent that suppliers protected the relevant amount of RO liabilities *and* purchased ROCs, there could be duplication or 'double-payment' of their obligations (i.e. there could be an impact on working capital for the time that the obligation to protect and the procurement of ROCs coincide) which could be likely to undermine their financial resilience and possibly lead to greater supplier failure – with negative consequences for consumers.
- Since suppliers would have to ringfence or otherwise protect RO payments, there could be an impact on working capital for all suppliers. While our Impact Assessment suggests that this proposal, along with the proposal to ringfence CCBs, will have a net benefit for consumers (see Chapter 7), that may not be the case if there is double counting of supplier obligations or if it impacts on the viability of or undermines the RO scheme.

3.22. We considered a number of approaches to address the risks of suppliers having to double-pay for the RO and/or being discouraged to purchase ROCs. Allowing suppliers to 'draw-down' protected sums for the purpose of ROC purchase would provide flexibility, but our view was that it would be difficult for suppliers to manage and for Ofgem to monitor and ensure compliance, though we would be grateful for stakeholder views on this. We also

considered evidencing of ROCs through power purchase agreements but do not think that this would provide a workable solution or the right level of protection. The best solution appears to be to allow suppliers to use ROCs held to discharge their obligation to protect. We therefore incorporated this solution into the third option we developed.

Option 3: A 'protect or discharge through ROCs' obligation

3.23. This option would require suppliers to evidence that their accruing RO is being met by holding ROCs or protecting funds equivalent to their liability in a mechanism that is as insolvency remote as possible – or a mixture of the two. As an additional protection, we are considering requiring suppliers to create a trust in favour of Ofgem over the proceeds of sale of these ROCs (up to the Buy-out price value and any late payment fees) so that Ofgem would be paid any value realised by an insolvency practitioner post-insolvency and would have the right to draw down on any sums in that trust account in the event of supplier insolvency or payment default).

Pros of Option 3

- This option provides protection from insolvency, or payment default, whilst still supporting interaction with the ROC market.
- Over time consumers should face reduced risks and costs of mutualisation under the RO.
- As suppliers will no longer be able to rely on the RO amounts collected from consumers as a source of free working-capital, it should help ensure suppliers are more financially resilient and consumers are less likely to be exposed to the risks of supplier failure.
- Likely to have less impact on working capital than option 2, as suppliers would be able to discharge their obligation to protect through the purchase of ROCs.

Cons of Option 3

- Added requirements of suppliers having to put in place protections and a significant uplift in reporting requirements.

- There could be a risk that the proposed trust arrangement would disincentive ROC trading or will not work as envisaged to deliver a complete 'insolvency remote' solution, which may undermine the effectiveness of this proposed solution. Options for mitigating this risk are set out in paragraph 3.25 below.

Proposed policy for Renewables Obligation Ringfencing

3.24. Having considered these options in the context of the stakeholder feedback we have received so far, we are proposing a policy in line with option 3 above that requires suppliers either to ringfence or otherwise protect funds equivalent to their liability under the RO ('RO Protected Funds') or, alternatively, to discharge (partially or in full) their obligation to protect funds by demonstrating that they hold ROCs in their account on the Register. Suppliers would need to ensure RO Protected Funds were held in a mechanism that is as insolvency remote as possible, choosing from a 'menu' of options, as for CCB. The Approved Protection Mechanisms we are considering are set out in Chapter 4. As indicated above, once the RO Protected Funds are ringfenced or otherwise protected, suppliers would not be able to 'draw-down' protected sums for the purpose of ROC purchase within the protection period (i.e., quarterly), so suppliers will need to decide as the obligation arises whether to ringfence the monies or to purchase ROCs.

3.25. We have considered an alternative approach to ringfencing RO Protected Funds, namely the client account approach discussed in Chapter 2. We have concluded that this approach is not appropriate for the reasons set out in that chapter. Furthermore, there are benefits in terms of administrative convenience and economies of scale in deploying the same method for protecting both CCBs and RO payments.

3.26. As noted above, one potential risk of allowing suppliers to purchase ROCs instead of ringfencing or otherwise protecting RO Protected Funds is that if the supplier becomes insolvent, consumers will not automatically receive the value of those assets. In order to ensure that mutualisation costs on supplier failure are minimised, we are considering requiring suppliers to create a trust in favour of Ofgem in respect of the proceeds of sale of any ROCs sold (up to the Buy-out price value of each ROC) so that Ofgem would have the right to draw down on these sums in the event of supplier insolvency or payment default or would have the right to be paid any funds realised by the sale of ROCs in an insolvency. If suppliers want to sell ROCs, they would be required to protect the proceeds of sale or an equivalent amount in the same way as RO Protected Funds (i.e., via an insolvency remote mechanism). We may consider allowing suppliers to draw down from these proceeds of sale

to buy new ROCs. We are still testing the feasibility of such an approach and would be grateful for views from stakeholders on this.

3.27. We consider that the approach described above best achieves our two main objectives: to remove incentives for suppliers to take excessive risk and pursue risky business models, and to reduce the mutualisation costs directly associated with ROs. Allowing suppliers to purchase ROCs instead of protecting the equivalent amount should provide an incentive to continue to engage in the ROC market, though we recognise that there is still a risk of unintended consequences (such as disincentivising ROC purchase, with possible knock-on effects on generators).

3.28. In addition to the broad design options outlined above, we have also considered how frequently we should expect suppliers to ringfence or otherwise protect RO Protected Funds and whether to use a forward-facing or backward-facing approach to protection.

Protection Period

3.29. For the periods across which RO sums must be protected we looked at using either six-monthly, quarterly, or monthly periods. The longer the periods the less administrative burden there would be on suppliers and Ofgem, but also the greater the sums at risk of mutualisation. At this stage, we consider that adopting a quarterly protection period finds a good balance between putting in place regular protection of RO sums and being manageable for suppliers and Ofgem. This was also the payment period that was favoured by suppliers in both the joint consultation with BEIS, as well as in subsequent bi-laterals and workshops. In addition, a quarterly payment period aligns with Levelisation under the Feed-in Tariffs (FIT) scheme for which most suppliers obligated under RO already provide quarterly supply volumes.

Forward or Backward-facing protection

3.30. We explored the advantages and disadvantages of either using a forward-facing forecast for protection (i.e., where suppliers would put protections in place ahead of the RO obligation period) or backward-facing forecasts (where suppliers put protections in place at end of a specified protection period).

3.31. Using a forward-facing forecast would require suppliers to estimate or forecast their upcoming RO for that period. Such an approach has the advantage that protection would be

in place before the start of the protection period, meaning those sums would be protected in case of supplier failure.

3.32. A retrospective or backward-facing assessment using actual supply volumes would be based on a level of RO liability closer to the actual obligation, but it would leave (assuming a quarterly protection period) four months' worth of RO liability at risk of mutualisation (three months of obligation plus one month to put protections in place).

3.33. On balance, we prefer a backward-facing forecast for the following reasons:

- It aligns with the accruing of the RO, with suppliers being asked to demonstrate their estimated ROC obligation or, where they are unable to demonstrate ROC purchase, protect funds equivalent to the ROC buy-out price they have secured from consumers through billing. This is fairer and less costly to suppliers;
- Suppliers were supportive of using a backward-facing basis during workshops; and
- It mirrors the process on an existing and similar government scheme – FIT Levelisation – which also uses a backward-facing forecast, actual supply volumes and subsequent third-party verification.

Table 2: Summary of preferred detailed design options

	Reasons for preferred design option
Allowing suppliers to use ROCs to discharge of their obligation to protect (under Option 3)	<ul style="list-style-type: none"> • Means suppliers can continue to engage in the ROC market • Reduces risk of cost mutualisation (particularly if we can implement a trust to protect ROCs).
Quarterly Protection Period	<ul style="list-style-type: none"> • Provides balance between regular protection of RO and being manageable for suppliers / Ofgem. Less burden than monthly protection but more protection than six-monthly variant. • There should be no more than four months of the RO at risk of mutualisation at any time – a significant improvement on the 19 months currently at risk • Impact should be minimal as the supplier is being required to protect what they are receiving from the consumer to pay for their RO
Backward-facing protection	<ul style="list-style-type: none"> • Suppliers would be protecting what they are receiving from the consumer to pay for their RO– impact on working capital should therefore be minimal and therefore be less costly for suppliers to put in place • Avoids having to estimate supply figures • Aligns to the accruing RO and the FIT scheme

Methodology

3.34. We cover the methodology behind the proposed policy in more detail in the Appendix to this document but have also provided a summary here.

How will the quarterly amount be calculated

3.35. The annual RO for each supplier is calculated according to the amount of electricity they supply to customers during each obligation period minus electricity they supply to Energy Intensive Industries (EIIs) (the 'relevant electricity' supplied).

3.36. To deliver the proposed policy, suppliers would be required to demonstrate they were meeting an accruing amount on a quarterly basis – either by collecting ROCs or putting credit cover in place.

3.37. Following each quarter, a supplier's electricity supply volumes for that quarter would be determined and the prevailing renewables obligation (ROCs per MWh) would be applied to that volume. This would set the 'Quarterly Amount' in ROCs.

3.38. In line with the published FIT levelisation schedule, which usually allows around a 10-working day period after the first day following the quarter for suppliers to provide electricity supply data to Ofgem, we anticipate aligning timings under the RO and publishing a schedule ahead of the upcoming obligation period.

How will the cumulative amount be calculated

3.39. At the end of each quarter, the total of all Quarterly Amounts within that obligation period would be combined. This would be the 'Cumulative Amount' in ROCs.

3.40. The result of this is that the cumulative amount will not match the annual obligation. However, the discrepancy is expected to be <1%. Furthermore, a near identical process already occurs on FIT whereby 'periodic levelisation' using less accurate supply volume data is reconciled with accurate volumes at the end of the FIT year via 'annual levelisation'.

How will suppliers meet the cumulative amount

3.41. Suppliers would need to meet their Cumulative Amount with ROCs and/or credit cover by a set date at the end of each quarter ('the deadline date'). We anticipate aligning the deadline date with the FITs levelisation schedule which would mean that this date would usually be 10 working days after Ofgem has communicated the 'Cumulative Amount' to suppliers. Any of the Cumulative Amount not met with ROCs must be met with credit cover that equals or exceeds the value of those ROCs according to the buy-out price in that obligation period.

ROCs submission

3.42. Given that Cumulative Amount would be measured in ROCs, we would look at the number of ROCs in the supplier's account on the Register with a status of "issued" at the end of each quarter.

3.43. To calculate the number of ROCs a supplier holds in at the deadline date for each quarter, we would capture the number of ROCs in the supplier's account at a set time on the deadline date. This deadline will be communicated to suppliers and published within the schedule ahead of the obligation period.

Credit Cover value calculation

3.44. Any amount of the Cumulative Amount not met with ROCs must be met with credit cover. Suppliers would be responsible for deciding which (if any) protection measure to present to Ofgem. This would be presented to Ofgem by the deadline date.

3.45. Ofgem would provide guidance and templates to suppliers on the evidence of protection that they would need to submit in order to demonstrate their compliance. Ofgem will check these submissions to ensure that they meet requirements (as set out in guidance, and in line with the provided templates).

Compliance, monitoring and enforcement

Assessing compliance

3.46. If we were to proceed to implement this option, we anticipate that the compliance assessment would occur following the deadline date, each quarter. It would capture the value

of ROCs in the supplier's account and value of credit cover they have lodged on the deadline date/time.

3.47. If, on the deadline date, the cumulative amount is met or exceeded, the supplier is compliant. If it is not, the supplier is non-compliant.

3.48. A non-compliant supplier would be notified, and Ofgem would then deal with each case of non-compliance individually and in line with our Enforcement Guidelines³⁵.

3.49. For any late submissions, Ofgem would again check the ROCs in the suppliers account and the credit cover value against their cumulative amount and determine compliance. Any late submission would be considered a non-compliance and the supplier would be listed on the Supplier Performance Report (the SPR).

Monitoring

3.50. We expect that further guidance would be published outlining additional detail on how suppliers will demonstrate compliance with the policy, should we ultimately decide to proceed with this proposed option. However, we want to set out a high-level approach, and options for monitoring.

3.51. It is agreed that suppliers may retrospectively change the composition and ratio of cumulative amount protected. For example, a supplier may elect to meet a quarterly amount using:

- Only credit cover or only ROCs. In following quarters, they may swap this with the other or a mixture of the two (e.g., withdraw protection/sell ROCs).
- A mixture of credit cover and ROCs. In following quarters, they may change the ratio of this mixture.

3.52. We considered whether we would allow these changes to occur unfettered between deadline dates or only at set points during the year and impose additional rules, for example:

³⁵ The Enforcement Guidelines | Ofgem

- the value of protection never falls below the cumulative amount (e.g., a supplier must lodge protection before selling ROCs)
- the value of protection may fall below the cumulative amount. However, the deficit must be filled within a certain period (e.g., 10 working days)
- protection changes must be reported to Ofgem according to criteria (e.g., if they exceed an absolute value or proportion of the supplier's quarterly/cumulative amount).

3.53. Our view is that monitoring of changes between deadline dates would be too complex, unpredictable and potentially resource intensive. Enforcement would also be difficult as there will be challenges in evidencing that these requirements were breached. Therefore, we propose that we should assess a supplier's compliance with their cumulative amount exclusively at the quarterly deadline dates. However, as described above, we anticipate that we would require suppliers to create a trust over the proceeds of sale of any ROCs up the Buy-out Price value. This would help ensure that the value of those ROCs would survive insolvency and / or be available to Ofgem on payment default to help reduce mutualisation.

Enforcement

3.54. Should a supplier fail to provide satisfactory credit cover, fail to grant a trust over the proceeds of sale of ROCs in favour of Ofgem and/or not hold sufficient ROCs by the deadline imposed, that supplier may be in breach of the relevant SLC which would leave it open to Ofgem to consider enforcement action.

3.55. In considering enforcement action, we would follow Ofgem's Enforcement Guidelines. The circumstances of each case would be assessed on its own merits, with Ofgem having discretion to take appropriate action in any given situation.

Transition

3.56. We are considering the transitional arrangements that need to be put in place for the proposed policy. We want to put a policy in place as soon as practicable to remove incentives for suppliers to take excessive risk and pursue risky business models and to reduce the mutualisation costs directly associated with RO payments. However, we also want to provide suppliers with an appropriate amount of time to transition, to ensure that our policy does not create resilience issues.

3.57. Our view is that suppliers should protect their full RO on a quarterly basis from the Obligation Period³⁶ starting April 2023, with the following phasing arrangements:

- **Phase 1a – short-term:** Immediately to 31 October 2022. We will require suppliers to report to us, to demonstrate how they plan to comply with their RO (for 2021/22) during this period. If it becomes clear that any supplier does not have adequate financial arrangements in place to meet RO costs at risk of being mutualised, we will consider compliance and enforcement action.
- **Phase 1b – short-term:** 31 October 2022 to 31 March 2023. We will require suppliers to report to us, to demonstrate how they plan to comply with their RO (for 2022/23) during this period. If it becomes clear that any supplier does not have adequate financial arrangements in place to meet RO costs at risk of being mutualised, we will consider compliance and enforcement action.
- **Phase 2 – long-term:** 1 April 2023 onwards. Proposed policy comes into effect: Suppliers must protect their RO (from 1 April 2023) on a quarterly backward-facing cumulative basis either through putting credit cover in place or discharging through ROC purchase.

Phase 1a and b – short-term

3.58. Whilst we continue to develop and implement our proposals, we intend to issue requests for information using our existing information-gathering powers³⁷ to more fully understand how suppliers currently plan to meet their obligations. We expect to implement this requirement (with Phase 1a falling immediately to 31 October 2022, and Phase 1b falling 31 October 2022 to 31 March 2023) until the proposed policy comes into effect (currently expected to be April 2023).

³⁶ Obligation Period means the period starting on 1st April 2016 and ending on 31st March 2017 or any subsequent period of 12 months (ending with the period of 12 months ending on 31st March 2037), except for the purposes of article 95" Art 2(1) of the ROO 2015 (as amended)

³⁷ The Renewables Obligation Order 2015, Article 79 and The Renewables Obligation (Scotland) Order 2009. Article 53

3.59. We welcome stakeholder views on the appropriate frequency of such a reporting requirement. We envisage that this may be issued once in the obligation period or as a quarterly reporting requirement:

- Issuing a request for information on a one-off basis to suppliers in the obligation period would be based upon a forecasted estimated of their obligation. A one-off request may be less administratively burdensome for suppliers, and appropriate for an interim reporting requirement.
- A quarterly request for reporting would be issued 10 working days after Ofgem issues suppliers with their calculated obligation. This would mimic the proposed frequency of our protection proposals, as well as the existing FIT scheme. A quarterly reporting requirement would remove the need to estimate renewable obligations and allow Ofgem to more closely monitor how suppliers intend to fulfil fluctuating obligation amounts.

3.60. Whilst we are yet to determine the precise nature of the information that we will request, we anticipate that we may ask suppliers to provide:

- A plan setting out how they will meet their RO;
- Evidence that funds accrued through consumer bills for RO are being effectively managed, e.g., through ringfencing, guarantees, or other measures/approaches;
- Evidence of any valid ("issued") ROCs through the Register; and
- Evidence of sufficient funds if the supplier intends to pay out into buy-out fund, e.g., cashflow forecasts, loans, or other forms of financing.

Phase 2 – long-term

3.61. We welcome stakeholder views on our proposal that suppliers should protect their full RO on a quarterly basis from the Obligation Period starting April 2023.

3.62. Similar to the approach described in Chapter 2 for CCBs, we have looked at the RO costs that suppliers have told us they expect to hold throughout the rest of the year in relation to their expected current assets, credit condition and access to funding. Our assessment is that domestic suppliers could be in a position to accommodate ringfencing of their full RO from April 2023.

4. Protection Mechanisms

Summary

We are proposing suppliers should protect both funds for the fulfilment of RO liability (RO funds) and CCBs through the use of measures selected from a 'menu' of mechanisms. In this chapter we set out the mechanisms that we are minded to accept as approved protection mechanisms. We are seeking views from stakeholders on these mechanisms and how they could be implemented.

Questions

Question 10: Do you agree with suppliers being able to select from a menu of protection mechanisms and do you agree with the mechanisms we are considering?

Question 11: Do you agree with the minimum requirements set out for each protection mechanism and do you have any further comments on the protection mechanisms or the guidance that should be provided on them?

Question 12: Do you consider that suppliers would be in a position to obtain suitable insurance to protect CCB or RO funds, and, if so, do you think that this would be competitively priced?

4.1. In our proposals to protect both RO funds and CCBs, we are minded to require suppliers to adopt one or more of a number of possible 'approved' protection mechanisms which are designed to afford a degree of protection, in order to minimise the cost of mutualisation on the consumer.

4.2. In this chapter we will detail the proposed 'approved' protection mechanisms that we consider suitable at this time. The requirement to implement approved protection mechanisms would be set out in licence modifications made to supplier licences and would require (i) the "protected amount" in each case to be the subject of the mechanism; (ii) a quarterly process for the protected amount to be calculated; and (iii) the supplier to provide information, certification and evidence to Ofgem in a form approved by it that protection measures that fully cover the protected amount are in force and effective. We detailed the

methodology for calculating these protection amounts for CCB and RO, in Chapters 2 and 3 respectively.^{38 39}

4.3. The licence modifications would also deal with how the supplier is able to change or supplement the approved protection measures over time. We will continue to review other protection measures as they become available and consider their eligibility as 'approved' protection measures.

4.4. Noting that each mechanism has particular pros and cons, we are minded to approve the following mechanisms. One factor we have considered is the extent to which each may protect funds if a supplier becomes insolvent (i.e. the extent to which each mechanism may be insolvency remote). The mechanisms are:

- Trust Account;
- Escrow Account;
- Third Party guarantee;
- Parent Company Guarantee;
- Standby Letter of credit.

4.5. We envisage these mechanisms could potentially be made available as a 'menu' of 'approved' protection mechanisms. Here a 'menu' refers to a limited set of Ofgem pre-approved mechanisms. This allows some optionality for suppliers to select the protection mechanism that best suits their business.

4.6. Our view is that, whilst restricting the 'menu' of protection mechanisms may mitigate against any potentially disparate impact across suppliers, doing so may not deliver our overarching aim of minimising the cost of mutualisation on the consumer. It is therefore our preference to allow suppliers to select a mechanism from a 'menu' of protection options.

4.7. The protection measure or measures selected by each supplier would be required to meet the minimum requirements for that measure. Our current thinking about these

³⁸ CCB Chapter, 2.20-2.35 (Page 27-32)

³⁹ RO Chapter, 3.34- 3.44 (Page 45- 47)

requirements is summarised in this consultation document but would be set out in more detail in licence modifications and any associated guidance.

4.8. Whilst we are aware that there are pros and cons to ringfencing funds using these protection mechanisms, we feel such an approach best meets our objectives. We have further detailed our rationale for ringfencing CCB and RO funds in Chapters 2 and 3, respectively.⁴⁰⁴¹

Trust

4.9. We are of the view that suppliers should have the option to hold protected amounts relating to the RO and CCBs on trust. It is proposed that these funds will be held in a separate bank account, acknowledged by the bank to be a trust account, only to be drawn down for purposes specified in the declaration of the trust and set out in the licence condition. Suppliers would be required to recalculate the protected amount quarterly and adjust the amount held in trust accordingly.

4.10. In this mechanism, the supply licence modifications would require:

(a) a declaration of trust by the supplier in respect of the relevant protected amount(s) that meets minimum requirements specified by Ofgem. The minimum requirements would include at least that:

- I) the supplier would be the trustee;
- II) the beneficiaries would be as stated in the relevant licence condition. In respect of RO protected amounts, the beneficiary would be Ofgem as it administers the RO, however, if we were to ultimately decide to ask suppliers to create a trust over the proceeds of sale of ROCs, the supplier may also be a beneficiary of that trust account for certain purposes (see III and (c) below and RO, chapter 3, paragraph 3.25 or more details). In the case of CCB protected amounts, the beneficiary would be Ofgem (or Ofgem's nominee(s), i.e. one or more SoLRs

⁴⁰ CCB, Chapter 2, 2.11-2.14, (Page 24-25)

⁴¹ RO, Chapter 3, 3.23 – 3.26, (Page 42- 43)

appointed in respect of the relevant supplier's customers) for the benefit of the relevant supplier's retail customers;

- III) the supplier would be entitled to access funds from the account for purposes stated in the relevant licence condition. In the case of CCBs, this would be (i) to settle amounts payable by customers in relation to supplied energy (in accordance with the condition) or (ii) if and to the extent that the amount credited to the trust account exceeds the then applicable protected amount. In the case of a trust account over the proceeds of sale of ROCs (if we were to ultimately decide to ask suppliers to create a trust over the proceeds of sale of ROCs), this could be to purchase new ROCs;
- IV) Ofgem would be able to direct the bank and the supplier to pay the protected amount to Ofgem (in the case of the RO) or a person or persons nominated by Ofgem (e.g. one or more SoLRs) (in the case of CCBs), on any insolvency of the supplier/appointment of a SoLR in respect of its customers;
- V) the trust prohibits: (A) creation of any security or encumbrance over the trust account; (B) the trust account from being overdrawn; (C) any withdrawals of the then applicable protected amount other than in accordance with directions by Ofgem; and (D) crediting of funds to the account other than the relevant protected amount(s) or proceeds of sale of ROCs for RO from time to time or interest accruing on the account.

(b) an obligation to pay amounts at least equal to the protected amount into the account;

(c) as explained above, in the case of the RO, if we were to ultimately decide to ask suppliers to create a trust over the proceeds of sale of ROCs, an additional declaration of trust in respect of the proceeds of any ROCs purchased and subsequently sold in respect of the relevant obligation period. Again, the declaration of trust would require to meet minimum requirements set out in the licence conditions.

(d) establishment of a segregated bank account over which the trust is declared and acknowledged by the relevant bank. The bank providing the account must be a UK

bank with minimum creditworthiness to be set by Ofgem. The terms of the account must oblige the bank to pay funds to any person directed by Ofgem.

4.11. If properly established when a supplier is solvent, this arrangement should be sufficiently remote from supplier insolvency and can, like an Escrow account (see below), accommodate fluctuating funds. Use of the trust will impact working capital as suppliers will forego use of the protected amount of customer credit balances and RO's or any proceeds of sale of ROCs as 'free working capital', and only have access to these funds for specified purposes.

4.12. Whilst less costly than other mechanisms, the trust may still require collateral from the supplier and may still create a barrier to market entry. Further, the quarterly decision by the relevant supplier to move funds into the Trust Account means that transfers made when a supplier enters the zone of insolvency may be at risk in a subsequent insolvency or the directors of a supplier in the zone of insolvency may decide that it is not consistent with their directors' duties to transfer funds into the Trust Account when they should be preserved for the benefit of the supplier's creditors.

Escrow Account

4.13. Funds will be placed in a ring-fenced escrow account, which is maintained by a third-party escrow agent. Funds would be payable to Ofgem or Ofgem's nominee(s) (i.e. a SoLR) on demand to reduce the CCB and RO mutualisation costs that would otherwise arise from the supplier's insolvency. The escrow agent would have no discretion not to pay funds on demand. This mechanism should ensure that money is insolvency remote from the supplier (if, as with a Trust Account, it is set up when the supplier is solvent), although Ofgem will determine a set of conditions under which funds can be drawn down from this account (e.g. in the case of CCBs, to cover consumed energy and working capital and, in the case of the funds held in escrow from to the proceeds of sale of ROCs, potentially to purchase new ROCs (see RO, chapter 3, paragraph 3.25).

4.14. As with a Trust Account, an Escrow Account should be sufficiently remote from supplier insolvency if set up properly when the supplier is solvent, should allow for the fluctuation of funds and its use will impact working capital. As is also the case with Trust Accounts, the quarterly decision to move funds into an Escrow Account means that transfers made when a supplier enters the zone of insolvency may be at risk in a subsequent insolvency or the directors of a supplier in the zone of insolvency may decide that it is not

consistent with their directors' duties to transfer funds into the Escrow Account when they should be preserved for the benefit of the supplier's creditors.

4.15. There may be some risk of non-compliance from suppliers. Suppliers may erroneously request draw down of funds, which may be approved by the agent, who is unregulated by Ofgem. Suppliers may then be able to utilise these for purposes not stipulated by Ofgem in the conditions. We are continuing to consider different options to mitigate against this risk.

4.16. An escrow account may incur material costs to the supplier. We envisage that the mechanism will alleviate the resilience risks incurred by suppliers using free working capital to prop up unsustainable growth in the market. However, it is possible that it may also produce a barrier to market entry, and there may potentially be a risk of pushing smaller suppliers to exit the market.

4.17. We anticipate that any such escrow account will be held in the name of the escrow agent with a UK bank and that the escrow agent will be a reputable, independent third party with experience of operating escrow accounts.

Third Party Guarantee (Financial Institution)

4.18. Another proposed approved protection mechanism is the use of a third party guarantee from a creditworthy financial institution. The institution will issue a guarantee to pay an amount up to a maximum guaranteed amount to Ofgem (in the case of the RO) or a person nominated by Ofgem (in the case of CCBs) on demand by that person or Ofgem. This means CCB, and funds for the fulfilment of the RO liability, are insolvency remote. This also allows a supplier to have access to working capital, whilst still ensuring customers do not bear the cost of mutualisation.

4.19. Third party guarantees are time-limited protection, with a cap on liability, meaning they may not readily accommodate fluctuating amounts. If available, a rolling arrangement could be potentially costly.

4.20. Whilst there is no impact on working capital, suppliers may have to post collateral, and/or pay a fee, to the guarantor. The former expense will likely be dependent on the creditworthiness of a supplier, and therefore could be more expensive for smaller, independent suppliers. This may disproportionately impact challenger suppliers, as well as acting as a barrier for new entrants to the market. It may also cause issues for suppliers who

are already financially distressed both in terms of availability of guarantees, and ability to pay fees to the guarantor at a time when creditors' interests are paramount.

4.21. Minimum requirements of a third party guarantee which will be set out in licence modifications will likely include at least:

(a) minimum credit rating requirements for the guarantor on its issue and throughout the duration of the guarantee;

(b) the guarantee to be an irrevocable, primary, first demand guarantee and on terms consistent with good UK banking practice (meaning that the guarantor will pay on demand any amounts claimed under the guarantee, without raising any defence to payment, without set-off or counterclaim, and notwithstanding, for example, the supplier's insolvency);

(c) issued in favour of the Authority as beneficiary, with amounts payable under the guarantee being payable to the Authority or in favour of any other beneficiary that the Authority may nominate;

(d) the guarantee must either be available for drawing on demand for the full duration of the guarantee or, during the full term of the required period, automatically renew (unless the guarantor issues a non-renewal notice at least [90/120] calendar days before the date upon which the guarantee would otherwise renew);

(e) subsequent licence drafting will set out what law the guarantee will be governed by – likely English or Scots law with an exclusive jurisdiction clause in favour of the English or Scottish courts. We would welcome stakeholder views on this.

Parent Company Guarantee

4.22. Suppliers with a parent company which meets specified creditworthiness requirements will have the option of their parent company providing a guarantee. As with a third party guarantee from a financial institution, the parent company would provide a guarantee to pay an amount on similar terms to those specified above for financial institutions. These funds are therefore not insolvency remote from the parent supplier, but should be insolvency remote from the supplier acquiring the guarantee.

4.23. The supplier would therefore be able to retain access to working capital, whilst still reducing the risk of mutualisation costs being assumed by consumers.

4.24. This would likely provide the lowest cost option to the supplier. However, this option may have a potential impact on the market as only bigger suppliers with a sufficiently creditworthy parent company would have access to this low-cost mechanism.

4.25. We anticipate that any eligible parent company guarantee will need to comply with the same requirements as an eligible third party guarantee (summarised above).

Standby Letter of Credit

4.26. Similar to a guarantee, suppliers may also opt to use a standby letter of credit (SBLC), provided by a financial institution with a minimum credit rating. We believe this provides a legally robust payment obligation, with less opportunity for the provider to claim a defence to the obligation. Therefore, this offers suitably insolvency remote protection of funds.

4.27. A SBLC allows a supplier to retain access to working capital, whilst still ensuring a reduction of the cost of mutualisation.

4.28. A SBLC is usually a time-limited protection and therefore will require regular replacement. Whilst a rolling arrangement may be available, this will likely be for a considerable cost to the supplier. A SBLC is irrevocable during the period for which it is valid, although an issuing bank has discretion not to extend or replace an existing letter of credit if the financial health of the supplier deteriorates.

4.29. Dependent on a supplier's financial health, a SBLC may require collateral from the supplier. This will likely be more expensive for smaller, independent suppliers. The cost of this protection mechanism may also act as a barrier to entry for new suppliers. As with a third party guarantee, it may also cause issues for suppliers who are already financially distressed both in terms of the availability of a SBLC, and the ability to pay fees at a time when creditors' interests are paramount.

4.30. The minimum requirements of a SBLC will be similar to those for a third party guarantee. Given that SBLCs are time-limited, where suppliers choose to protect via a SBLC, we expect that we may require suppliers to report regularly to us on the status of that SBLC. This may create a prohibitively burdensome reporting and monitoring regime.

Discounted options

Insurance

4.31. Of the options assessed, we are minded to discount the option of insurance for the protection of CCB and RO funds. This is because we understand that whilst credit insurance could be sufficiently insolvency remote, it may not be available to suppliers or may be prohibitively expensive. As above, we should be grateful for stakeholders' views on this.

4.32. As set out in chapters 2 and 3 we have considered a client account for CCBs but concluded that this approach is not appropriate, for the reasons set out in chapter 2.

Minimum requirements and guidance

4.33. For each of the detailed protection mechanisms to be accepted by Ofgem, that mechanism would have to meet a set of minimum requirements.

4.34. We have set out above the minimum requirements we propose for each of the approved protection mechanisms.

4.35. If a protection mechanism fails to meet the stipulated minimum requirements, the mechanism will not be recognised and the licensee will be in breach of the licence conditions.

4.36. In addition to meeting the minimum requirement, set per protection mechanism, we are seeking views as to what further implementation guidelines suppliers might benefit from.

4.37. We have considered the use of a template for suppliers to use in respect of SBLCs [and guarantees]. This template may closely reflect the letter of credit templates required as part of the Green Gas Levy Scheme.⁴² Requiring a similar template for RO and CCB could potentially make the process across schemes more aligned and uniform, although we welcome views as to how prescriptive this template could be. We view that such a template may provide greater clarity and make the process less administratively complex. However, this may also inhibit some flexibility in the process, and could be potentially more

⁴² [Green Gas Levy Guidance | Ofgem](#) (Page 66-68)

administratively burdensome for suppliers. We are seeking views, therefore, as to whether suppliers agree that a template would be beneficial, and, if provided, how prescriptive this should be.

CCB and RO

4.38. We will continue to develop our thinking, in light of consultation responses, as to whether the same approach to protection mechanisms should be applied across RO and CCBs, or whether we treat these separately. Combining our approach may involve using the same mechanism for combined RO and CCBs protection, or use of the same types of mechanism, but with RO and CCB instruments kept separate from each other. Combining them could be inherently more complex to set up but may have advantages in reducing administrative burden, once established.

4.39. As stated in Chapter 3, we are considering the use of a trust to protect the proceeds of sale of any ROC (up to the Buy-out price value of each ROC).⁴³ The decision on this proposal will also impact the extent to which we combine the protection of RO and CCBs.

4.40. We welcome stakeholder's initial views on whether a combined approach would be preferable.

⁴³ RO Chapter, Option 3, 1.22 (Page 13)

5. Hedging

Summary

In this chapter we set out some early options on possible approaches to preserving the value of an insolvent supplier's hedges for the benefit of their customers in order to reduce mutualised costs following the supplier's failure.

Questions

Question 13: What do you consider would be the impact on your business and the wholesale market of implementing the two options we set out and how might these be mitigated?

Question 14: Are there other options to more effectively reduce the wholesale costs to consumers of supplier insolvencies?

Background: interaction between SoLR and Insolvency Regime on Hedging

5.1. Supplier insolvencies, in the autumn and winter of 2021/22, highlighted the need to carefully consider the interactions between the insolvency and SoLR regimes.

5.2. One area where this interaction needs consideration is how the value of supplier hedges are treated by the insolvency process. Hedging is used by suppliers to buy wholesale energy in a way that reduces their exposure to price risk between their selling price to customers and movements in the wholesale energy market. Hedging involves suppliers purchasing electricity and / or gas for delivery on a future date, over varying time periods, that protects the supplier from the volatility of short-term price fluctuations on the cost of wholesale gas and electricity.

5.3. Last month Ofgem published guidance on the treatment of wholesale prices observed during the transition to a new price cap methodology due to start in October 2022.⁴⁴

⁴⁴ [Price cap - May 2022 updated guidance on treatment of price indexation in future default tariff cap | Ofgem](#)

5.4. If a supplier becomes insolvent, any 'in-the-money' hedges (i.e. hedging contracts which have a positive value because they allow purchase of gas or electricity more cheaply than the prevailing market prices) can become an asset of the insolvent company and will likely be liquidated by the appointed insolvency practitioner. Where there is value in these hedges, the proceeds from their liquidation may be used, alongside other company assets, to pay company creditors.

5.5. The SoLR process sees the customers of an insolvent supplier transferred to a SoLR but the hedges, procured to meet those customers' future energy demands, do not transfer to the SoLR. Therefore, the SoLR must incur the wholesale energy and other related costs associated with purchasing energy for the customers they inherit from the insolvent supplier. In the autumn and winter of 2021/22, these costs were significantly higher than the amount that could be recovered through the price cap, meaning that SoLRs made very high claims on the levy (estimated total wholesale market costs were circa £1.7bn see Figure 1 in Chapter 1).

5.6. This interaction can result in a material detriment to consumers for two reasons:

- The wholesale energy costs incurred by the SoLR may - if approved - be reclaimed via the SoLR Levy, which is paid for by all consumers by way of higher electricity and gas Distribution Use of System charges (DUoS), which increase customer bills.
- Should the insolvency practitioner liquidate 'in-the-money' hedge(s) of the insolvent supplier it can result in a large financial return/windfall. That financial return can be sufficient to pay all creditors in full and result in a financial surplus which is returned to company shareholders, at the expense of consumers who incur the cost of the supplier's failure through higher bills and do not benefit from the reduced pricing that hedging was intended to deliver. We believe this is a potential outcome for a small number of the supplier insolvencies that occurred in 2021. The Government introduced a time-limited tax to address a related risk, such as when the hedges are held separately by another company in the same group.⁴⁵

⁴⁵ [Technical Note - Public Interest Business Protection Tax.pdf \(publishing.service.gov.uk\)](#)

Potential solutions

5.7. A preferable outcome for consumers would be for a SoLR to access the financial benefit of hedges held by insolvent suppliers. Doing so could reduce the value of their SoLR Levy claim that is ultimately paid for by consumers in the form of higher bills. This would also reduce the likelihood of a scenario where consumers foot the bill of a supplier's insolvency while the shareholders of the insolvent supplier profit from a surplus when the insolvent supplier is liquidated.

5.8. We acknowledge that this is a complex issue and requires careful consideration of the interaction between insolvency, company structures, the commercial arrangements entered into between a supplier and a counterparty and Ofgem's licensing regime.

5.9. We consider that the most effective solution to this issue would need to be delivered through legislative change. However, we recognise that there are complex interactions with insolvency law and it may take some time to change legislation. In the meantime we have considered two potential ways for a SoLR (acting on behalf of customers) to access the financial benefit of hedged positions of insolvent suppliers.

- i. **Option 1: Licence change:** require that the proceeds of 'in-the-money' supplier hedges, once liquidated, must be paid directly into a trust established by the supplier when the hedges are taken out (or be paid to the SoLR) for the benefit of their customers. In the event of the supplier's failure, the proceeds of the hedge should be preserved for the benefit of the SoLR to cover the additional costs of the SoLR purchasing gas and electricity.
- ii. **Option 2: Contractual change:** require the supplier to include in all its customer contracts an obligation on the supplier to pay to a SoLR (acting on behalf of customers) an amount up to the costs incurred by the SoLR as a result of the supplier entering insolvency. The intention would be to create a debt owed by the supplier to the customer, enforceable by the SoLR.

5.10. We considered whether it would be possible under our regulatory powers to mandate a transfer of hedging arrangements from the failing supplier to the SoLR. Our view is that the challenges to implementation are such that they undermine this option and it should therefore be discounted. However, we welcome stakeholder views on whether we should explore this option any further.

5.11. Our thinking on these proposals (options 1 and 2) is at an early stage. We set out in this Chapter the two options that may evolve into more detailed options that allow SoLRs to access the financial benefit of insolvent supplier's hedged positions. . We want to better understand how hedges are structured and to what extent these proposals would be effective in accessing the value of hedges for SoLRs. We need industry to participate by giving us their views on the challenges that would be encountered when implementing these options. We therefore welcome views on the impact of these options if Ofgem were to pursue their implementation.

Licence change option

5.12. In order to ensure that proceeds of any 'in-the-money' hedges entered into by or on behalf of a supplier are held in a trust for the benefit of their customers, suppliers with hedging arrangements in place will be required to create a trust account and declare a trust in respect of funds in it. Proceeds from the liquidation of a hedge, net of fees associated with liquidating the hedge agreement, will be paid directly by the hedge counterparty into the trust account, and held for the benefit of the supplier's customers in the event of the supplier's insolvency. The appointed SoLR would have access to the funds held in the trust to reduce the cost of the SoLR Levy.

5.13. This option would see a new licence obligation on suppliers requiring the licensee to:

- i.* Have legal entitlement to the benefit and proceeds of any relevant hedge and to demonstrate it has in place such arrangements, on request by Ofgem and / or each time new hedge arrangements are put in place.
- ii.* Create an insolvency remote, segregated trust account into which all proceeds of the liquidation of hedges held must be placed for the benefit of its customers either automatically or following a direction from Ofgem.
- iii.* Provide a declaration that the trust would be for the benefit of the supplier's customers and would provide for a SoLR to have access to the funds on behalf of customers to reduce SoLR costs arising from the supplier's failure.
- iv.* Include in all its customer supply contracts obligations by the supplier to undertake all the actions needed to comply with the new licence condition and to ensure that the SoLR has access to the funds held on trust. The SoLR would be granted, third party enforcement rights in respect of these provisions; and provide a deed poll in favour of

and enforceable by any SoLR and Ofgem declaring the obligations so that they survive and are enforceable after licence termination.

- v. Require the licensee to procure an ultimate controller undertaking to ensure that these terms are complied with.

5.14. We anticipate that a supplier would have access to the funds held in trust in certain specified circumstances, for example if hedges were liquidated by a solvent supplier as part of a process of re-hedging or restructuring company finances. If the licensee becomes insolvent and Ofgem appoints a SoLR, Ofgem would rely on the trust already declared (the trust assets not forming part of the insolvent estate) and the deed poll to direct the transfer of funds from the trust account to the SoLR to reduce the costs to potentially be claimed from the SoLR levy.

5.15. The trust will survive the supplier's failure. If hedges have not been liquidated at the point of insolvency (and consequently the balance in the trust account is low or zero) this transfer may occur once the appointed insolvency practitioner has liquidated the hedge and the proceeds credited to the pre-designated trust.

Benefits of licence change option

5.16. We have set out below our early thinking on the benefits of preserving the value of insolvent supplier hedges by creating a trust.

- *Reduced SoLR costs:* The creation of a trust will enable the value of the hedge, net of the costs associated with liquidating the hedge, to be made available to a SoLR. Therefore, it should reduce the wholesale market and related costs incurred by a SoLR when purchasing energy for customers inherited from an insolvent supplier.
- *Insolvency Remoteness:* The creation of a trust, if put in place when hedges are created, while the supplier does not have issues regarding its solvency, should mean that the proceeds from the liquidation of the hedge, that are held in trust, are preserved for the benefit of customers rather than the supplier's creditors and shareholders.
- *Limited administrative burden:* This option would see the proceeds of the hedge transfer to the SoLR. It would not require action on the part of the SoLR to submit a claim as a general creditor to the appointed insolvency practitioner. However, we note that the extent and intrusiveness of a monitoring regime would need to be determined.

Challenges with implementation

5.17. We have summarised the risks associated with Option 1 under the following headings

- *Supplier Business Model or Group Structure Issues:* It may be the case that the supplier group will hedge the supply business separately from other market exposures within its group, or that the hedge arrangements will not be straightforward and capable of ready disaggregation. Therefore, it is possible that compliance with Option 1 could be impracticable for a supplier and / or be difficult to monitor. Creating a trust (or other form of security) arrangement could also be inconsistent with a supplier's (and its group's) negative covenants in its existing debt arrangements, and therefore could be inoperable or require debt refinancing. Similarly, the creation of the trust account structure (and its operation) might be operationally burdensome.
- *Monitoring and compliance issues:* The trust account structure is dependent on the supplier instructing its hedge counterparties to pay hedge termination proceeds to the trust account and on the supplier not withdrawing sums for purposes which are not permitted purposes. The licence condition proposed would require the proceeds to be paid into the segregated account and would restrict withdrawals to "business as usual" purposes, but this would not prevent fraud or directors of a company in the zone of insolvency choosing to breach the licence condition.
- *Hedge value:* This solution captures only the net proceeds of the liquidation of hedging arrangements i.e. net of fees associated with liquidating a hedge, which can be substantial. It may not protect the full value of the hedge prior to its liquidation. Moreover, this is a 'one way' protection. While we want to ensure that customers of a failed supply can benefit from the value of 'in-the-money' hedges, we do not expect a SoLR or transferred customers to be responsible for hedging contracts that are 'out-of-the-money' (i.e. that have a negative value because they allow purchase of gas or electricity that is more expensive than prevailing market prices).

Contractual change option

5.18. This option would amend the terms and conditions of customer contracts to create a debt owed to the customer in the event of the supplier's failure. The debt would be equal to the costs incurred by the SoLR that are attributable to meeting deemed contract obligations to that customer. This would allow the SoLR to submit a debt claim to the appointed insolvency practitioner in respect of the costs it incurs in taking on the SoLR.

5.19. This structure would create a debt owed by the supplier to the customer, enforceable by the SoLR (and, under the deed poll, Ofgem). The debt would mean that the customers (with the SoLR as proxy) would be unsecured creditors of the insolvent supplier. This would mean that the debt this creates would be paid before any payments to shareholders of the insolvent supplier, alongside debts owed to other creditors of the supplier.

5.20. We anticipate that such an arrangement would involve new licence modifications including:

- an obligation on the supplier to include a suitable clause in all its customer contracts (and provide evidence of such inclusion to the Authority);
- an obligation to pay to the customer on/after appointment of a SoLR in respect of the failed supplier an amount equal to the costs incurred by the SoLR attributable to meeting deemed contract obligations to that customer;
- provisions for any SoLR appointed to have third party rights in respect of enforcement of the above new provision and to apply the proceeds to reduce the costs it claims under the SoLR levy;
- An obligation on the supplier to execute a deed poll in favour of Ofgem and any SoLR appointed by it to be able to recover sums which are the subject of the supply contract obligations; and
- provision, on the appointment of the SoLR, for the SoLR to be obliged to exercise the third-party rights and pursue the failed supplier to make the payments referred to above.

Benefits of Option 2

5.21. *Reduction in SoLR Levy claim:* In situations where the positive value of hedges is significant, this option may reduce the amount of the SoLR Levy claim by the amount that the SoLR is able to recover from the insolvency of the supplier. Whilst this option would not preserve the full value of the hedges for customers, because hedge liquidation costs would reduce that value as would dilution of the amount recovered by the SoLR ranking as an unsecured creditor alongside other creditors, any amount recovered would reduce the SoLR levy claim.

5.22. *Shareholder windfall reduced:* This option would see the SoLR being paid before any payments to shareholders could occur, thus preventing shareholders from benefitting at the expense of customers.

Challenges to implementation

5.23. The risks associated with Option 2 are as follows:

- *Failed Debt Claim:* If a supplier is already experiencing financial difficulties when it enters into contracts with customers, there may be a risk that a subsequently appointed insolvency practitioner could refuse a debt claim associated with those contracts. The insolvency practitioner may do so on the basis that the new obligations were entered into at a time when insolvency and transfer to a SoLR was possible and that entering the contract was an undervalued transaction, if the payments received from customers were not considered sufficient.
- *Dilution of funds:* Option 2 is effective in lowering the cost of the SoLR Levy only to the extent that there are assets within the business that can be realised for creditors. The value of those assets, once realised, will then be shared among all company creditors. Creditors of companies in administration will often get a percentage of the debt returned from an insolvency. Therefore, in many cases option 3 will not fully offset SoLR levy costs.
- *Contractual terms:* The success of this option rests of the supplier putting in place correct contractual terms that create the debt that is owed to consumers.

6. Capital Adequacy

Summary

In this chapter we set out some early thoughts on possible approaches to capital adequacy.

Questions

Question 15: What are your views on our proposed high level approach to a capital adequacy framework? Do you agree that capital adequacy requirements would be required in addition to our ringfencing proposals?

Question 16: Do you agree with our suggestion that a capital adequacy framework should take a segmented approach – with measures implemented in a proportional way for different segments of the market, largely based on the level of risk that a company could pose to the market?

Question 17: What risks do you think are most appropriate to target with a capital adequacy regime? What risks do you currently target in your internal risk assessments and risk capital determinations?

Question 18: Do you have any views on the level of financial resilience that a capital adequacy regime should seek to target? What are your views on an appropriate time horizon for calculating capital requirements? What time horizons do you use in internal risk management?

Question 19: What type of capital should be included under capital adequacy requirements and what criteria could be used to determine this? How do you currently define what can be considered as sufficiently loss-absorbing capital for unexpected shocks in internal risk management?

Background

6.1. The current regulatory framework requires suppliers to maintain robust financial and risk management arrangements. New entrants must demonstrate they can adequately fund their operations for at least their first year of operation, outline how they expect to comply with key regulatory and market obligations and show their plans to provide proper levels of

customer service.⁴⁶ 'Fit and proper' assessments to assess the suitability of a supply licence applicant will look at disclosures in respect of directors, major shareholders and others with significant managerial responsibility or influence.⁴⁷ .

6.2. Suppliers are also subject to milestone assessments to ensure they are adequately prepared and financially resourced to serve customers and meet regulatory obligations as they grow.⁴⁸ The framework for current licence holders was recently strengthened via changes to the standard licence conditions (SLCs), introducing additional notification requirements for significant commercial developments, including trade sales and mergers and senior personnel changes.⁴⁹

6.3. The Financial Responsibility Principle (FRP) is a licence condition introduced in 2021, which requires suppliers to have adequate financial arrangements in place (including capital where necessary) to meet costs at risk of being mutualised.⁵⁰ Under FRP guidance, suppliers must evidence that they have plans in place to meet government obligations, effective processes for setting direct debit levels and returning customer credit balances, sustainable pricing approaches to cover costs, the ability to finance their overall business plan and robust financial governance and decision-making frameworks.⁵¹ The Operational Capability Principle, also introduced in 2021, requires suppliers to demonstrate they have the capability, systems and processes in place to effectively serve customers and comply with regulatory obligations.⁵²

6.4. Ofgem also has extensive information-gathering powers. SLC 5 requires suppliers to provide information to Ofgem in response to Requests for Information (RFIs), which are used by Ofgem to gather data on supplier financial resilience and respond where there are concerns.⁵³ Through these powers, we have been monitoring on a regular basis the amounts of working capital that suppliers hold and their hedging behaviour, to identify and address market risks. In January, Ofgem launched a programme of stress testing with suppliers to

⁴⁶ Guidance: [Applying for a gas or electricity licence \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/applying-for-a-gas-or-electricity-licence)

⁴⁷ Guidance: [Applying for a gas or electricity licence \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/applying-for-a-gas-or-electricity-licence), p. 26

⁴⁸ [Electricity Supply Standard Licence Conditions Consolidated - Current Version.pdf \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/standard-licence-conditions-consolidated-current-version) [Gas Supply Standard Licence Conditions 01 09 2021 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/gas-supply-standard-licence-conditions-consolidated-current-version) ; Guidance: [Milestone assessment guidance \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/milestone-assessment-guidance)

⁴⁹ [Decision on strengthening milestone assessments and additional reporting requirements \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/decision-on-strengthening-milestone-assessments-and-additional-reporting-requirements)

⁵⁰ [Gas Supply Standard Licence Conditions 01 09 2021 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/gas-supply-standard-licence-conditions-consolidated-current-version); [Electricity Supply Standard Licence Conditions Consolidated - Current Version.pdf \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/electricity-supply-standard-licence-conditions-consolidated-current-version)

⁵¹ See paragraph 3.5 of Ofgem's recently updated [Guidance on the Operational Capability and Financial Responsibility principles](https://www.ofgem.gov.uk/guidance/guidance-on-the-operational-capability-and-financial-responsibility-principles)

⁵² [Electricity Supply Standard Licence Conditions Consolidated - Current Version.pdf \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/standard-licence-conditions-consolidated-current-version); [Gas Supply Standard Licence Conditions 01 09 2021 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/gas-supply-standard-licence-conditions-consolidated-current-version)

⁵³ [Gas Supply Standard Licence Conditions 01 09 2021 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/gas-supply-standard-licence-conditions-consolidated-current-version); [Electricity Supply Standard Licence Conditions Consolidated - Current Version.pdf \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/guidance/electricity-supply-standard-licence-conditions-consolidated-current-version)

assess whether they are robust to a range of pricing and demand scenarios. Where we have identified concerns as an outcome of the stress testing, we will be working with suppliers to develop and support improvement plans over a suitable transition period to address them. In cases where suppliers do not take the action that we think is needed and/or where there is high risk to consumers, we will also take compliance and enforcement action. It is our intention to repeat stress tests on an ongoing basis to assess supplier resilience. Based on this round of stress testing, we will, as part of our assessment, determine the frequency of future testing.

6.5. Ofgem also issued RFIs to gather information on supplier Management Control Frameworks in January. We are reviewing suppliers' risk management processes to identify suppliers that do not have adequate procedures in place to manage risks and we are considering whether to ask some suppliers to develop action plans to address inadequate procedures.

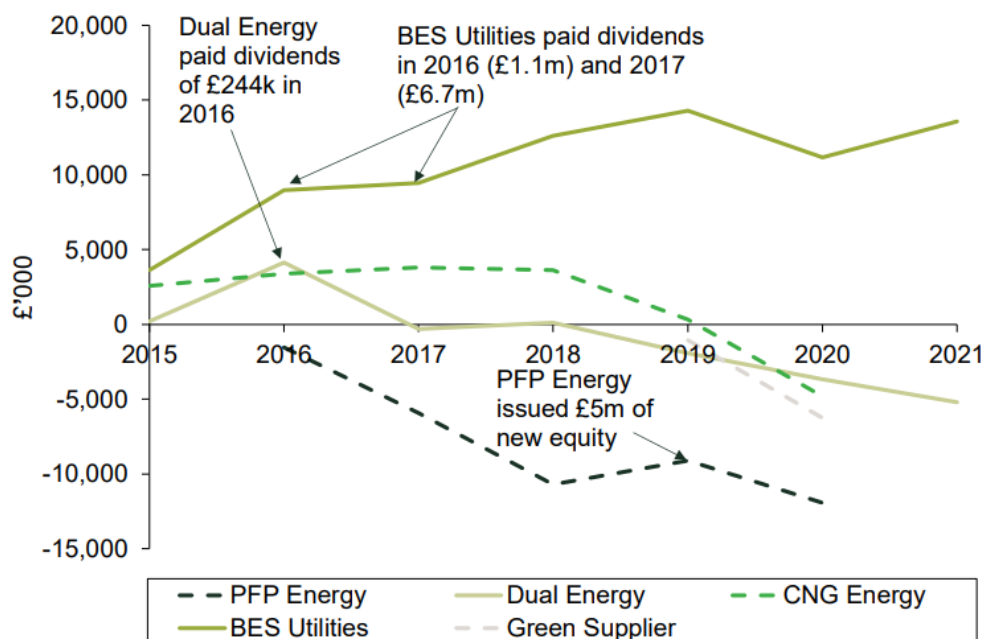
Case for specific Capital Adequacy measures

6.6. Beyond these existing powers, we see the value in working towards a framework that more specifically targets capital requirements as part of a wider strategy to manage financial resilience risks. This is particularly important given the clear role that insufficient capital and financial resilience played in supplier failures during the recent price volatility.

6.7. As set out in Chapter 1, analysis by Oxera shows key characteristics of failed suppliers included negative equity balances, poor liquidity, low levels of working capital, insufficient levels of hedging, and over-reliance on customer credit balances. Riskier business models limited the ability of suppliers to absorb demand and price shocks. Meanwhile, due to low levels of capital and the mutualisation of costs associated with exit, equity holders saw low opportunity costs associated with exit.

6.8. Analysis of equity balances by Oxera shows that for small and medium suppliers, all failed suppliers had negative equity balances at the end of FY2020, and that overall, supplier failure is clearly associated with persistent negative equity balances.

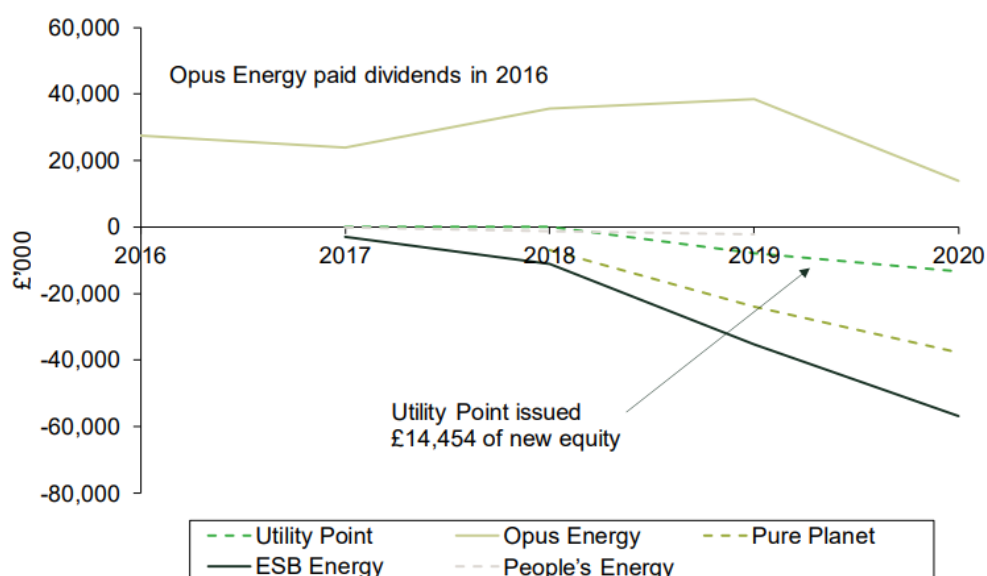
Figure 5: Equity balances for small suppliers, FY 2016-20



Note: Dual Energy was acquired by SmartestEnergy Limited on 6 December 2019 and rebranded to SmartestEnergy Business Limited.

Source: Oxera analysis of companies' financial data from Companies House.

Figure 6: Equity balances for medium suppliers, FY 2015-20



Source: Oxera analysis of companies' financial data from Companies House.

6.9. Analysis showed that insufficient hedging also played a role in reduced supplier resilience. Evidence suggests some suppliers pursued a "timing" model, where suppliers

undercut hedged rivals by entering the market when prices are low to offer long-term supply agreements with customers at low spot rates. This strategy would result in failure in the face of increasing spot prices. It also underpins a market where suppliers are competing on price differences not informed by underlying costs – but rather driven by suppliers’ hedging approaches, with more risky approaches resulting in lower prices – meaning that the competitive process does not necessarily lead to the least cost mix of suppliers.

Our Proposed Approach to a Capital Adequacy Regime

6.10. We consider that suppliers should be required to maintain sufficient minimum levels of capital to better survive market shocks and incentivise robust risk management (e.g., around hedging behaviour). While Ofgem’s existing rules, including the FRP, already allow us to set capital adequacy expectations (where a certain level of capital would be required for a supplier to meet its obligations under the FRP), we believe that more specific requirements and a greater level of regulatory oversight are likely to be needed to increase supplier resilience and incentivise more robust risk management.

Scope

Our focus in this consultation is on domestic retail suppliers, since they carry the highest risks around costs mutualisation. Businesses’ credit balances are not guaranteed to be returned in the non-domestic SoLR processes. Since the price cap does not apply to non-domestic consumers, SoLRs for such customers can pass those costs through to individual consumers without the need to mutualise these across all customers. However, our capital adequacy interventions are likely to be helpful in protecting non-domestic consumers and we will therefore consider whether and how any capital adequacy policy should be expanded to these suppliers. We also are aware of the interactions across vertically integrated companies, and the important role and risks associated with other stakeholders in the supply chain like gas shippers. We also intend to consider these other stakeholders and examine how a capital adequacy framework might involve them or interact with them.

Desired outcomes

6.11. Our overarching objective for our financial resilience work is to develop a more resilient energy supply market in which consumers, energy suppliers and investors can have confidence going forward. Designed appropriately, we expect a capital adequacy regime to increase the resilience of the sector and deliver the following outcomes:

- **Robust minimum standards** – setting clear expectations to incentivise better risk management
- **Protecting customer money** – reducing the risk of failure and therefore the total mutualised costs, and potentially supporting more orderly or managed exits achieving better outcomes for customers
- **Accountability** – placing requirements on leadership to ensure appropriate governance
- **Proportionality** – a clear and adaptive framework to ensure the right level of resilience, while minimising unnecessary burden and barriers to innovation.

6.12. Our intention is not to eliminate entirely the possibility of supplier failure, but rather to better align supplier incentives with more sustainable business models that can withstand reasonable stress.

Interactions with CCB and RO ringfencing proposals

6.13. As set out in Chapter 1, the introduction of any capital adequacy regime should be designed to complement CCBs and RO ringfencing reforms in a dynamic way, to ensure the full range of policies operate together efficiently to deliver our objective of improving supplier financial resilience for the benefit of consumers. There is an important trade-off here. Increasing capital adequacy requirements will result in an initial cost associated with raising capital, which will ultimately be passed on to consumers – although in the long run we expect financial resilience measures will result in lower costs of capital overall for suppliers due to better creditworthiness. Therefore we expect that the wider benefits of increased financial resilience, which are likely to include fewer failures and associated mutualisation costs and therefore overall a more resilient market with greater competition and investibility, would outweigh those increased costs. And we would like to develop a flexible and adaptive regulatory toolkit that would enable us to tighten or loosen regulatory arrangements over time to adapt to changing market conditions.

6.14. There is a clear distinction between what ringfenced and non-ringfenced capital can achieve. Capital that is not ringfenced or otherwise protected (as envisaged under our proposals on CCBs and RO payments) is not insolvency remote. And, as set out in Chapter 1, we consider that ringfencing has other benefits over capital adequacy requirements in terms of proportionality and deliverability. However, we may consider the possibility of scaling back

ringfencing requirements in the future when capital adequacy requirements are sufficiently robust to reduce the probability of default to a point where the risk of those mutualisation costs arising at all is sufficiently small.

6.15. As part of our work on capital adequacy, we propose to consider the extent to which an amount of flexibility and scalability between how these different financial resilience policies combine would enable us to ensure a consistent and acceptable level of risk across different business models in the most cost-efficient way – maximising outcomes for consumers and competition.

Capital adequacy and review of price cap returns

6.16. We recognise that any capital adequacy policy will need to strike a balance between greater resilience and any impacts on competition and innovation to optimise outcomes for consumers whilst having regard to licensee financeability. For competitive tariff offerings such as fixed term tariffs, we expect suppliers to be able to consider capital and risk management as part of their pricing, and our reforms will ultimately lead to more sustainable competition.

6.17. The design of a capital adequacy regime is being developed in tandem with wider changes in the regulation of the retail market, including a review of how returns are allowed under the Default Tariff Cap. We acknowledge that if suppliers are required to hold different amounts of capital because of capital adequacy rules and/or other licence requirements, this may impact the profits / returns that a notional efficient and well-hedged supplier could generate as part of the price cap. Ofgem is currently reviewing its approach to calculating these returns.

6.18. The Default Tariff Cap was designed to reflect the rate of return a notionally efficient supplier would generate given the risks involved and amount of capital employed. Currently the price cap includes a fixed 1.9% margin on Earnings Before Interest and Taxes (EBIT) based on analysis of certain types of supplier by the Consumer and Markets Authority.

6.19. As set out in our 2018 price cap decision document,⁵⁴ the 1.9% EBIT margin was originally set based on analysis by the Competition and Markets Authority as part of its

⁵⁴ [Default Tariff Cap: Decision, Appendix 9 - EBIT](#)

energy market investigation, including the CMA's judgement on the Return on Capital Employed (ROCE), estimates of Weighted Average Cost of Capital (WACC), and on the capital required by efficient suppliers. The 1.9% EBIT margin is applied to the cost allowances in the price cap – such as wholesale, operational, and policy cost allowances – meaning the amount generated by the EBIT margin fluctuates with consumer bills.

6.20. We intend to review this approach to consider:

- Whether the assumptions on supplier capital and returns underlying the EBIT margin remain robust;
- The impact of capital adequacy and other potential changes to the licence on capital employed; and
- Whether an EBIT margin that scales fully with the bill level remains appropriate in light of the impact of recent high price volatility on consumer bills.

6.21. Our work on capital adequacy will be developed alongside work on reviewing price cap returns to ensure alignment and feed directly into considering the right approach to ensuring a proper return in the price cap for a notional efficient and well-hedged company. However, a capital adequacy framework will, of course, need to go beyond considering any benchmark used for these specific price cap calculations. Any capital adequacy framework will need to be designed to consider in practice the right level of capital against the risks in the range of business models in the market and how to best bolster market resilience.

Stakeholder feedback so far

6.22. Over the past months we have engaged extensively with suppliers on financial resilience, including specifically on capital adequacy. This includes in a number of bilateral meetings, as well as workshops in February and May this year. We have summarised feedback from suppliers below.

Case for change

6.23. Although there is broad support for a capital adequacy regime, some suppliers question the need for it, in particular as an added policy alongside CCBs/ RO ringfencing. Suppliers raised concerns about double-counting of risks that are already being covered by ring-fencing measures.

6.24. As above, Ofgem will look to deliver a decision on the proposed CCBs/RO ringfencing by the end of the year, and most stakeholders have broadly agreed with the need to progress this policy area as a priority. Ultimately, however - as above - we will be considering the extent to which in the future capital adequacy and ringfencing can be scaled against each other to achieve a certain level of resilience at the most efficient cost to maximise outcomes for consumers.

Approach

6.25. Stakeholders have overall been in favour of a risk-based approach to a capital adequacy framework. For some, this has meant evaluations should consider the competence, governance, and maturity of the supplier. Some have suggested that any capital requirement should be contingent on Ofgem not being satisfied a supplier can manage its own risk, or that more rigorous monitoring or rules should be applied to certain suppliers with less rigorous internal monitoring. Other suppliers suggested that, considering the recent stresses the sector has been subjected to, increased regulation should only be applied to new suppliers intending to enter the market, while others recommended Ofgem issue guidance for less mature suppliers to assess hedging and risk management strategies.

6.26. Our minded-to position is that any capital adequacy framework should be risk sensitive, as a key outcome we have set for capital adequacy policy is that it needs to incentivise proper risk management. As part of designing any policy, Ofgem will consider how to make the policy most effective and efficient across the wide range of business models in the market.

Timing

6.27. Some responses noted the need to build in capital adequacy requirements over time to allow suppliers and the market to adjust. Others suggested that capital adequacy is a policy that should have been prioritised by Ofgem over CCBs/RO ringfencing.

6.28. Ofgem is proceeding at pace on developing financial resilience policy, including capital adequacy. Decisions on timing for any capital adequacy rules will be developed in a way that takes into account the outcomes and impacts of other policy reforms, such as CCBs/RO ringfencing, as well as our ongoing assessment of market resilience and any concerns that suggest the need for earlier intervention. We will consider the best and most efficient route to implementation - including any need for a transitional phase-in, and alignment with the review on returns under the price cap.

Competition impact

6.29. Some suppliers are concerned a capital adequacy framework would create barriers for smaller suppliers and risks consolidating the energy market by encouraging a convergent view of risk. Responses included concerns that complex regulation and raising capital are already major challenges for small players. Other responses were concerned about low investor confidence and the high cost of raising working capital in current market conditions. Questions were also raised about the impact a capital adequacy framework may have on innovation and the ability of the future energy retail market to deliver Net Zero.

6.30. Any capital adequacy policy will be subject to appropriate impact assessment, which will include considering impact on consumers, competition and achieving net zero. As above, we propose to consider an overarching approach to achieving supplier resilience through the combination of financial resilience measures in the most efficient way possible, and potentially taking a segmented approach across business models for most efficient outcomes. We are also progressing our review of returns under the price cap alongside our work on capital adequacy to ensure alignment. We intend to engage extensively with relevant stakeholders as we develop this policy to ensure impacts and risks are well understood.

Approaches to a capital adequacy regime

6.31. To meet the outcomes we've set out, our minded to position is that an enduring capital framework would need to have some element of risk sensitivity and supplier segmentation. The majority of suppliers we have engaged with also have supported a risk-based framework despite some added complexity, compared to more blunt 'one-size-fits-all' approaches.

6.32. There is a broad spectrum of regulatory approaches that could accommodate a risk-sensitive view of capital adequacy. We do not seek to propose a specific number or equation for levels of capital in this consultation. However, we have proposed key elements for any regulatory approach to capital adequacy and some initial emerging views, in order to facilitate engagement on these foundational aspects of any capital adequacy regime.

6.33. These include:

- What risks should a capital adequacy regime cover?
- What is the right level of financial resilience that a capital adequacy regime should seek to target?

- How should “capital” for the purpose of a regulatory framework be defined, and should it be set at subsidiary or parent level or some combination?
- What design should a capital adequacy regulatory regime take?

What risks should be considered to determine regulatory capital levels?

6.34. Below we summarise the range of risks we understand suppliers face in their business to invite views on their inclusion in any capital adequacy requirement, their relative importance and on any other risks that should be considered.

6.35. Our view, supported by recent experience, is that the most material risks facing energy suppliers currently relate to the procurement of the commodity to meet retail demand. Risks relating to the onward sale of gas and power – such as bad debt – have historically been less of a driver of supplier failure, though we expect them to still be a feature of an overall assessment of supplier resilience.

- **Price risk:** where suppliers have entered into fixed term contracts without hedging, they may need to continue delivering lower prices even as the prices they purchase energy at rise. Suppliers can also be impacted by falling prices – where they are locked into paying a certain price for supply due to hedges, while they have to reduce the prices they charge consumers to stay competitive. The level of price risk a supplier is exposed to can be considerably reduced through effective hedging strategies. As mentioned above, returns under the price cap will assume a notional well-hedged supplier.
- **Churn/ volume/ demand risk:** the impact of significant shifts in customers, as well as in customer demand – for example caused by unexpected weather conditions can leave suppliers over or under-hedged to meet demand, and having to secure supply they did not anticipate needing, or with excess supply. Churn can also affect the extent to which a supplier can recover operating costs, given the lag between adjusting the operating cost base to shifts in customers. Ofgem is seeking to address churn specifically associated with the price cap⁵⁵ through its changes to

⁵⁵ Where there is a price cap, active consumers will move to the capped tariff when prices rise, as there will be a lag before any increase. This leaves suppliers with higher demand than expected or hedged for. When prices fall, consumers move off the cap, leaving suppliers with unexpectedly lower demand. This risk is discussed in Ofgem’s [Statutory Consultation on changes to the wholesale methodology](#)

the wholesale methodology. Ofgem is also seeking to address the costs associated with backwardation associated with the cap in these reforms.⁵⁶ Currently, a time-limited measure is in place where suppliers acquiring a domestic customer must pay a Market Stabilisation Charge to the losing supplier to represent a proportion of the economic loss to the losing supplier for the energy purchased on behalf of their customer, when wholesale prices fall considerably below the relevant wholesale price cap index.⁵⁷

- **Counterparty credit risk:** For example, in the event a hedge counterparty fails, a supplier would 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 PPA or GSA in place and the counterparty fails to deliver on that PPA/ GSA.⁵⁸
- **Liquidity risk:** in addition to low liquidity that can drive price risk (covered in market risk), liquidity risk covers the cash liquidity within a supplier to meet obligations. A major source of liquidity risk is that in a stressed market, suppliers will be forced to cover rising margin requirements associated with procuring energy.
- **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.
- **Credit risk:** consumers may not always be able to pay their bills, in which case suppliers will take on increasing levels of “bad debt.”⁵⁹

⁵⁶ Suppliers will face a backwardation cost when the basis risk between over-recovery of costs in the summer and under-recovery in the winter don't net out. Ofgem is seeking to reduce the impact of this risk through its changes to the wholesale methodology, as set out in the statutory consultation.

⁵⁷ [Decision on short-term interventions to address risks to consumers from market volatility | Ofgem](#)

⁵⁹ Ofgem provides for an implicit allowance in the price cap for debt-related costs that efficient suppliers incur. If there is an external shock, and Ofgem determines efficient costs have increased, Ofgem would consider any need to change the cap methodology to provide additional allowance for debt-related costs, and any need to do this in an expedited way (for example, using initial estimated costs to provide relief). This is the approach Ofgem used in its consultation on [Reviewing the potential impact of Covid-19 on the default tariff cap](#). As a result, there may be a more limited role for a capital adequacy framework in relation to this risk.

- **Operational risk:** risks associated with shortcomings in governance; reputational risk; business disruption and IT risks
- **Systemic risk:** the central position of some companies in the market can mean that any impact on their financial position can have knock-on effects on the market and other companies.

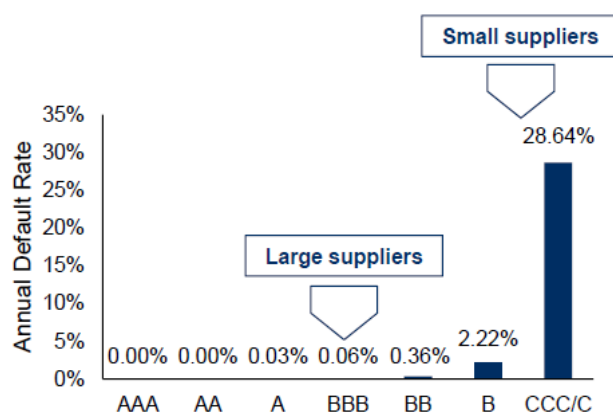
What is the right level of financial resilience that a capital adequacy regime should seek to target

6.36. In addition to understanding what risks a capital framework should cover, we are considering the trade-offs associated with the level of “insurance” that a certain level of capital adequacy provides, and over what time period.

6.37. The appropriate level of insurance will depend on an overarching judgement on risk appetite and accepted probability of default – essentially, what capital is needed to remain a viable going-concern, including under a certain level of stress, over a certain time period.

6.38. Our Impact Assessment in Chapter 7, and the NERA report, help to frame these principles. Prior to any policy reforms, small suppliers are found to have an annual default rate of 11.42 %, implying a credit rating between B and CCC. Credit ratings for large suppliers range from BBB to BBB+, implying an annual default rate of 0.06%.

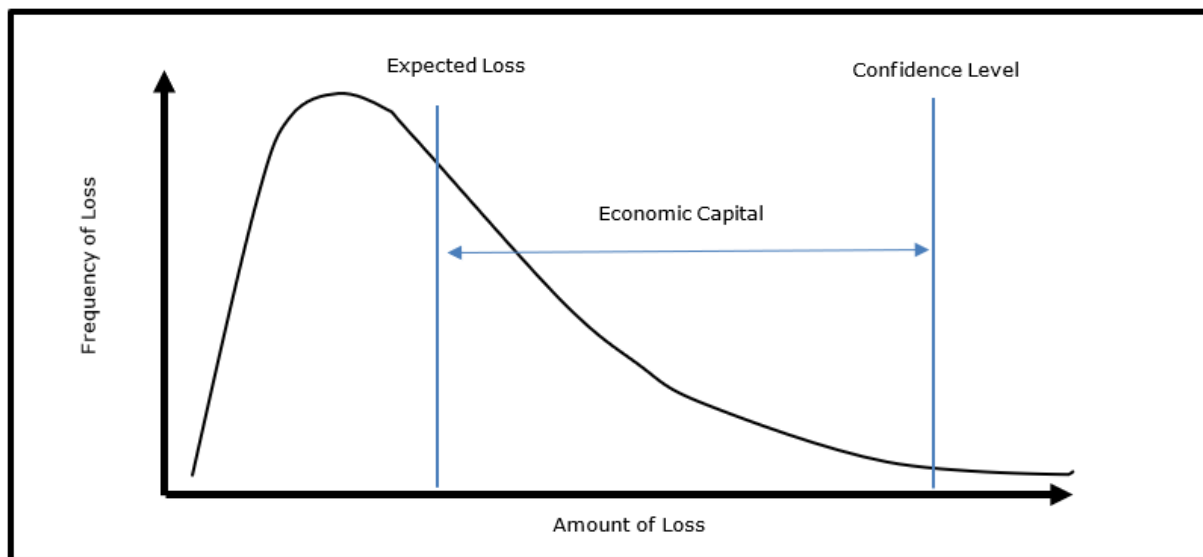
Figure 7: Annual default rate by credit rating



Source: S&P

6.39. A default rate can be translated to confidence intervals, to speak to the level of resilience a business has to a stress event of a certain probability. For example, a 0.5% default probability translates to a 99.5% confidence interval, suggesting a business can withstand an event expected to happen once over a 200 year period. A target default rate can be used to help determine an appropriate level of capital.

Figure 8: Relationship between chosen level of resilience and necessary capital to absorb unexpected losses



6.40. Ultimately, the appropriate benchmark of resilience will need to be devised considering both a top down and bottom-up approach. This means considering a calibration in terms of its impact on the resilience of the system as a whole, as well as considering how calibration maps across the different range of supplier business models that make up the market. As above, we consider that a segmented approach may be most efficient, where expectations are proportionate to the size and importance of a business to the market.

6.41. Proposed rules around ringfencing of CCBs/RO funds are expected to have the effect of bolstering supplier resilience and reducing probability of default. We intend to consider how the impacts of financial resilience policy including any ringfencing measures and capital adequacy combine to efficiently underpin a target level of resilience.

6.42. We also propose to consider the time horizon for any regulatory assessment or requirement on capital. The longer the time horizon, the greater value of potential loss – making it more expensive to insure against a risk over a longer time period. Time horizons are usually chosen to reflect the 'holding period' of an investment – in this case the tariffs.

For example, under a quarterly price cap with an associated lag, the average holding period would be 4.5 months, and so we may expect suppliers to hold capital commensurate with the risk over this period.

6.43. The costs and benefits associated with insulating the market against a certain level of risk are baked into wider trade-offs associated with decreasing risk of failure and improving market stability. How capital is defined for any regulatory measures will impact the cost of the insurance against the level of risk – the section below goes further into considering the content of capital. Impacts felt by suppliers may also flow through to consumers if suppliers' costs increase as a result of capital requirements. Overall trade-offs are summarised below.

Table 3: Overall trade-offs

	Costs	Benefits
Supplier trade-off	Initial cost of raising required capital or more thoroughly hedging	Benefit of lower cost of capital and collateral due to reduced probability of default
Consumer trade-off	Increased costs associated with tariffs that are hedged or capitalised against	Reduced costs associated with lower failure rates and consequential consumer switching
Market trade-off	Higher entry/growth bar	More sustainable business models which ultimately contribute to greater investibility, supporting greater competition and innovation in the market

How should “capital” for the purpose of a regulatory framework be defined, and should it be set at subsidiary or parent level or some combination?

6.44. We understand suppliers will have different business models, and as a result different balance sheets, sources of funding, and ranges of assets across subsidiaries, groups and parent companies. We also acknowledge that suppliers will have different approaches to risk management, and processes to make judgements on what amount of capital is required to ensure solvency and withstand unexpected losses at a certain level of confidence over a period of time, specific to their business model. However, we consider that an effective regulatory framework on capital adequacy requires a definition of regulatory capital.

6.45. Regulatory capital can be put into two broad categories: going concern capital to absorb unexpected losses to allow a company to keep operating; and gone concern capital to be set off against obligations and reduce costs should a company fail. Our primary outcome

for the purpose of a capital adequacy framework is to increase supplier resilience and reduce failure, which suggests our main focus should be on going-concern capital.

6.46. Generally speaking, going concern capital is that which can immediately and reliably absorb unexpected losses. That means it usually is limited to those instruments which are high quality and reliably available to be able to absorb losses even in a situation where market conditions might be deteriorating. Principally, this traditionally is equity, which can be more expensive.

6.47. Retail suppliers have different funding models and sources they draw on to weather unexpected shocks – also called contingent capital. This can include cash, but also sources of funding that don't appear on balance sheet- like access to overdraft and credit facilities, sometimes through a parent company, or letters of credit within a Group. These sources of funding tend to be less expensive.

6.48. The overarching financial resilience framework will need to consider how different measures – including ringfencing and capital adequacy – line up to achieve an appropriate level of resilience, including an appropriate share of equity alongside contingent capital.

6.49. Any element of contingent capital in a regulatory capital calculation would likely need to be subject to criteria to assess the extent to which it could be reliably drawn on for the purpose of absorbing unexpected losses. Some criteria that could help make this judgement are:

- What is the maturity of the instrument?
- Are there any conditionalities around access to this source of funding?
- To what extent is it subordinated, meaning in the case of default, where does it rank in terms of when it needs to be paid out in full?
- Are there requirements or triggers in the instrument that jeopardise its loss-absorbency?

Table 4: Going concern capital and contingent capital

Going Concern capital (on balance sheet)	Equity Retained Earnings Reserves Any other perpetual capital instruments that are sufficiently subordinated
Contingent capital (off balance sheet)	Credit facilities Letters of credit Overdraft facilities Parent company guarantees

6.50. For those retail suppliers in a group, we would also need to consider the extent to which any regulatory capital measure is set at a subsidiary versus group level and on a consolidated basis, or a combination of approaches. This would likely be influenced by the level of confidence on the ability of a firm to actually access funding needed to absorb unexpected losses in a reliable manner.

6.51. We published updates to guidance⁶⁰ in May clarifying that suppliers are required under the OCP to have sufficient control over material assets required to run their supply business, and under the FRP to have sufficient control over any asset it uses to meet its obligations under the FRP. We are publishing a statutory consultation⁶¹ alongside this policy consultation to embed the key components of this guidance into the supply licence. Any approach to defining regulatory capital adequacy would take into account the impact of these existing rules.

6.52. In addition, we propose to consider how some independent business models that already rely heavily on cash reserves for risk capital also may need to draw heavily on that cash during a period of stress to post collateral.

⁶⁰ [Guidance on the Operational Capability and Financial Responsibility principles](#)

⁶¹ <https://www.ofgem.gov.uk/publications/statutory-consultation-supplier-control-over-material-assets>

What design should a capital adequacy regime take?

6.53. We have been considering approaches that regulators have taken in other sectors to understand best practice, and the high-level spectrum of models that we could pursue. Ultimately, any approach would have to suit the specificities of the energy retail market to get the best outcome for consumers.

6.54. A regulatory regime to underpin sufficient levels of capital in suppliers could take a number of forms, ranging in terms of the level of intervention, complexity and cost and the market stability and benefits they afford.

Table 5: Approches to capital adequacy

	High restrictions, lower ongoing monitoring	Lower restrictions, higher ongoing monitoring
Design	Hard-edged, uniformly applied rules designed to minimise incidence and costs of failure, requiring less frequent and rigorous monitoring	Highly targeted and/or principles-based interventions aimed at suppliers that fail financial resilience assessments, requiring frequent, granular, and rigorous monitoring
Limitations	May be more limiting to certain business models given uniform rules, and capital levels may not be set as efficiently as possible Could encourage gaming.	More complex and resource intensive High granularity likely means more adjustment needed over time Less transparent than a rules-based approach
Benefits	Lower complexity and cost, with maximum transparency Offers stability over time	Compatible with a range of suppliers and business models More efficient capital requirements as based on risk More responsive to changes in supplier/market behaviour

6.55. It may be possible to apply different approaches to distinct market segments – with higher scrutiny or requirements associated with those business models that posed the greatest risk to the market. We would need to consider how such an approach could be aligned with Ofgem’s existing supply licence framework entry requirements.

6.56. As noted above, we are considering in parallel a review on how returns are allowed under the Default Tariff Cap. Capital requirements and the consequential return allowed through the price cap will be set based on what a notional efficient and well hedged company needs in order to reach a certain level of resilience. However, the amount of capital actual

suppliers could be expected to hold would depend on their individual circumstances. We may, for example, require higher risk (e.g. poorly hedged) suppliers to hold more capital or to take additional risk management actions in lieu of more capital. We would also expect suppliers to consider capital requirements in their pricing if they choose to set competitive (non-SVT) tariffs.

6.57. Our suggested approach to a financial resilience framework including capital adequacy is a combination of elements across the spectrum of prescriptiveness to allow for an approach implemented via licence conditions and guidance that is both flexible across business models while ensuring an appropriate target level of resilience and appropriate level of return under the price cap.

Table 6: Approaches and monitoring/enforcement

	Approach:	Monitoring/ Enforcement
Pillar 1: Minimum regulatory capital buffer	<p>Suppliers will be expected to maintain a minimum buffer. The regulator will define:</p> <ul style="list-style-type: none"> • Minimum amount of capital needed for well-hedged supplier to endure a certain level of unexpected shock and remain solvent • What that capital must consist of (equity versus contingent capital) <p>This will be fed into determining the appropriate return under the price cap.</p>	<p>A wider financial resilience monitoring framework will allow for ongoing monitoring of suppliers' capital positions and overall financial resilience, including:</p> <ul style="list-style-type: none"> • Possible new Capital Adequacy Assessment reporting, in which suppliers describe how they meet minimum Pillar 1 requirements, and how they conduct their own internal risk management and stress testing to ensure sufficient capital for their specific business model and risks. • Ongoing monitoring and reporting related to range of financial resilience measures, MCF, CCB and RO protections, FRP, OCP, and entry and milestone assessments • Ongoing regulatory stress testing <p>Taking all these elements together,</p>
Pillar 2: Additional bespoke capital buffer	Ofgem will consider the holistic picture of a supplier's financial resilience in practice to	Ofgem will consider on a proportionate basis the need for any additional measures for a supplier to manage risk and meet a target level of resilience,

	determine what additional actions are needed – including possible additional capital – to meet a target resilience level.	including the possibility of additional capital requirements. The amount and content of additional requirements would be determined on an individual basis, and this amount would not be covered by price cap returns.
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6.58. The Pillar 1 minimum buffer would be developed based on considering what capital a well-hedged supplier needs to ensure they can withstand a certain shock and remain solvent. This will need to be based on coming to a view on the questions set out in above – what risks are most relevant for the supplier business and what is the appropriate level of insurance against those risks, which will allow for a determination on the appropriate level of loss-absorbing capital needed and how it needs to be defined for a well-hedged supplier. This determination will also need to consider the extent to which ringfencing and capital adequacy measures work together dynamically to reach this target level of resilience and certain capital levels.

6.59. The Pillar 2 approach could evolve as needed to suit our dynamic approach to the overarching financial resilience framework. For example, should ultimately the framework allow for reduced ringfencing on the basis of suppliers having a certain level of capital, more granular or prescriptive reporting requirements may be needed regarding those capital levels. Or, should regulatory stress tests and supplier reporting on capital adequacy assessments reveal weaknesses in how suppliers are determining levels of risk and capital for their business model, Ofgem may evolve rules to include more granularity around how risks and capital are calculated and reported. More granular rules could be targeted to different suppliers based on sophistication. This could involve, for example, allowing suppliers with sufficient internal modelling capacity to continue using internal models subject to certain standards, and providing a standardised modelling approach for suppliers with less sophisticated internal modelling capacity.

Examples from Banking: Pillar 1 and Pillar 2 Capital

Our suggested approach to capital adequacy as part of a wider financial resilience framework reflects elements of approaches to regulatory capital for banks.

Pillar 1: Minimum Capital and prescribed modelling:

Under the international Basel standards for bank capital adequacy, minimum regulatory capital requirements for certain risks, including market risk, can be calculated using standardised or internal elements. Market risk can be calculated using an internal modelling approach, a standardised approach, or a simplified standardised approach. Subject to approval, a bank can use internal models to calculate risks in required calculations. Otherwise, the standardised approach uses a sensitivities-based method, which specifies certain approaches and elements like risk factors and associated risk weights. For those banks with smaller and less complex portfolios, a simplified standardised approach was maintained.

Pillar 2: The Supervisory Review process and bespoke assessments:

Pillar 2 requirements are additional and subject to the discretion of individual regulators. The Prudential Regulation Authority (PRA) follows a Supervisory Review and Evaluation Process (SREP), whereby it evaluates a firm's Internal Capital Adequacy Assessment. Pillar 2 capital will be set to address firm-specific risks not adequately covered under Pillar 1. The SREP process is done in a way proportionate to the size of firms. The PRA may also impose a firm-specific "PRA buffer," which is set based on three components: an assessment of capital firms needs to withstand a severe stress scenario; a risk management and governance assessment; and general supervisory judgement.

6.60. As we develop our wider approach to financial resilience we may consider the value of any additional elements. This for example could include a separate fund that could be established with supplier contributions to further cover costs associated with supplier failure.

6.61. This fund by itself could not cover the full outcomes desired from a financial resilience framework as set out in the chapters above. For example, it is not clear this approach would meet our objectives on its own of removing incentives on suppliers on taking excessive risk and pursuing risky business models. It would also likely take time to set up a fund of this nature appropriately.

6.62. However, this could serve as a supplementary add-on to further insulate the wider market and consumers against the fall-out of supplier failure. Contributions to the fund could be a set amount, based on a certain company size, or could potentially be based on the level of risk a supplier posed to the market.

Example from the Civil Aviation Authority: ATOL

The Civil Aviation Authority (CAA) manages the ATOL financial protection scheme for holiday makers.

All licensed travel companies – save for small franchise companies – are subject to ongoing risk assessments based on financial criteria set by the CAA. Companies that don't meet CAA financial criteria may have additional licence conditions imposed on them prior to licence renewal, such as cash injection. In addition, licence holders contribute to a trust fund used to support consumers to minimise disruption to their holiday in the event their package organiser ceases trading. This ATOL Protection Contribution (APC) is funded via a flat levy applied to each traveller.

The ATOL regime is currently being reviewed to consider ways to further protect consumer money and make the regime more risk sensitive. The CAA is considering a range of options, including:

- Total or partial segregation of advanced customer money

- A more risk-sensitive contribution to the ATOL fund based on, for example, companies' risk profiles and capital structures, and the extent to which a company has ringfenced advanced customer money.

Next steps

In developing this policy we will need to have regard to licensee financeability. The regulation of the retail market is evolving alongside this policy development and we plan to particularly align the development of this and price cap return reforms. As part of this, we plan to facilitate stakeholder engagement following this initial policy consultation and as we progress policy development, with the intention of then consulting on further developed proposals by Autumn.

7. Impact Assessment

Summary

In this chapter is our analysis of the impacts of our proposals.

Questions

Question 20: Do you have any views on our analysis of the impacts of our proposals?

7.1. We commissioned NERA to produce a report detailing and quantifying the potential impacts our proposed interventions, on CCBs and RO (as described above in Chapter 2 and 3). We have worked closely with them to develop the methodology and understand its findings as we develop the proposals. This chapter aims to provide details of the problem under consideration and the mechanisms through which we believe transfers and net benefits to consumers may occur, summarise these transfers and net benefits, and provide our view of the unquantifiable costs and benefits of the proposals. Their report is published alongside this consultation to ensure full transparency

7.2. We are not publishing a detailed impact assessment on Capital Adequacy or hedging proposals at this stage. Nevertheless, the current IA indicates the general consumer benefits from a more resilient supply sector and further protection measures.

Problem under consideration

7.3. The proposals in this policy consultation are designed to improve the range of market and regulatory failures, which can result in excess risk-taking and therefore lead to cost inefficiencies, borne by consumers. Although the policy consultation explicitly separates CCBs (Chapter 3) and the RO (Chapter 4) policy interventions, the assessed proposals both relate to the cost mutualisation in the event of a supplier failure. The failures under the current arrangements therefore result in a single 'problem statement' across both CCBs and the RO. A detailed description of the market failures and the problem statement is given in Section 2 of NERA's report. The proposals in this policy consultation aim to protect CCBs and the RO in the event of supplier failure. As a result, consumers would no longer implicitly provide insurance for CCBs and RO and they would no longer be recovered through the SoLR levy, funded by all consumers in the event of a supplier failure. Instead, suppliers would have to

engage directly with third parties to either insure their balances or to provide working capital in its place (for example, if it is placed in an escrow account).

7.4. In the IA and NERA's report we assume that the cost of doing this will be passed through to consumers, either through an allowance in the Default Tariff Cap for default tariffs and/or through price competition for those consumers not served by default tariffs. As such, the proposals take a cost which consumers only bear *ex-post* when suppliers fail and turn it into a form of insurance which would be paid regardless of supplier failure. As a result, in this IA and NERA's report, explicitly insuring or protecting CCBs and ROs does not change the total cost in expectation. In a competitive capital market, we assume that these products would be priced fairly (and equivalently) to reflect the risk and expectation of default / payout.

7.5. This could benefit consumers since recent experience shows us that bankruptcies are more likely to occur when wholesale prices are rising. As such, SoLR levy costs add an additional cost onto consumers' bills, exacerbating any issues they are already experiencing due to rises in the cost of living. For instance, customers currently face a £65 SoLR levy from the 2021 bankruptcies and at the same time, the price cap is increasing by £693 due to rising wholesale costs.⁶²

7.6. Many of the costs and benefits which we assess between the two cases (pre- and post-policy worlds – see below) are actually transfers from one group to another. For example, while consumers, particularly the disengaged, pay for the risky business models supported under the current arrangements, the customers who are served by these risky suppliers themselves benefit from the low rates that they receive before failure. By limiting the ability and incentive of suppliers to offer below-cost tariffs supported by implicit insurance from the generality of customers, customers will no longer have access to these rates. This represents a transfer between customer groups. All consumers will benefit from fewer SoLR events, saving them money in the process.

7.7. A policy that stops or reduces the extent of these transfers is still a worthwhile outcome on equity grounds: one group of customers generally should not have to pay for the benefit earned by another. This is particularly the case if the burden of transfers falls on disengaged and vulnerable customers. Therefore, even though transfers may fall outside the

⁶² <https://www.ofgem.gov.uk/publications/price-cap-increase-ps693-april>

scope of the 'true' economic benefits, there are wider, equity-based benefits for the implementation of the policy. Specifically, disengaged customers are more likely to be lower income than engaged customers, so a policy that redistributes value from engaged to disengaged customers will tend to be more socially beneficial than the pure transfers of money would suggest.

7.8. In addition to transfers and equity-based benefits, we believe that the proposals could lead to net benefits to consumers by addressing the information asymmetries that exist under current arrangements. Specifically, the moral hazard⁶³ associated with suppliers not bearing the full cost of their risk taking by have access to cashflows (CCBs and RO) that they do not have to pay back if they fail. This leads to excessive risk-taking. In particular, a supplier may take on risky business strategies supported by the working capital provided by (a) standing customer balances; and (b) the ability to defer purchasing ROCs or sell existing ones.

7.9. If a supplier fails, the value of these mutualised costs are paid by the generality of customers, meaning that the failed supplier does not have to pay back lenders before failure, or accept a larger loss to equity holders. As a result, the supplier has an inefficiently large incentive to take risks: equity holders share the downside with the generality of customers and have sole ownership of the upside.

7.10. In addition, consumers do not typically observe the business strategies of suppliers and therefore cannot easily discern whether a supplier has a viable business model or not. The most observable characteristic of a supplier is the price it offers, and risky strategies (such as hedging less energy) are generally cheaper when they do not result in failure. Moreover, the existence of the SoLR regime limits customers' incentives to monitor supplier behaviour: when a supplier fails, customer credit balances are not at risk. As a result, consumers have incentives to switch to the cheapest (potentially high risk) suppliers irrespective of the probability of failure. The inability to distinguish between well-run suppliers and poorly-run suppliers and the tendency for riskier suppliers to offer lower prices creates a problem of adverse selection, where suppliers must adopt riskier strategies in order to be able to compete with other risky suppliers.

7.11. As a result of these market failures, the industry implicitly supports business models which are inefficiently risky and prospective suppliers may enter into the market without a

⁶³ Moral hazard occurs when decision makers do not bear the full cost of their actions, leading to excessive risk-taking.

viable strategy for long-term success. As a result supplier failure rates are likely to be higher than they otherwise would be and consumers will consequently pay for the costs of supplier failure more often than is efficient.

7.12. By protecting CCBs and RO payments, suppliers would internalise the costs of financing. As a result, they would have a greater incentive to operate with a reliable business model and more scrutiny by investors. We believe this will result in lower failure rates among small suppliers in particular. This could lead to number of potential benefits, including lower administrative costs associated with entry and exit, fewer inefficient switches and a lower cost of mutualising CCBs and RO. These are detailed further below.

Methodology

7.13. In this chapter, we describe the high-level approach NERA has taken to assess and quantify the potential impacts of the proposals. A more detailed description, including how each cost/benefit item is estimated, can be found in Section 5 of NERA's report.

7.14. This impact assessment estimates the costs and benefits of Ofgem's proposed policy interventions by analysing the economic transfers between consumers and suppliers in a "pre-policy" world and comparing these with the transfers between consumers and suppliers in a world where the proposed policies have been implemented ("post-policy"). By taking the difference between the costs of these two 'worlds', it assesses both the total net benefit of the policy as well as the net benefit to individual groups.

7.15. NERA use two alternative approaches to assess the potential impact of our proposals. The first takes an 'equilibrium view' to calculate what the equilibrium effect of our proposals would be. This is done by calculating the changes in the cost of insuring CCBs and RO, hedging costs, domestic tariffs for different consumer groups, switching costs and administration costs of the policy once the moral hazard described above is addressed and supplier incentives to operate with reliable business models are improved. The second takes a 'historical view' by measuring the costs which have materialised in recent years, for example the amount of mutualised positive credit balances, RO costs and hedging costs of customers of failed suppliers. This, by definition, is backward looking and so only calculates the costs that might have been reduced had the policy been in place and the moral hazard been addressed, rather than positing a future, post-policy world.

7.16. NERA's analysis is informed by the historical pattern of supplier failures and their impacts within a reference window between January 2016 and December 2021 ("the

reference window"). We have chosen this reference window as the Competition and Markets Authority mandated a price cap for prepayment meter customers in 2016, which also saw the first supplier failure in over a decade and marked the beginning of a period in which small suppliers began to have a more material share of the domestic market, achieving 14 per cent combined market share in March 2016. 2021 was characterised by very high wholesale energy prices and ensuing supplier failures. These circumstances may not occur as frequently in our sample (eg in one year in a six year sample). As a result, including 2021 may overstate the benefits of reform. To test this assumption NERA have performed a sensitivity where they use a post-price cap reference window of 2019 to 2021 but weight 2021 to reflect what would happen if it were a 1-in-20-year event. This can be found in Appendix B.3 of NERA's report.

7.17. Our post-policy world is primarily defined by the assumption that the proposed interventions will reduce risk-taking behaviour and so reduce default rates by putting the capital of equity and bondholders of supply businesses at risk when suppliers fail. Our estimated range of impacts is defined by the extent to which the interventions are effective at reducing the rate of default, and consequently for some benefits, the cost of capital. NERA report results for two scenarios, referred to as a "Partial Effectiveness" scenario, in which small supplier default probability falls to one consistent with a typical B-rated firm (2.22%), and a "Full Effectiveness" scenario in which small supplier default probability falls to one consistent with a BBB-rated firm (0.06%).⁶⁴

7.18. In this IA we only present the most conservative results of the 'equilibrium view', that is that small suppliers reach a B credit rating. Because the equilibrium view is more theoretical, NERA has produced a high and low estimate of the costs of the pre-policy world. These are produced below for the B credit rating scenario. Detailed assumptions underlying these high and low estimates can be found in Section 5 and Appendix C of NERA's report. All other results and sensitivities can be found in Section 6 and Appendix B of NERA's report, respectively.

7.19. In forming a view on the impacts of the policy a range of further assumptions are made, which are detailed in Section 5 and Appendix C of NERA's report.

⁶⁴ Detailed assumptions around supplier default rates and cost of capital can be found in Section 5 of NERA's report.

Summary of quantified costs and benefits

7.20. We consider that proposals set out in this policy consultation should lead to a lower cost of supplier failure for all domestic consumers. Through a transfer of risks from consumers to suppliers and improved incentives on suppliers to reduce the associated costs of these risks, the proposals should also reduce the incidence of supplier failure, and therefore further lower the cost of failure. Furthermore, the proposals should also reduce the total cost of the SoLR process, administering failed suppliers and 'inefficient' consumer switching (where consumers gain little to no long-term benefit, for example where a supplier prices at an unsustainably low level), which together represent the social cost of current arrangements. As a result, the proposals should reduce social costs.

7.21. The high-level impacts of the proposed policy interventions (the detailed impacts being available in Sections 4.2-4.4 of NERA'S report) are that:

- Domestic consumers, in particular disengaged consumers, will generally transfer less money to the customers of failed suppliers to cover for mutualised CCBs and RO, due to both fewer defaults and the protection of CCBs and the RO when default occurs;
- Domestic consumers, in particular disengaged consumers, will generally transfer less to the customers of failed suppliers to cover differences between wholesale prices and allowances under the price cap, due to the lower frequency of default. This difference is only material in an increasing wholesale prices environment, which will be partially mitigated by Ofgem's proposal to introduce a quarterly price cap period;⁶⁵
- Customers of suppliers who would otherwise fail are likely to face higher prices due to decreased incentives for those suppliers to offer unsustainably low prices based on subsidised capital. Other engaged consumers may see a knock-on impact, at least in the short run, if reduced competitive pressure on rival suppliers allows them to increase their prices;
- Customers of failed suppliers, and suppliers themselves, will see reduced switching costs due to a reduced failure rate, and hence reduced rates of forced switching (eg, after a SoLR process); and
- Customers will have to pay for the additional implementation and enforcement costs that Ofgem will incur in administering the policy, and for the compliance costs of

⁶⁵ <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology>

suppliers. We have not included estimates of these costs, but they are likely to be relatively immaterial to the other costs/benefits.

7.22. While all consumers together should benefit from these proposals, all domestic consumers may not benefit equally as this will depend on their supply and the type of tariff they are on. Table 1 below presents the impact of the policy on different groups of consumers if the policies achieve Partial Effectiveness (i.e., default probability of small suppliers to that broadly consistent with a credit rating of B). The total impact on the three different customer groups (customers of failed suppliers, engaged customers with other suppliers and disengaged customers) yields a net benefit of the policy for consumers of between between **£87m** and **£467m** per year.

Table 7: Net benefits to each group in 'Partial Effectiveness' equilibrium view (£m/year)

	Customers of failed suppliers		Engaged customers with other suppliers		Disengaged Customers		Total Consumers	
	Low	High	Low	High	Low	High	Low	High
Cost of Insurance - CCB	(2)	(0)	13	22	34	46	45	68
Cost of Insurance - RO	(4)	(4)	7	7	27	28	30	31
Hedging	3	27	16	126	22	179	41	332
Additional Tariff Increase	(30)	(21)	(44)	(28)	0	0	(75)	(49)
Switching Costs	39	77	3	4	4	6	45	87
Admin Costs of Policy	0	0	0	0	0	0	0	0
Total	6	79	(6)	130	87	258	87	467
(£ per affected customer)	3	34	(1)	12	6	17	3	16
Total (social equity weighted)	6	76	(6)	125	90	269	90	469
(£ per affected customer)	2	33	(1)	10	6	17	3	16

7.23. Finally, in this IA, we assume that large legacy suppliers will continue to operate under sustainable business practices and maintain their BBB rating. However, if the status-quo world endures, distorted competition may induce prudent suppliers to exit the market or incentivise these suppliers to engage in risky behaviour. As a sensitivity, NERA modelled their scenarios under the view that the pre-policy rating for large suppliers falls to a BB and is upgraded back to a BBB post-policy. The report presents results which demonstrates net benefits from the policy of between £155 million and £474 million post-policy. See Section B.2 of NEREA's report for more detail.

Distributional consumer impact

7.24. We believe that the proposals have a positive distributional impact on consumers due to the general transfer of costs/risk from the majority of consumers, including disengaged consumers, back to engaged consumers with unsustainable suppliers. The small positive distributional impact is reflected through the difference between the unweighted and socially weighted benefits in Table 1 above.

Impact of different policy measures

7.25. Our assessment of the individual impact of the proposed measures (in particular RO and CCBs) suggests that a single one is insufficient to adequately address the moral hazard. For example, the protection of RO alone appears unlikely to bring about sufficient changes in the incentives for suppliers. Nevertheless, we believe that a combination of RO and CCB protections could address the moral hazard issue sufficiently to achieve 'Partial Effectiveness'. We intend to publish a full impact assessment of the capital adequacy measures in due course. The latter should reflect an increase in effectiveness compared to the Partial Effectiveness scenario as the additional capital adequacy measures should be designed to correct for further market failures.

Impact on market structure and competition

7.26. We believe that these proposals, alongside other measures, are likely to enable a more sustainable competitive market that should be beneficial to consumers over time through increased market stability and a better environment for innovation to take place. On the other hand, we recognise that these proposals could affect suppliers' entry and/or expansion, and could even lead to exit. However, we believe that it is beneficial to consumers to limit the opportunities for inefficient expansion or entry. These dynamic benefits are not accounted for in the table above.

Other unquantified costs and benefits

7.27. We believe that there are various consumer benefits that support the case for intervention which we have not sought to quantify.

7.28. Despite the best efforts of Ofgem and many SoLRs, a number of consumers report having experienced issues throughout the SoLR process. A recent Ofgem consumer survey⁶⁶ showed that:

- Around half (52%) of SoLR'd credit meter customers said they were double billed (i.e. billed from their old and new supplier for the same time period);
- A similar proportion of SoLR'd credit meter customers (50%) said their smart meters stopped working when they were moved supplier (although about 80% of these said it had started working again by the time of the survey), and
- Four in ten (41%) SoLR'd prepayment meter customers reported having temporary difficulty topping up their meter after being moved supplier)⁶⁷.

7.29. We have heard that consumers have felt their payments have been 'tied up' with failed suppliers and the experience, at a time of financial distress for many households, has caused significant anxiety. We believe that this policy should bring material, unquantified consumer benefit in reducing the likelihood of supplier failure and therefore reduce the likelihood that consumers face these negative experiences.

7.30. We consider that consumers should experience improved bill stability as a result of the proposals both because of lower rates of failure and lower SoLR levy costs in the event of failure. This benefit is particularly important when supplier failures have typically taken place when prices are increasing and consumers may already be struggling financially.

7.31. Engagement in the market could fall as tariffs for small suppliers in particular could increase, and so tariff differentials fall, as a result of them facing the social costs of their actions. A possible reduction in engagement is neither quantified nor taken into account in the cost benefit analysis, and could contribute towards lower competitive pressure on larger incumbent suppliers.

7.32. These proposals could increase costs for small suppliers relative to large legacy suppliers as they don't necessarily have access to capital at the same cost of capital in order

⁶⁶ Ofgem has recently commissioned a multi-wave quantitative survey, intended to monitor customer experiences of the current energy market. The first wave of this research, undertaken in March 2022 with 3,479 GB energy consumers, will be published in due course.

⁶⁷ The sample size of prepayment meter customers who said they experienced a SoLR was low (n=39) and so these exact figures should be treated with caution.

to replace the CCBs and RO they would otherwise have access to. As a result, this could lead to lower competitiveness of small suppliers.

Risks and limitations

Risks

7.33. The key driver of the costs and benefits described above is the assumptions that by suppliers internalising the costs of their risk-taking and so removing the moral hazard that exists, suppliers will experience a lower failure rate commensurate with B or BBB rated companies (depending on the scenario), and for some benefits, that this will attract a lower cost of capital. If the proposals fail to achieve this, then costs and benefits will not materialise as expected. Alternatively, if a subset of the policies were to correct the market failure⁶⁸ then suppliers may face a higher cost of doing business than they otherwise would. However, consumers would still no longer have to pay as much mutualised costs in the event of supplier failure (since CCBs and RO are protected). In equilibrium and on an expected annualised basis these should net out.

7.34. These proposals could create a further barrier to entry/expand for suppliers. Although this is a natural consequence that we believe will contribute to building a more stable and sustainable market, it could conversely dampen the competitive pressure on existing suppliers.

7.35. The net benefits presented above are dependent on the design and efficacy of the proposals. The current methodology assumes that the policies will effectively address the market failures described above. For example, if the proposals themselves and/or some external circumstances prevent suppliers from abandoning risky business models, the costs and benefits quantified and described above will fail to materialise.

Limitations of the approach taken to quantify the impacts of proposals

7.36. *Reference window:* In assessing the likely impact of the proposals our assessment has been informed by the reference window between January 2016 and December 2021. We could rely on evidence from alternative windows. However, this period represents the longest window for which we have consistent data, and where smaller suppliers make up a significant

⁶⁸ This is however difficult to justify given there would still be remaining moral hazard in suppliers' incentives.

market share (i.e., greater than 10 per cent in aggregate). This period is an imperfect view of an equilibrium going forward. The price cap was only introduced in January 2019 and it may have affected both the probability and cost of failure. Therefore, including years 2016 to 2018 may understate the benefits of reform. Conversely, the most recent period since Autumn 2021 has witnessed high gas prices by historical standards which has prompted around half of all SOLR events and a large proportion of hedging costs from SOLR events in particular. We consider that we have struck the appropriate balance in the selection of the reference window. NERA have however explored a sensitivity with an alternative reference window. See Section B.3 of their report for details.

7.37. *Effectiveness of the interventions*: NERA's approach to quantifying the impacts of reform is to identify the potential consequences of the market failures arising from current arrangements and to compare these to a position where policy interventions resolve those market failures. NERA's report presents results based on alternative assumptions about the extent to which the policy interventions resolve those market failures and lower the failure rate of suppliers.

7.38. *Transactions costs and the cost of raising capital*: The approach assumes that the risks surrounding the cash-flows of the business primarily determine the credit rating achieved by a business and the rate of interest it pays. As such, it does not capture the transactions costs associated with raising capital except insofar as those are manifested in the payments to providers of that capital.

7.39. *Intensity of competition*: We have assumed that obligations and costs imposed on suppliers, particularly entrant suppliers, will ultimately feed through to prices paid by consumers due to competitive pressures in the active customer segment of the retail market. We similarly assume that changes in the costs faced by creditors feed through into prices paid to those creditors due to competitive pressures in the market for capital.

7.40. *Effectiveness of the individual proposals*: The current assessment does not explicitly distinguish the impact of each proposal. This is because the benefits associated with a lower mutualisation of wholesale costs is attributable to one or the other proposal but to the overall reduced rate of failure.

7.41. *Transitional Arrangements*: In evaluating whether the proposed policies could be implemented, we have looked at what suppliers have already told us through our regular monitoring activities about their expected obligations, credit condition and access to funding.

We are seeking through this consultation and an accompanying RFI on CCBs to better understanding individual supplier specific circumstances.

7.42. Many assumptions have been taken in order to quantify the potential impacts of the proposals. We have highlighted here what we consider the most significant, however detailed modelling assumption behind NERA's analysis can be found in Appendix B of their report.

8. Appendix

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Appendix 1: Consultation Questions

Chapter 1: Introduction

Question 1: Do you think that the measures we are proposing sufficiently and proportionately address our objectives? Are there other measures that you think we should consider to better meet our objectives?

Chapter 2: Customer Credit Balances

Question 2: (For suppliers) What impact would ringfencing customer credit balances have on your business and to what extent could this be mitigated through transitional arrangements? Please explain your response and provide supporting evidence where possible.

Question 3: Do you agree that we should apply the Gross Credit Balance net of Unbilled Consumption definition for the purpose of ringfencing CCBs? Please explain your response and provide supporting evidence where possible.

Question 4: Do you agree with our view that the Protection Amount Calculation should be updated quarterly and based on backward-facing data, forward-facing projections, or a combination of the two? Please explain your response and provide supporting evidence where possible.

Chapter 3: Renewables Obligation

Question 5: Do you agree that option 3 ('protect or discharge through ROCs' obligation) is the best approach for addressing supplier payment default under the RO - and if not, what is your preference and why?

Question 6: How, and to what extent, would a requirement to protect your RO impact your business and the way you currently interact with the scheme? If we were to ask suppliers to create a trust in favour of Ofgem over the proceeds of sale of ROCs, do you foresee any challenges with this and would it disincentivise you from buying ROCs?

Question 7: How, and to what extent, do you think a requirement to protect your RO would impact the ROC market?

Question 8: Do you agree the proposal should be effective from April 23? Do you see any issues or concerns with the transitional phases we have laid out?

Question 9: What, in your view, would be the appropriate frequency of the reporting requirement: once an obligation period or quarterly?

Chapter 4: Protection Mechanisms

Question 10: Do you agree with suppliers being able to select from a menu of protection mechanisms and do you agree with the mechanisms we are considering?

Question 11: Do you agree with the minimum requirements set out for each protection mechanism and do you have any further comments on the protection mechanisms or the guidance that should be provided on them?

Question 12: Do you consider that suppliers would be in a position to obtain suitable insurance to protect CCB or RO funds, and, if so, do you think that this would be competitively priced?

Chapter 5: Hedging

Question 13: What do you consider would be the impact on your business and the wholesale market of implementing the two options we set out and how might these be mitigated?

Question 14: Are there other options to more effectively reduce the wholesale costs to consumers of supplier insolvencies?

Chapter 6: Capital Adequacy

Question 15: What are your views on our proposed high level approach to a capital adequacy framework? Do you agree that capital adequacy requirements would be required in addition to our ringfencing proposals?

Question 16: Do you agree with our suggestion that a capital adequacy framework should take a segmented approach – with measures implemented in a proportional way for different segments of the market, largely based on the level of risk that a company could pose to the market?

Question 17: What risks do you think are most appropriate to target with a capital adequacy regime? What risks do you currently target in your internal risk assessments and risk capital determinations?

Question 18: Do you have any views on the level of financial resilience that a capital adequacy regime should seek to target? What are your views on an appropriate time horizon for calculating capital requirements? What time horizons do you use in internal risk management?

Question 19: What type of capital should be included under capital adequacy requirements and what criteria could be used to determine this? How do you currently define what can be considered as sufficiently loss-absorbing capital for unexpected shocks in internal risk management?

Chapter 7: Impact Assessment

Question 20: Do you have any views on our analysis of the impact of our proposals?

Appendix 2: Technical Appendix (Renewables Obligation)

Methodology

Quarterly Obligation

8.1. The Annual Renewables Obligation for each supplier is calculated according to the amount of electricity they supply to customers during each obligation year minus electricity they supply to Energy Intensive Industries (EIIs) (the 'relevant electricity' supplied). To do this, in July (and in June for estimated figures) following the obligation period, Ofgem receives backward-facing:

- total supply volume data submissions from Elexon and suppliers, and
- EII supply volume data from EMR Settlement Limited (EMRS) and suppliers

8.2. To deliver the proposed policy, suppliers would be required to demonstrate they were meeting an accruing amount on a quarterly basis – either by purchasing ROCs or putting credit cover in place.

8.3. Following each quarter, a supplier's relevant electricity supply volumes for that quarter would be determined and the prevailing renewables obligation (i.e. ROCs per MWh) would be applied to that volume. This would set the 'Quarterly Amount' in ROCs.

8.4. The Quarterly Amount would be calculated as:

$$QA = RES \times LO$$

Table A.1 - Quarterly Amount values

Value	Full title	metric	comments
QA	= Quarterly Amount	(ROCs)	In a given quarter this would be the number of ROCs a supplier needs to own or provide equivalent credit cover for in accordance with the ROC buy-out price for that obligation period.
RES	= Relevant Electricity Supplied	(MWh)	The amount of electricity supplied by a supplier in a given quarter, exempting any supply to EIIs.
LO	= Level of Obligation	(ROCs per MWh)	The number of ROCs that suppliers must present for each MWh of RES supplied. For obligation period 2022/23 this is 0.491 ROCs per MWh in Great Britain ⁶⁹ .

8.5. The process to determine Relevant Electricity supplied is already done on the Feed-in Tariffs (FIT) scheme to conduct 'periodic (quarterly) levelisation'. We will use data outputs from this process to avoid duplication, removing Green Import Exemptions (GIE) which are factored into FIT, but not RO calculations.⁷⁰

8.6. Under the FIT scheme, suppliers are required to provide electricity supply data to Ofgem within 10 working days of the end of the quarter. As the same process will be followed, the same deadline would be given.

8.7. Ofgem will undertake checks of that data and communicate the 'Cumulative Amount' to suppliers within 10 working days of the supply volumes submission.

⁶⁹ This is published on the Ofgem website annually ahead of the obligation period

⁷⁰ GIE (or 'qualifying renewable electricity' in [article 27 the FIT Order 2012](#)) is the deduction from supply volume of electricity sourced from an EU member state. It is evidenced with Guarantees of Origin (GoOs), and was stipulated under EU state aid rules; The government is currently consulting on the removal of GIE following Brexit.

Cumulative Amount

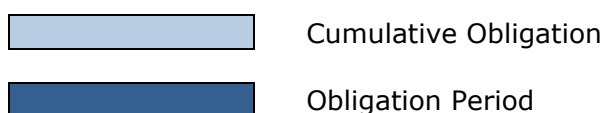
8.8. At the end of each quarter, the total of all elapsed Quarterly Amounts within that obligation period would be combined. This would be the 'Cumulative Amount' in ROCs:

$$\text{Cumulative Amount} = \text{sum of Quarterly Amounts in Obligation Period}$$

8.9. A supplier's Cumulative Amount increases throughout the obligation period. The table below visualises this over 19 months.

Table A.2 – process schedule

*Two-month late payment window (during which suppliers may only present money into buy-out fund – they cannot present ROCs)



Basis	Obligation period (OP)				Settlement period	
	Q1	Q2	Q3	Q4	OP end +3 months	OP end +6 months
SLCs						
RO Order					Settlement	

8.10. The supplier's annual obligation would continue to be calculated and confirmed by Ofgem. It would be settled separately, as stipulated by the Orders. Since the Cumulative Amount will be set using Elexon data each quarter, it will be using data from monthly Settlement runs that are less accurate than those used for annual settlement.

8.11. The result of this is that the cumulative amount will not match the annual obligation, however the discrepancy is expected to be <1%. Furthermore, a near identical process already occurs on FIT whereby 'periodic levelisation' using less accurate supply volume data is reconciled with accurate volumes at the end of the FIT year via 'annual levelisation'. The

relationship between the Cumulative Amount and the Annual Obligation on RO would be analogous to periodic levelisation and annual levelisation on FIT.

How will suppliers meet the cumulative amount

8.12. Suppliers would need to meet their Cumulative Amount at the end of each quarter with ROCs and/or protection. We anticipate aligning the deadline date with the FITs levelisation schedule which would mean that this date would be 10 working days after Ofgem has communicated the 'Cumulative Amount' to suppliers. Any of the Cumulative Amount not met with ROCs must be met with protection that equals or exceeds the value of those ROCs according to the buy-out price in that obligation period.

8.13. By way of example, if a supplier had a Cumulative Amount of 100 ROCs in Obligation Period 2022-2023:

Table A3 – credit cover calculation

Cumulative Amount in ROCs	ROCs in account on deadline date	Outstanding ROCs	Buy-out price (£)	Minimum protection required on deadline date (£)
100	90	10	52.88	10 x 52.88 = 528.80

8.14. Therefore, a supplier would meet their Cumulative Amount if:

$$ROCs\ in\ account + (Credit\ Cover \div Buyout\ Price) = \geq Cumulative\ Obligation$$

8.15. We would capture and compare these 4 values to determine whether a supplier has met their Cumulative Amount.

ROCs submission

8.16. Given that cumulative amount would be measured in ROCs, we would look at the number of ROCs in the supplier's account 10 working days after Ofgem has communicated the cumulative amount to suppliers.

8.17. Suppliers typically have several accounts on the Register each serving a different purpose. For the purposes of meeting their cumulative amount and, in accordance with the settlement process Ofgem will only recognise the ROCs in the supplier account on the Register used to discharge their obligation.

8.18. To calculate the number of ROCs in at/by the deadline date for each quarter, we would capture the number of ROCs in the supplier's account at a set timestamp on the deadline date.

8.19. Only ROCs that have a status of "issued" on the deadline date and time will be recognised as meeting the suppliers Quarterly Amount. This aligns with the Fuel Mix Disclosure (FMD) process and the Renewables Energy Guarantees of Origin (REGOs) report which is extracted from the Renewables and CHP Register by midday 1 July. Only REGOs with a status of "issued" in the suppliers account are recognised towards the FMD.

8.20. Data verification in relation to ROCs held in the supplier accounts is unnecessary as pulling reports from, or receiving presentations of ROCs through, the Register from suppliers both rely on products and services that Ofgem build, control and can trust.

Protection Measures submission

8.21. Any amount of the Cumulative Amount not met with ROCs may be met with protection.

8.22. Suppliers would be responsible for deciding which (if any) protection measure to present to Ofgem. This would be presented to Ofgem by the deadline date.

8.23. Ofgem would provide guidance and templates to suppliers on the evidence of protection that they would need to submit in order to demonstrate their compliance. Ofgem will check these submissions to ensure that they meet requirements (as set out in guidance, and in line with the provided templates).

8.24. Protection requirements are already in place on the Green Gas Levy (GGL) scheme, whereby each obligated supplier must protect capital - either through a letter of credit or cash payment into an Ofgem affiliated Government banking account - in case they do not meet their GGL obligation. Ofgem may then draw down on that cover if a supplier fails to meet the levy deadline.

8.25. For Letters of Credit, we anticipate that we would stipulate the use of the template⁷¹ (adjusted accordingly) similar to that used in the GGL scheme.

⁷¹ [Green Gas Levy Guidance | Ofgem](#) Appendix 1

Appendix 3: Privacy Notice on Consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be as specific as possible.)

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for ***(be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')***

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case, use “the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this”.

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

9. More information For more information on how Ofgem processes your data, click on the link to our “[Ofgem privacy promise](#)”.