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for energy consumers

Consultation

Statutory Consultation: Strengthening Financial Resilience

Subject	Details
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Response deadline:	03 January 2023
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We are consulting on introducing a capital adequacy regime and ringfencing of Renewables Obligation receipts attributable to domestic supply to strengthen the financial resilience of the energy supply market. We would like views from a range of organisations, including suppliers, consumer groups, charities, government bodies, and trade associations. We also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at 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.

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Foreword

The energy crisis has had a profound impact on the sector: its business models, our approach to its regulation, and the way we think about risk. More importantly, it has been an incredibly difficult time for the customers we are ultimately here to serve, who are now facing another tough winter with extremely high energy bills.

At Ofgem, we have been open that there are some things we should have done differently, both before the crisis hit and afterwards. The focus on expanding competition and promoting choice, while benefitting consumers through lower prices, ultimately led to low financial barriers to entry and light regulation of financial risks. The energy crisis exposed problems with this retail market model, leading to a large number of supplier failures towards the end of last year, ultimately costing all consumers through higher bills.

While the profound volatility we have seen in the gas market would have led to some supplier failures in any circumstances, we have been clear that tougher controls and standards should have been in place sooner.

Since our action plan last December, we have made significant progress, setting out a series of measures to strengthen supplier resilience and financial controls. But we also recognise there is a great deal still to do. As such, in May we published an independent report by the economics consultancy Oxera to look at what went wrong, and where we need to go further and faster on retail market reform.

The report laid out a number of characteristics common to failed suppliers: not enough capital to withstand market shocks, unsustainable pricing strategies, and poor hedging against financial risks. It also identified several lessons for Ofgem about how we regulate the sector.

This consultation sets out our proposals to rectify these problems. To prevent the excessive costs of supplier failures that ultimately cost consumers through their bills, it proposes a series of measures to reduce the financial risks that suppliers can run. This is aimed at ensuring the sector is resilient enough to withstand future shocks, while also driving competition that leads to lower prices, better customer service, and the innovations we need to make the transition to net zero.

To do this, it sets out ambitious but achievable short term financial controls, such as the ringfencing of Renewable Obligations receipts from 1 April, while also setting a clear

trajectory to longer term goals, such as increasing minimum capital buffers for suppliers to reduce risks of exit, and rolling out a new monitoring framework to ensure suppliers' liabilities can be met. This transitional approach is aimed at ensuring we can increase resilience while still maintaining a competitive market.

I recognise some of these proposals will be controversial, and suppliers run very different business models. We are seeking views across the industry on how they can be improved; in particular, whether we have struck the right balance between resilience and competition. However, ultimately we have a responsibility as a sector to ensure we are protecting consumers' interests by making sure our financial arrangements are as robust as they can be. At a time of extremely high energy bills, that responsibility is more important than ever, and I look forward to working with the sector to achieve that goal.

Jonathan Brearley, CEO

Executive summary

In June, we consulted on proposals to require suppliers to ringfence customer credit balances (CCBs) and Renewables Obligation (RO) receipts attributable to domestic supply, as well as introducing a capital adequacy regime and proposals to retain hedge values for customers when a Supplier of Last Resort (SoLR) takes a failed supplier's customers. These proposals are part of Ofgem's wider efforts to strengthen the financial resilience of the energy supply sector in the consumer interest, as set out in our Action Plan published in December 2021.[1]

This statutory consultation sets out our revised proposals and accompanying licence conditions. We have listened to the feedback from the June consultation, held stakeholder workshops and bilateral meetings, and further refined our economic appraisal of the policies. We continue to believe there is a strong case to improve the financial resilience of the sector in the consumer interest and that this can be most effectively achieved by setting a market-wide minimum capital requirement for domestic suppliers as well as requiring ringfencing of RO receipts attributable to domestic supply. We are proposing to support this with an enhanced Financial Responsibility Principle and monitoring framework, which will also clearly define Ofgem's expectations on how much suppliers can rely on CCBs for working capital. We continue to consider the responses to our hedging proposals and will respond in due course.

Our focus in this consultation is largely 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. However, we recognise there is a need to ensure financial resilience for non-domestic supply, and to support this we are proposing that our enhancements to the Financial Responsibility Principle will also apply to non-domestic suppliers where appropriate. Through this we plan to closely monitor the non-domestic market and consider the need to extend any of our other proposals to these suppliers.

We believe that setting a robust minimum capital requirement alongside ringfencing of RO receipts is necessary to develop better resilience in the sector and address the 'moral hazard' (i.e., incentives to take excessive risk) which led to so many energy suppliers failing during the energy crisis. The cost of the supplier failures during the energy crisis,

[1]Action Plan on Retail Financial Resilience, 15 December 2021, https://www.ofgem.gov.uk/publications/action-plan-retail-financial-resilience

which is paid for by consumers on their bills, is estimated to be £2.6bn.[2] This figure is likely to increase as we are continuing to process claims from Suppliers of Last Resort appointed in this period. It does not include the cost to the taxpayer of the Bulb Special Administration, currently estimated by the Office for Budget Responsibility to be £6.5bn.[3] It is Ofgem’s view that reducing the risk of failure is strongly in the consumer interest because it will reduce the costs borne by customers and ensure a more stable market which is attractive to investment. However, we recognise that this must be balanced with the cost of introducing these proposals now and their impact on sustainable competition, which drives fair prices.

We believe our minimum capital requirement should ultimately be informed by the level of capital employed allowances set in the default tariff cap. However, given current market conditions, we acknowledge that introducing new capital and ringfencing requirements immediately and at robust levels could be destabilising and introduce unnecessary costs to consumers. We are proposing suppliers meet an interim minimum capital requirement by the end of March 2025 of between £110 and £220 per customer, this range being materially lower than the likely level of capital employed under the revised default price cap EBIT[4] allowance, and on which suppliers will receive a regulated return. Given current market conditions, we expect the March 2025 requirement to be towards the bottom of the range, but we want to test the implications of higher figures with stakeholders. After this initial period, we would expect to set higher targets, building up to the full requirement over a period of years. In relation to ringfencing of RO receipts, we continue to propose requiring all suppliers to ringfence receipts attributable to domestic supply from the 2023/24 scheme year onwards, though we will consider feedback on the optimal implementation period.

What problem are we trying to address?

Recent events in the energy market have exposed that retail businesses have too often had insufficient capital to manage the business of supply and pursued unsustainable strategies with low downside risk to investors. Some supplier business models have been overly reliant on CCBs and money collected to meet RO receipts for working capital,

[2] This figure is comprised of £1.8bn (rounded) approved SoLR claims from SoLRs appointed since August 2021, £423m of minded to SoLR claims (rounded), which are being consulted on and may therefore change, and £296m (rounded) of RO and FiT payments since July 2021.

[3] OBR Economic and Fiscal Outlook, November 2022, p.9

[4] Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance | Ofgem

despite Ofgem's Financial Responsibility Principle and guidance[5] requiring that suppliers are not overly reliant on CCBs, and RO receipts being a government pass-through, not supplier money.

Suppliers without sufficient capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure. They are also more likely to pursue excessively risky strategies because they are less reliant on investor capital. Under present market conditions, the costs of failures borne by customers have far exceeded the costs of refunding the credit balances and RO receipts 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.

As Oxera identified in the lessons learned report commissioned by Ofgem's Board, these models are not in the consumer interest overall because such models do not incentivise good operational performance or good customer service. Suppliers could 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. While this benefited some highly engaged customers in the short term, it added costs for all customers in the longer term as the costs of failure are mutualised, and may have discouraged responsible new entrants from entering the market.

Our overarching objective is to protect current and future consumers by developing a more resilient energy supply market. We want to remove incentives for excessive risk-taking with consumer money whilst enabling an environment for investment and sustainable competition, at the lowest overall cost to consumers. An efficient future supplier should be well-capitalised and able to withstand severe but plausible financial stress. They should be prudently run and risk should be properly managed. This will ensure that consumers, energy suppliers and investors can have confidence in the energy supply market going forward.

[5] https://www.ofgem.gov.uk/publications/decision-proposed-guidance-operational-capability-and-financial-responsibility-principles

What are we consulting on?

Evidence submitted in response to the policy consultation highlighted that introducing all three measures we consulted on may not be in the consumer interest as it would represent over insurance and therefore add unnecessary costs to consumers. It is also clear that inefficiencies and financial frictions in the capital markets mean that it will be very challenging for some suppliers to raise the additional capital to comply with these requirements in the short term. We have developed our proposals since June to strike the right balance between financial resilience and sustainable competition. We are consulting on the following proposals:

Enhanced Financial Responsibility Principle: We are proposing to enhance the existing Financial Responsibility Principle (FRP) set out in supplier licences. It will embed the minimum capital requirements for domestic suppliers, as well as introduce a positive obligation on all supply licensees to evidence that they have sufficient business-specific capital and liquidity so that their liabilities can be met on an ongoing basis. The enhanced FRP will provide Ofgem with additional regulatory tools to facilitate ongoing resilience and minimised mutualisation costs, such as a requirement on suppliers to inform Ofgem when they hit certain triggers indicating potential financial issues including a set level of CCB reliance, and to notify Ofgem ahead of paying out dividends when those triggers, or the minimum capital requirement, are hit. The enhanced FRP will also include the ability to require ringfencing of CCBs by direction through the licence for domestic suppliers who are at risk of or do not meet the enhanced FRP and / or the minimum capital licence requirements. See chapter 2 for more detail.

Market-wide capital requirement: Our quantitative impact assessment suggests that a capital adequacy regime will bring significant net consumer benefits. We therefore propose setting a market-wide minimum capital requirement for domestic suppliers. Noting the sector is currently under-capitalised, and the impact that the current economic environment may have on financing, we recognise that capitalisation will need to take place over time. We propose setting a shorter-term target for domestic suppliers to have £110-220 per domestic customer of net assets by end of March 2025, with suppliers required to submit transition plans showing clear 'staging posts' or increments for how they intend to reach that target. In addition to balance sheet net assets, suppliers would be able to meet requirements with alternative sources of funding – such as Parent Company Guarantees of long-term liabilities – subject to criteria in the licence and SLC guidance. We welcome views on how achievable this proposal would be in terms

of both the proposed range and the timescale, and any alternative suggestions that would be in consumers interests. See chapter 3 for more detail.

Ringfencing RO receipts: We acknowledge and agree with a view that is widely held among stakeholders (including almost all suppliers) that action needs to be taken to reduce the level of risk posed by current RO payment arrangements. We continue to believe that the government legislating for more regular payment of RO receipts would be the optimal solution to address misuse of RO receipts[6] by suppliers. In the absence of such legislation we consider that ringfencing is an appropriate and proportionate approach to tackling a long-standing issue that has contributed to the 'moral hazard' we have identified and added to mutualisation costs where suppliers have failed and the mutualisation threshold[7] has been triggered. We also see a principled case for ringfencing money that was never intended to support suppliers' business operations and is instead a clear 'pass through' arrangement which could easily circumvent suppliers altogether were the scheme designed in a different way. As such we propose introducing market-wide ringfencing of RO receipts attributable to domestic supply on and from 1 April 2023 to coincide with the 2023/24 RO scheme year.

We recognise that the requirements of the RO scheme and design of our draft supply licence conditions will facilitate a gradual ramp-up of the protection requirement which should smooth the journey for those suppliers needing to acquire alternative working capital to replace RO receipts. We also believe that clearly signalling our intent now allows suppliers sufficient time to initiate discussions with commercial lenders to acquire alternative working capital.

Why we are not proceeding with market-wide CCB ringfencing

We acknowledge that it will take some time for the supply market to become sufficiently resilient and we wish to use only the most effective interventions to achieve this transition. We recognise the views presented by some stakeholders that market-wide CCB ringfencing would be untargeted and impose costs on all suppliers – including efficient suppliers – in a way that on balance we do not believe to be in the interests of

[6] Renewables Obligation (RO): addressing electricity supplier payment default under the RO scheme - GOV.UK (www.gov.uk)
[7] Mutualisation only occurs when there is a payment shortfall which exceeds a threshold. Since 1st April 2021 this has been set at 1% of scheme costs, equivalent to £63.7m for the 2021/22 obligation year for RO England and Wales, with a static threshold of £1.54m for RO Scotland. Below these thresholds, any shortfall is left unrecovered.

consumers. It may also result in 'inactive' capital that could be more effectively deployed – particularly in the short term – as capital reserves that would directly increase supplier resilience.

Our revised impact assessment shows that we would expect a minimum capital requirement alongside market-wide RO ringfencing to have net consumer benefits of £74m-£93m per year on average over the next six years[8], £34m-£53m more than market-wide CCB and RO ringfencing.

Further, we believe that concerns relating to reliance on CCBs can be addressed by building on the existing requirements, which have not been extensively leveraged to date. For instance, we recently strengthened rules around how suppliers can set Direct Debits. Coupled with the requirements we are proposing in this consultation, these changes should help to limit the level of CCBs accrued in the first instance, reducing excessive reliance on CCBs for working capital and the amount of CCBs at risk of mutualisation.

On these grounds, we are no longer proposing introducing market-wide CCB ringfencing. Nonetheless, we do recognise that the ringfencing of CCBs may be necessary in some circumstances. We are therefore proposing to include the power for the Authority to direct individual suppliers to ringfence CCBs when they are at risk of not meeting or do not meet the financial standards and requirements set in the enhanced FRP and / or the minimum capital requirements.

Related proposals

We have published separately an updated impact assessment of the proposals in this document. The findings of the impact assessment are referenced throughout this consultation. As noted above, our impact assessment finds that setting a minimum capital requirement and ringfencing RO receipts will deliver net consumer benefits of £74m-£93m per year on average over the next six years, depending on the level of capital required.

We expect our ringfencing proposals to add £8 per year for the typical consumer under the April price cap. We do not think the capital requirement or new elements of the FRP will add costs to the price cap due to the proposed policy design. While we recognise that

[8] Range of benefits given for the requirement between £110 and £220 per customer, respectively.

adding any costs to consumer bills at a time of high energy prices is difficult, we judge that these costs are in the consumer interest overall and should reduce costs in the future.

We are in parallel publishing a policy consultation on the EBIT allowance under the price cap with the intention for the updated EBIT allowance to be reflected in the price cap from Q3 2023. We have considered this timing in proposing the transition phase of capital adequacy.

Next steps

We welcome further stakeholder views on the proposals set out in this document, the accompanying draft SLCs, and the impact assessment by Tuesday 3 January. Subject to the responses received to this consultation, we intend to publish a decision on these proposals in February 2023.

Consultation stages

Related publications

1.1. This consultation is Ofgem's response to the policy consultation on strengthening financial resilience published in June 2022. We have also published draft licence conditions and an impact assessment of our proposals.

1.2. In June we consulted on proposals to retain the value of hedges in the event that customers are transferred to a Supplier of Last Resort (SoLR). We continue to consider those responses and will provide a response in due course.

1.3. In developing this consultation and we have carefully considered interactions with the EBIT allowance policy consultation and price cap announcements.

Consultation stages

1.4. This publication follows the June policy consultation on strengthening financial resilience, where feedback and comments have been carefully considered and taken into account in developing our policy proposals.

1.5. We invite stakeholders to submit comments on any aspect of this consultation on or before 3rd January 2023. Following this statutory consultation we will review and consider responses received from stakeholders on proposals prior to a decision being reached and published in February 2023.

How to respond

1.6. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.7. We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.8. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.9. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.10. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.11. If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see appendix 3.

1.12. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.13. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

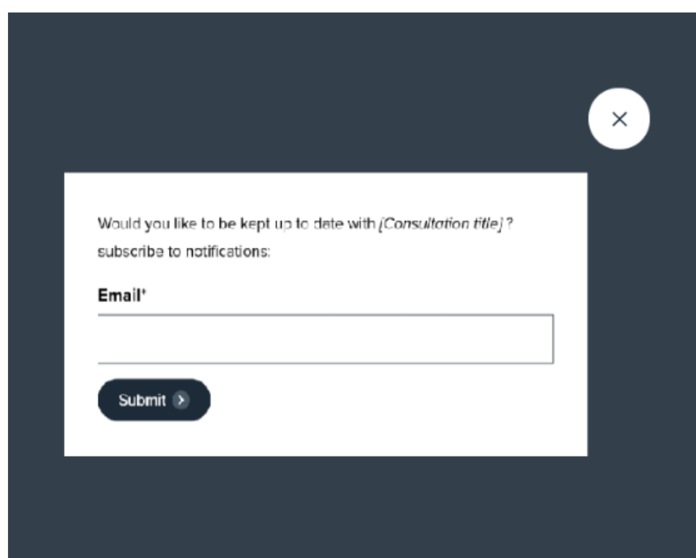
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

1.14. Please send any general feedback comments to stakeholders@ofgem.gov.uk

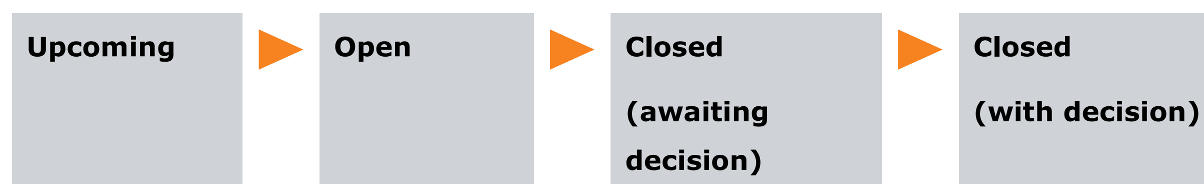
How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations.

Notify me +



Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



1. Introduction

Section summary

This section explains why we think our proposals are required to strengthen the resilience of the energy supply market in the interest of consumers. It also summarises the feedback from the June policy consultation and explains how it has informed our policy development. It asks for feedback on our overall approach and our proposals for a transition period.

Questions

Question 1: Do you agree with our package of proposals and overall approach?

Context to proposals

1.1 In December 2021, we published an Action Plan with a package of measures to boost financial resilience in the energy retail market.[9] This included our intention to consult on the wider regulatory framework for supplier financial resilience and ringfencing. The proposals in this consultation should be considered in the context of the objectives of that plan.

1.2 In the Action Plan, 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. Table 1 shows how our proposals map against these outcomes

[9] Ofgem Action Plan on Retail Financial Resilience, 15 December 2021, https://www.ofgem.gov.uk/publications/action-plan-retail-financial-resilience

Figure 1: Ofgem financial resilience outcomes and existing and proposed policies

	Proportionality			
	Ofgem should regulate as necessary, and no more than needed			
	Transition			
	Regulation should enable a sustainable, innovative, and competitive market, to facilitate our transition to net zero			
	Robust minimum standards	**Protecting customer money**	**Account-ability**	**Control**
Consultation proposals	*Regulation provides robust minimum standards, to ensure commercial risk is well managed*	*Suppliers should not pass inappropriate risk to consumers and minimise cost of failure*	*Minimum requirements for staff in significant leadership and appropriate board governance*	*Suppliers need to have ownership or sufficient control over all material assets required to run their business*
Minimum capital requirement	✓	✓		
Ringfencing RO receipts		✓		
Enhanced Financial Responsibility Principle	✓	✓		
Existing Ofgem regulations and guidance				
Asset control requirements				✓
Fit and proper requirements			✓	

1.3 Since December last year, Ofgem has introduced a range of reforms to help deliver those outcomes. We have:

- introduced stress-testing to assess whether suppliers are robust to a range of market scenarios;
- put in place stronger rules on calculating customer direct debits using the best and most current information;
- requested assurance on suppliers' management control frameworks for financial risk
- undertaken compliance and enforcement 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.

1.4 We have also taken action to ensure that suppliers have sufficient control over the material economic and operational assets needed to run their business. In August 2022 we published a decision to enshrine in the electricity and gas supply licences the key components of the guidance accompanying the Financial Responsibility Principle (FRP) and the Operational Capability Principle (OCP) recently updated in May 2022. The May 2022 update clarified what is expected of suppliers in relation to ownership or control of material assets. We are currently conducting a Market Compliance Review to test suppliers' compliance against our expectations.

1.5 These reforms have started to strengthen the financial resilience of the sector. In the June consultation responses, some suppliers felt that the progress made since December 2021, and the fact that existing suppliers have survived a significant shock, undermines the case for further intervention. We have taken stock of the cumulative impact of our reforms and consider that there is still a strong case for further intervention.

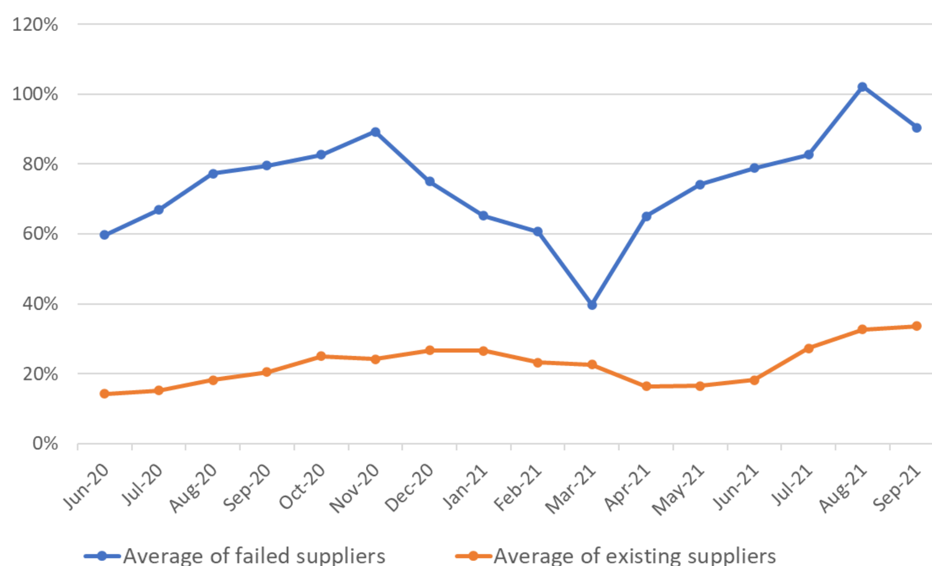
The case for intervention

1.6 Recent events in the energy market have exposed that retail businesses have too often had insufficient capital to manage the business of supply. Since August 2021, 30 suppliers, most of whom primarily served domestic consumers, have failed, directly affecting almost 4 million customers[10], and ultimately affecting all customers due to the mutualisation of failure costs. Some supplier business models were reliant on customer credit balances (CCBs) for the majority of their working capital, despite Ofgem's Financial Responsibility Principle and guidance[11] requiring that suppliers are not overly reliant on CCBs (see Figure 2). Some suppliers have also relied on RO receipts despite this money being a clear 'pass through' intended solely to fund a government renewables scheme.

[10] 1.6 million of which were customers of Bulb which went into a Special Administration Regime. See here for full list of suppliers and appointed SoLRs: Check who's taken over your energy supply | Ofgem. NB: this list does not include the UK Energy Incubator Hub which failed in July 2022.

[11] https://www.ofgem.gov.uk/publications/decision-proposed-guidance-operational-capability-and-financial-responsibility-principles

Figure 2: Customer credit balances as a proportion of forecast total assets



Source: Ofgem analysis of COVID RFI

1.7 Under current market arrangements, suppliers can accrue and use credit balances and RO receipts 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. Suppliers without sufficient capital and sustainable business models are vulnerable to market shocks, making them more susceptible to failure.

1.8 The Oxera lessons learned report identified that a number of suppliers that failed 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 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.

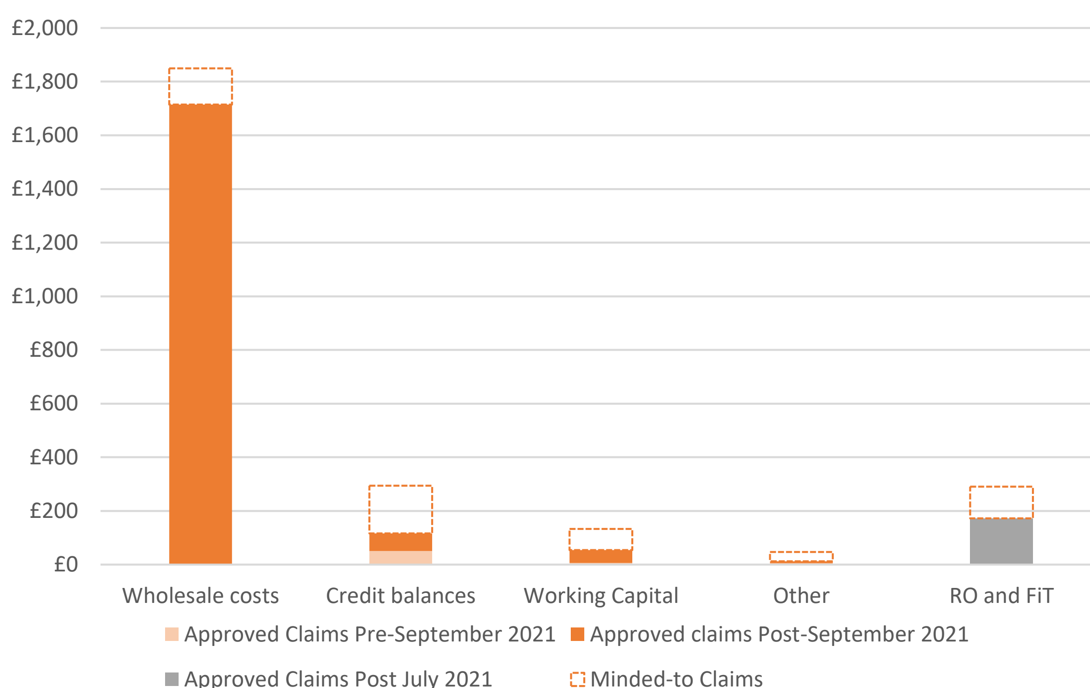
1.10 Under the existing regulatory regime domestic consumers collectively share the risks of supplier failure. We continue to think this is appropriate given that individual consumers cannot reasonably be expected to assess the financial risk of a supplier and the potential costs of failure when choosing to switch.

1.11 When supplier firms failed under recent market conditions, the significant costs of failures borne by customers have gone well beyond the costs of refunding CCBs and RO payments of individual suppliers (see Figure 3). This increases prices for consumers and creates systemic risks to the retail supply market, even in circumstances where the majority of suppliers do not rely on such unsustainable business models. The cost of the supplier failures during the energy crisis, which is paid for by consumers on their bills, is estimated to be £2.6bn.[12] This figure is likely to increase as we are continuing to process claims from SoLRs appointed in this period. It does not include the cost to the taxpayer of the Bulb Special Administration, currently estimated by the Office for Budget Responsibility to be £6.5bn.[13]

[12] This figure is comprised of £1.8bn approved SoLR claims from SoLRs appointed since August 2021, £423m of minded to SoLR claims, which are being consulted on and may therefore change, and £296m of RO and FiT payments since July 2021, which includes estimated RO 21-22 Mutualisation shortfall.

[13] OBR Economic and Fiscal Outlook, November 2022, p.9

Figure 3: Mutualised SoLR and RO costs (2018-present, £m)



1.12 It is Ofgem's view that many suppliers remain under-capitalised, which has been exacerbated by the recent wholesale energy price crisis. While our other reforms[14] (including reforms to the price cap methodology) will act to reduce risk exposure to price volatility and strengthen financial controls in energy supply businesses, we think additional controls are required to address the problem that suppliers can still take excessive risk without 'skin in the game' and are not sufficiently well capitalised to withstand shocks.

Objectives of our proposals

1.13 Our overarching objective is to protect current and future consumers by developing a more resilient energy supply market. We want to remove incentives for excessive risk-taking with consumer money (the moral hazard) whilst enabling an environment for investment and sustainable competition. Suppliers should have sufficient capital and sustainable business models to ensure they are sufficiently resilient to market shocks and that customers are shielded from the impacts of

[14] This includes the reforms listed in paragraph 2.3 and 2.4 as well as changes to reduce supplier exposure to market risk, e.g., price cap backwardation and quarterly caps, and Market Stabilisation Charge.

supplier failures as far as possible. This must all be achieved at the lowest cost to consumers.

1.14 Protecting consumers also means we must maintain a competitive energy supply market. Competition brings benefit to consumers by encouraging innovation and investment in new products and services, which will be essential to aid the transition to net zero and keep prices low in a sustainable way. Our analysis shows that challenger suppliers did bring consumer benefit in the form of better customer service and lower prices. However, it is clear from the Oxera report that too many suppliers were offering cheap tariffs that were unsustainable and that ultimately all customers ended up paying more as a result. Therefore, the proposals in this consultation aim to create the conditions for sustainable competition, and enable credible new entrants, whilst removing the ability for suppliers to pursue excessively risky strategies which destabilise the market.

Overview of the June policy consultation feedback

1.15 In June we consulted on introducing market-wide ringfencing of CCBs and RO payments attributable to domestic suppliers, as well as introducing a capital adequacy regime and proposals to retain hedge values for customers in the event that customers are transferred to a Supplier of Last Resort (a SoLR scenario). We received 30 responses to the June policy consultation from a range of stakeholders, mostly domestic and non-domestic suppliers, and also consumer representatives, a price comparison website, a trade union, and a trade body. We have published all non-confidential responses on Ofgem’s website.[15] Further detail on the feedback on specific proposals, and our response to it, can be found in the relevant chapters. Below is an overview of the key themes and Ofgem’s response.

Support for further interventions

1.16 Overall respondents were supportive of our objective to develop a more financially resilient energy supply market, recognising that the failures of winter 2021 did not represent a good outcome for consumers. They agreed that to achieve this we

[15] https://www.ofgem.gov.uk/publications/policy-consultation-strengthening-financial-resilience

needed to reduce the risk and cost of supplier failure. However, there were polarised views on how we best achieve this aim.

1.17 Larger incumbent suppliers and some consumer groups broadly favoured our proposals and thought they should be introduced as quickly as possible. Whereas other respondents, mostly challenger suppliers but also trade bodies and a price comparison website, questioned whether the proposals in our June consultation were necessary to achieve our aims. Their view is that the residual risk in the energy supply market has been seriously reduced and further requirements risk over-regulating the market, adding unnecessary costs for consumers.

1.18 Some suppliers were of the view that if a supplier had survived winter 2021, they had demonstrated that they were sufficiently resilient and that their business model could withstand shocks. Even if there were further failures, some respondents noted that given the shape of the current market, the mutualised cost of supplier failure would also be lower than before. Some noted that the customer credit book is retained with the customers in a Special Administration Regime scenario[16], and in practice, customer credit balances were absorbed by the SoLR in some previous cases.

1.19 However, other respondents disagreed and thought that ringfencing CCBs was the only way to protect them from being mutualised in the event of failure. These suppliers also noted that customers should always be able to request their money back and that ringfencing CCBs would enable this. Respondents in favour of our proposals also referred to the existing Financial Responsibility Principle requirement not to be overly reliant on customer money to fund operations and said that ringfencing CCBs would bring all suppliers into compliance. The view of respondents who favoured ringfencing and capital adequacy is that tougher

[16] Ofgem and government may appoint an administrator to run a supplier if it gets into financial difficulty. This is known as a Special Administration Regime (SAR). The decision to follow a SAR process is discretionary and is intended to deal with situations where use of our SoLR powers would not be practicable. The administrator will ensure that the supplier continues to operate. It will look at ways to rescue the supplier and it may look at ways to transfer customers to another supplier.
https://www.ofgem.gov.uk/sites/default/files/docs/2017/09/solr_revised_guidance_final_21-10-2016.pdf

financial controls are required to prevent the risky and unsustainable business models that failed last winter, and that some business models of existing suppliers would have to change to become more sustainable.

1.20 We agree that the energy supply market today looks very different to that of 2021. However, we consider that the proposals set out in this statutory consultation are needed to protect the interests of both existing and future consumers. The current Financial Responsibility Principle licence condition focuses on mutualisation costs and we think there is scope to clarify and expand some aspects of these rules to make it more effective at encouraging prudent management of a supply business, for example, with clearer monitoring approaches for 'over reliance' on CCBs to fund operations, as well as a broadening of the focus of the FRP beyond the risk of mutualisation costs. We think there is benefit in putting the onus on suppliers to proactively manage and report in a way that best reflects their business models and specific risks because it encourages financially responsible behaviour while accounting for supplier variation. Having clear requirements and a robust monitoring framework, underpinned by early warning notifications, will encourage this.

Alternative solutions

1.21 Two respondents suggested that a co-insurance fund for supplier failures would be a more appropriate mechanism for managing the impact of supplier failure. Though this would ensure there was a source of funding to pay for SoLR costs, we do not think this adds significant value beyond the existing SoLR levy scheme as consumers would ultimately pay for the insurance, whether in advance of or after supplier failure. Furthermore, this approach does not address the moral hazard risk. We have therefore not taken this solution forward for development. Further analysis of this proposal is provided in the accompanying impact assessment.

Challenging market conditions

1.22 A common theme in the June responses, particularly from challenger suppliers, was that our proposals risked decreasing financial resilience in the short term due to very challenging market conditions. The combination of difficult economic headwinds, the constraints imposed by the price cap, and the current frictions in

the financial markets[17] are all contributing to a difficult investment landscape for the energy supply market.

1.23 Our previous impact assessment assumed that suppliers had efficient, "frictionless" access to financial markets such that the pricing of their risk is the same as other corporates of equivalent credit rating (e.g., most small suppliers being equivalent to CCC-rated). It is clear from respondents and our own engagement with lenders that such access is particularly difficult at present. Most challenger suppliers explained that they would struggle to raise the capital required to implement ringfencing and a capital adequacy requirement in the current market and that their cost of capital was currently much higher than that assumed in the June Impact Assessment. They were concerned that these proposals would not create a level playing field for suppliers and would give large legacy suppliers a significant advantage.

1.24 We recognise the difficult conditions in the energy supply market and wider economy make it challenging to raise additional capital, which will be required by most suppliers to meet these new requirements. This has been a key consideration driving the development of our policies.

1.25 We are mindful of the risk of exposing customers to unnecessary costs from inefficient suppliers. If we were to make too large an allowance for the cost of capital in the price cap, for example, we risk adding unnecessary costs to consumers, giving a large windfall to efficient suppliers and weakening the incentive for suppliers to be more efficient. However, if we set too low an allowance, this may lead to financeability constraints. We also recognise that the cost of capital may have a differential impact for suppliers which are vertically integrated as compared to standalone.

1.26 A clear objective of our proposals is to increase supplier resilience such that more suppliers can access efficient capital. We understand that for most challenger suppliers this will take some time to achieve. Our proposal for a transition period is designed to reflect this trade-off.

[17] We have found evidence that suppliers currently face particularly high inefficiencies and financial frictions in accessing capital.

Interaction with the price cap

1.27 Most suppliers said that the price cap did not allow for a realistic rate of return and this was the main barrier to a more financially resilient market. We have taken action over the last year to ensure that the price cap better reflects the costs that an efficient supplier faces in operating in this market (e.g. our reforms on the frequency of the price cap and on backwardation, and allowances for the extra costs from shaping, imbalance and unexpected SVT demand) and we are also reviewing the EBIT allowance mechanism in the price cap to ensure that there is sufficient regulatory certainty as to the returns that an efficient supplier can make. Suppliers have been providing views on what we should consider when calculating the EBIT allowance, including capital employed. The EBIT policy consultation, published separately alongside this consultation, seeks to confirm suppliers' views on this.

1.28 We are also proposing to amend the price cap allowance to account for the additional capital required to implement 100% ringfencing of RO receipts from the 2023/24 scheme year onwards. Our modelling indicates this change would allow for an additional £2 per customer in Q2 2023. The full methodology can be found in appendix 1 of this document.

Interaction with other Ofgem policies

1.29 Some respondents felt that Ofgem had not given due consideration to the cumulative impact of other policies to strengthen financial resilience and incentivise financially responsible behaviour – such as enhanced stress testing, fit and proper requirements, and the Market Stabilisation Charge. They argued that Ofgem needed to fully assess the impact of these proposals before introducing any further financial controls.

1.30 Our policy appraisal and impact assessment take into account the reforms Ofgem has introduced since the December 2021 Action Plan, and our existing regulations, and suggests that the proposals set out in this consultation represent a net monetised benefit for consumers. The impact assessment also includes sensitivity analysis to assess how far the price cap, financial frictions, our policies on asset control, and different scenarios for retaining hedges in a SoLR affect the net benefits. In each scenario our preferred option returns net benefits to the consumer.

1.31 We also considered different combinations of ringfencing and capital requirements together, as well as assessing their impact separately. In doing so we have identified that introducing capital adequacy and ringfencing of both CCBs and RO receipts is likely to represent over-insurance, particularly when also taking into account our asset control requirements under the FRP and our proposed enhanced FRP. We have developed our proposals in light of these findings.

Our impact assessment

1.32 We received robust feedback on our original impact assessment that we published alongside the June policy consultation. Whilst we received comments on the assumptions that we used previously, we did not receive comments that proposed a different fundamental approach, and we consider that the suggestions above can all be addressed within a similar framework. Hence, we have adopted a similar approach, albeit with significant refinements to reflect stakeholder feedback on near-term effects, especially on cost of capital. More detail on the methodology and findings can be found in the accompanying publication.

What are we consulting on?

1.33 Taking into account the consultation feedback and our revised impact assessment, it is our view that a minimum capital requirement and ringfencing RO receipts attributable to domestic supply represent the best way to reduce the risk and cost of supplier failure. An enhanced financial responsibility principle and monitoring framework will underpin these requirements and set clear expectations to suppliers of appropriate risk management.

1.34 In coming to our revised position, we have recognised that current market conditions mean that imposing all the policies we consulted on in June immediately would likely have the unintended effect of increasing market instability in the short term, which we do not consider to be in the interest of consumers. We have developed our proposals with this in mind and are consulting on the following:

- **An Enhanced Financial Responsibility Principle** (enhanced FRP). This will embed the minimum capital requirements for domestic suppliers, as well as introduce a positive obligation on all supply licensees to evidence that they have sufficient business-specific capital and liquidity so that their liabilities can be met on an ongoing basis. The enhanced FRP will provide

Ofgem with additional regulatory tools to facilitate ongoing resilience and minimise mutualisation costs, such as a requirement on suppliers to inform Ofgem when they hit certain triggers indicating potential financial issues, including a set level of CCB reliance, and to notify Ofgem ahead of paying out dividends when those triggers are hit, or where the minimum capital requirement is not met. The enhanced FRP will also include the power for Ofgem to require ringfencing of CCBs by direction through the licence for domestic suppliers who are at risk of or do not meet the enhanced FRP and / or the minimum capital licence requirements. See chapter 2 for more detail.

- **A market-wide capital requirement**, which ultimately will be closely informed by the level of 'capital employed' on which suppliers receive a return under the EBIT allowance. In this consultation, we propose setting a shorter-term target for domestic suppliers to have £110-220 per domestic customer of net assets by the end of March 2025, with suppliers required to submit transition plans showing clear 'staging posts' or increments for how they intend to reach that target. This is covered in chapter 3.

- **Ringfencing of RO receipts attributable to domestic supply** to ensure that suppliers are not reliant on money that was never intended to fund their operations. We propose that this requirement begins from 1 April 2023 to coincide with the 2023/24 RO scheme year, though the obligation would ramp up quarterly in arrears and – as noted above – we would amend the price cap allowance to account for the additional capital required to implement this proposal. This is covered in chapters 4 and 5.

- **A transition period** for the minimum capital requirement, in recognition of the challenging market conditions and our objective of maintaining a level playing field. This is covered in this chapter below.

Transition period

1.35 We are proposing that suppliers must hold £110-220 per customer net assets by March 2025, and begin fully ringfencing their RO payments from the 2023/24 scheme year onwards. Our intention is that suppliers should ultimately hold the amount of capital employed closely informed by the level compensated for under

the price cap. However, we will consult on the amount and manner of further increases beyond 2025 as part of the transition to reach that target.

1.36 This transition period will apply to both new and existing suppliers. We have several routes to ensure than suppliers entering the market or scaling have sufficient resources under entry requirements, milestone assessments and the enhanced FRP. As part of these assessments Ofgem assesses supplier business plans. We propose that suppliers evidence how they will credibly meet the expected minimum capital requirement.

Question 1: Do you agree with our package of proposals and overall approach?

Next Steps

1.37 We welcome further stakeholder views on the proposals set out in this document, the accompanying draft SLCs, and the impact assessment by midday on Tuesday 3 January 2023. Subject to the responses received to this consultation, we intend to publish a decision on these proposals in early 2023.

2. Enhanced Financial Responsibility Principle

Section summary

In this chapter we summarise what we consulted on in June and the responses to that consultation. We set out our proposals for an enhanced Financial Responsibility Principle, which underpins our overall approach to strengthening the financial resilience of the energy supply market. We set out why we propose to introduce this framework, how we propose it will work in practise and how it will interact with the minimum capital requirement and ringfencing proposals. We welcome views on this overall approach and on the specific components.

Questions

Question 2: Do you agree with our proposal to enhance the FRP to require suppliers to ensure there is no significant risk that liabilities cannot be met as they fall due?

Question 3: Do you agree with our proposed approach to FRP reporting, including Trigger Points and annual self-assessment reporting?

Question 4: Do you agree with our proposal regarding the notification and monitoring approach for reliance on CCBs – including the proposed 50% of total assets threshold – or would it be more beneficial to set a prescriptive maximum reliance on CCBs?

Question 5: Do you agree with our approach requiring notification by suppliers ahead of non-essential payments when in breach of the FRP, and regarding the ability to direct hard ringfencing of CCBs?

What we consulted on

2.1 In our June consultation, we reiterated expectations from Ofgem's December 2021 Action Plan on Financial Resilience that we consider suppliers should be required to maintain sufficient minimum levels of capital to survive market shocks and incentivise robust risk management (e.g., around hedging behaviour). We said that while Ofgem's Financial Responsibility Principle 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.

2.2 We set out a proposal for a framework where suppliers would be subject to a minimum regulatory capital requirement (Pillar 1) supplemented by a framework to come to a view on any additional business-specific capital buffer or other risk management strategies (Pillar 2). Pillar 2 would involve a monitoring regime to determine if any additional actions – including any additional capital – were needed for the supplier to be sufficiently resilient.

2.3 We suggested this framework could comprise possible new capital adequacy assessment reporting where suppliers would need to set out how they meet any minimum requirement, as well how they conduct their own internal risk management and stress testing to ensure sufficient funding for their specific business model and risks. This, alongside other regulatory reporting including regulatory stress tests, would allow Ofgem to take a view on the need for any additional measures beyond the minimum capital requirement.

2.4 We suggested that our Pillar 2 approach could evolve as needed. This could be to better suit an adaptive framework, or, to evolve into a more granular reporting requirement should regulatory stress tests and supplier reporting expose weaknesses in how suppliers determine their risks and necessary capital. This could in the future result in – for example - more granular rules around standards for risk modelling in regulatory reporting.

Summary of consultation responses

2.5 Most consultation responses were more specifically targeted at the detail of ringfencing or minimum capital requirements, rather than the proposed broader Pillar 2 monitoring framework. However, responses, including verbal discussions, suggested some suppliers were more in favour of a higher amount of reporting regarding resilience to which Ofgem could respond on an ad-hoc basis compared to a one-size fits all approach.

2.6 Suppliers were largely supportive of Ofgem developing a risk-based regulatory approach that is targeted and proportionate to the risks imposed by individual suppliers and is designed around lower restrictions but higher enhanced monitoring. One supplier proposed a regime where suppliers who fall short of

minimum prudential standards should be subject to more frequent monitoring. Another supplier stated that FRP guidance, alongside the proposed financial monitoring framework, would allow for more targeted interventions where self-assessment indicates concerns.

2.7 Responses also reflected a general desire for proportionality and emphasised the need to consider the range of business models when designing the monitoring framework. One supplier noted that arrangements should reflect the bespoke nature of a supplier's business model. Another supplier outlined the need to reflect the internal financial monitoring and reporting arrangements of individual suppliers, noting that some already have high standards of financial oversight due to the complexity of their business. Another response outlined that some suppliers are already required to undertake annual audits that focus on their 'going concern' assumptions, noting the need to recognise that there is likely some overlap between that obligation and Ofgem's proposed capital adequacy framework.

2.8 One supplier suggested that the most appropriate way to introduce a capital adequacy regime would be using an outcomes-based regulatory approach where suppliers could be required to complete a self-assessment demonstrating their financial health, consistent with the existing guidance on financial responsibility. They suggested that suppliers demonstrate how they believe they have sufficient capital to withstand shocks. They suggested that this should be flexible, allowing the regime to respond to developments in the market, be risk sensitive and adapt to the range of different financing arrangements and company structures.

What we are proposing

2.9 We are proposing to enhance the Financial Responsibility Principle to more clearly underpin requirements about ongoing supplier financial resilience. The SLC drafting would cover both the Pillar 1 minimum capital requirement elements covered in more detail in chapter 3, as well as the broader Pillar 2 elements. This chapter focuses on the Pillar 2 elements.

2.10 The existing FRP requires suppliers to manage responsibly, at all times, the costs that could be mutualised and take appropriate action to minimise such costs. Guidance sets out that this means demonstrating – among other things – sustainable pricing approaches to cover costs over time, and that risks of any pricing approach sit with investors and not consumers; robust financial governance

and decision-making frameworks; and the ability to meet financial obligations while not being overly reliant on customer credit balances for its working capital.

2.11 Ofgem already can and does enforce responsible financial management under the existing FRP. We are proposing to set more explicit financial resilience and responsibility requirements in the enhanced FRP and accompanying guidance. We propose that these requirements will include an obligation for suppliers to maintain sufficient capital and liquidity to ensure they are able to meet their reasonably anticipated liabilities as they fall due.

2.12 We propose that this will complement the Pillar 1 minimum capital requirement set out in chapter 3 – by building on this market-wide minimum standard to require that a supplier is able to manage its business-specific risks. The Pillar 1 requirement is based on an amount a notional, well-hedged supplier would require. New Pillar 2 elements under the FRP would require that suppliers are expected to understand and mitigate their business-specific risks to ensure they have sufficient capital and liquidity to remain resilient. Supplier self-assessment reporting regarding business-specific risks (combined with ongoing Ofgem monitoring) will help Ofgem understand if further interventions are needed to maintain this required level of resilience.

2.13 It is proposed that the draft enhanced FRP SLC will apply to both domestic and non-domestic suppliers, save for the specific elements that relate to minimum capital requirements and directing ringfencing of CCBs. Our reasoning is that the existing FRP already covers non-domestic suppliers, and the other new proposed elements of the enhanced FRP seek to more clearly underpin expectations about responsible supplier financial management. (Further detail on our proposed ability to direct ringfencing of CCBs is set out at the end of this chapter, and the scope for the minimum capital requirement is in chapter 3).

2.14 Our monitoring approach for non-domestic suppliers will be proportionate to the risk of mutualisation. As credit balances for non-domestic customers cannot be recovered through Last Resort Supply Payments, and tend to be proportionately lower than domestic balances, our monitoring may be lower for non-domestic suppliers.

2.15 The draft enhanced FRP SLC which has been published separately alongside this statutory consultation sets out:

- **Clearer expectations of suppliers regarding ongoing financial resilience:** We are proposing broader obligations than the current FRP to require suppliers to maintain sufficient resources to ensure that they are able to meet their reasonably anticipated financial liabilities, as well managing responsibly and minimising costs at risk of mutualisation.

- **More pro-active financial regulatory reporting and response:** As suggested in our policy consultation, we propose introducing additional reporting requirements to capture existing and emerging financial risks associated with specific supplier business models. We propose that the detail on this would be set out in FRP guidance and include annual reporting on capital adequacy and risk management, as well as trigger reporting points that serve as indicators of early financial stress. These are set out in appendix 2.

- **Enhanced monitoring of reliance on CCBs:** Currently, the FRP guidance suggests suppliers should not be overly reliant on CCBs for working capital. The enhanced FRP guidance would set requirements for monitoring reliance on CCBs by suppliers, enabling Ofgem to track reliance and take action to reduce the risk of costs being mutualised where necessary.

- **Clearer expectations about financial regulatory reporting and monitoring:** Supplier feedback has suggested a desire to ensure that how Ofgem asks for data is as streamlined as possible and considers linkages and burdens. The enhanced FRP guidance would set out information on new reporting obligations alongside embedding existing reporting obligations like stress testing, with the aim of making the holistic picture of financial reporting clearer.

Clearer expectations on suppliers about ongoing financial resilience

2.16 We are proposing to broaden the scope of the FRP to require that licensees must:

- Ensure that they maintain sufficient capital and liquidity so that they are able to meet their reasonably anticipated financial liabilities as they fall due on an ongoing basis

- Ensure that, were the supplier to exit the market, the exit would be orderly – meaning the supplier has ensured its operational and financial arrangements are such that any Supplier of Last Resort ("SoLR") or special administrator appointed would be able to efficiently and effectively serve the supplier's customers, and the exit will not result in material mutualised costs.

- Maintain a minimum capital requirement (as set out in chapter 3)

2.17 This broader wording is intended to set clear expectations about a supplier's ongoing management of their business specific risks. It will also provide a clearer backdrop for the Pillar 2 financial reporting and monitoring framework which Ofgem will use to understand suppliers' actual resilience and the need for further intervention or capital beyond the minimum capital requirement. It further underpins Ofgem's expectations that suppliers make efforts to manage responsibly and minimise costs at risk of mutualisation and requires suppliers to ensure that, should they exit the market, their customers can continue to be served through the SoLR or Special Administration process in an efficient way. Our approach is based on similar requirements set out by financial regulators.

2.18 We consider that broadening the focus of the FRP beyond the risk of mutualisation costs will provide a better context and backdrop for Ofgem's overarching financial resilience package, which seeks to ensure suppliers maintain adequate financial arrangements on an ongoing basis. This will support earlier and more pro-active engagement with suppliers regarding any financial stresses, resulting in better outcomes for consumers.

More pro-active financial regulatory reporting and response

2.19 The proposed enhancements to the FRP include requirements on suppliers to pro-actively report to Ofgem in relation to how they are meeting requirements for ongoing financial resilience, and to flag pro-actively when risks to their financial situation arise.

2.20 We propose to require suppliers to evaluate their business-specific risks and mitigations throughout the reporting period, ensuring they have sufficient capital and liquidity to meet their financial liabilities considering severe but plausible stresses their business model could reasonably be expected to face. The new

reporting framework also introduces more opportunities for early intervention and targeted responses.

2.21 This approach reflects supplier feedback, which encouraged the design of a framework that is proportionate to business-specific risks, allows for targeted intervention, acknowledges the broader suite of financial monitoring powers required by Ofgem, and considers existing internal financial and management controls. The design of the enhanced FRP regime also draws on the reporting approaches of financial regulators, which set clear financial obligations and minimum standards, underpinned by a self-assessment reporting framework.

2.22 FRP guidance would set out further detail on the full scope of financial reporting requirements, and expectations on suppliers for those reporting requirements. Appendix 2 provides an overview of the material elements of this FRP guidance. We plan to publish a draft of the guidance shortly after this consultation to allow stakeholders to consider and feedback ahead of Ofgem's decision on changes to the licence. The SLC sets out how Ofgem may go about changing this guidance in the future, which we may choose to do as this policy area evolves. New pro-active elements of reporting include the below.

Annual Adequacy Self-Assessment

2.23 We propose to introduce an annual requirement on suppliers to submit a self-assessment of their business model, risks and mitigations over the coming year, illustrating how they are compliant with the FRP. Our view is this approach will respond to supplier feedback by allowing a more proportionate policy - both in terms of the administrative burden on suppliers – given they are likely able to use outputs from existing internal analysis and external audits – as well as in terms of Ofgem's response, given it will allow us to better understand the specific situation of each supplier.

2.24 We will set out how suppliers report to Ofgem in the FRP guidance, including expectations for self-assessment reporting, including:

- Self-assessment of appropriate financial and operational resources to meet their business requirements, risks, and regulatory obligations throughout the reporting cycle, where any financial projections have been internally stress-tested. This should cover detail such as hedging, reliance on the balancing

market, presence of purchase agreements, collateral requirements, commentary on risk management based on tariffs offered, and internal stress testing methodology and processes for identifying and mitigating risks.

- A capitalisation plan that spells out how the supplier intends to build up to the 2025 minimum capital requirement. To credibly be en-route to meet this 2025 requirement, we would expect suppliers to illustrate how they will be above zero net assets within about a year. Suppliers' annual adequacy self-assessment should explain the supplier's capitalisation plan to reach the 2025 requirement, including how the supplier will mitigate the impact of projected market and supplier risks on this progress. Where a licensee supplies both domestic and non-domestic consumers, this explanation should also seek to explain any split of assets between the supply business for non-domestic supply versus domestic supply, to help shed light on how the net assets calculation for the minimum capital requirement maps across the business and if there are any implications for the impact of the measure on resilience.

- Once the minimum capital requirement target is met, suppliers should continue to explain how they will meet the minimum capital requirement throughout the reporting period, any projections that suggest this level will not be met and, where the supplier projects it may not be able to meet the minimum capital requirement, how it intends to remedy this to remain compliant or to come back into compliance expeditiously.

- How the costs at risk of mutualisation are managed in line with relevant requirements and that consumers are protected in event of failure

- Relevant governance arrangements and processes, including an explanation of core business functions (including those outsourced) and how they will be resourced. This should include statements of responsibility for each core function, the names of those responsible for each area and how they are suitable to manage those responsibilities. The reporting should also include projected growth and the number of staff forecast for each function, as well as an overview of any internal audit capability and processes.

2.25 We propose that the supplier's Directors would be required to sign a declaration of financial and operational adequacy, approved by the licensee's Chief Financial Officer (or senior official with equivalent responsibility) to accompany the self-assessment report to provide assurance that they have a reasonable expectation that the licensee meets its obligations under the FRP.

Reporting triggers

2.26 We are proposing to establish a proactive reporting requirement which creates a reporting obligation where the supplier must notify us in writing when it becomes aware there is a risk that it will not hold the minimum capital requirement or any of the trigger points will not be met.

2.27 This will make it easier for us to intervene where we may be concerned about a supplier's financial situation and increase the likelihood that the impacts of any financial stress can be understood and addressed earlier, resulting in more proportionate and targeted responses for suppliers, and better outcomes for consumers. It also provides further certainty on the circumstances under which we expect to be notified where supplier situations change between reporting periods.

2.28 Suppliers are required to notify us in writing in the case of any change in their circumstances or projections that could have a material impact on their financial situation and ability to meet the FRP. New FRP guidance will set out a range of specific key reporting triggers based on financial indicators to underpin this. Licensees will be expected to notify Ofgem when they anticipate a trigger point will occur, or as soon as reasonably practical once the supplier becomes aware the trigger point has occurred. This will allow for early engagement on signs of financial stress that could indicate where a supplier's ability to meet the enhanced FRP is, or could become, compromised. We propose the following reporting triggers for this purpose:

- Projected or actual material changes to access to sources of funding identified as the basis for the supplier's ability to meet the FRP. This could be actual or projected instances where the licensee identifies challenges in access to funds from investors / parent company / banks / lenders, or if funds or borrowing allowances have been reduced or subject to additional conditionality in any way.

- Projected or actual changes to profit levels, where outflows are not matched by cash flows, or if there is a drop in revenue over a period leading to sustained losses, potential breaches of debt, or financial covenants.

- Change and/or potential failure of counterparties which may have a material impact on suppliers' ability to meet their obligations as they fall due (eg, the likelihood of the failure of a significant counterparty which might lead to liquidity shortfalls or for the supplier to default on their own obligations).

- Changes in net assets/net liabilities which may have a material impact on the suppliers' ability to meet the FRP, including loans, dividends, and value redistribution within a group.

- Significant unwinding of hedges, or a change in the hedging position that may have a material or sustained impact on whether a supplier can continue to meet its obligations under the FRP.

2.29 Where a supplier does reach a trigger, we would use it as an opportunity to engage with a supplier. Where we have concern about a suppliers' compliance following a notification, we may decide to undertake further assessment and engagement, request an independent audit, consider whether a direction to protect its CCBs is appropriate or move to consider enforcement action if there is a need to bring a supplier into compliance with the FRP.

Defined monitoring of reliance on Customer Credit Balances

2.30 We also intend to use the triggers framework to monitor reliance on CCBs. Currently, the FRP guidance suggests that a supplier should have the ability to meet its financial obligations while not being "overly reliant" on customer credit balances for its working capital. We propose to set reporting triggers in the FRP guidance regarding a proportion of CCBs in relation to suppliers' Total Assets to allow Ofgem to be aware of levels of reliance, and to be able to respond as needed. Where suppliers exceed the threshold, we may also consider directing protection of CCBs in line with the draft SLC and as described in more detail below.

2.31 As with the early warning triggers, the CCB reporting trigger provides an indicative point where suppliers will be required to notify Ofgem as soon as they anticipate going beyond the stated threshold, and when they actually do hit the threshold.

This allows us to be more proactive with suppliers to avoid over-reliance on CCBs, and to respond in a clear and timely manner where suppliers breach FRP requirements to manage costs at risk of mutualisation. We intend to set the threshold for reporting on reliance on CCBs as below:

- Suppliers must notify Ofgem when Gross Domestic Credit Balances net of Unbilled Consumption represent the equivalent of 50% or more of their Total Assets, as well as when they project or anticipate this occurring.

- We will continue to review this number to ensure it can achieve the intended outcome of encouraging suppliers to avoid over reliance on CCBs, and therefore this number may be subject to change.

2.32 The calculation is based on the licensee's Total Assets but limited to domestic CCBs. In the case where a licensee supplies both domestic and non-domestic consumers, suppliers should explain any split of assets between a licensee's domestic and non-domestic supply business. We will consider this to help us understand any impact this has on understanding the implications of the reporting, and as a result, the appropriate response.

2.33 We have set this reporting threshold at 50% in proportion to a supplier's Total Assets based on considering suppliers' current balance sheets and what we currently consider is a useful level to monitor to understand potential supplier reliance on CCBs.

Clearer expectations about financial regulatory reporting and monitoring

2.34 Currently, Ofgem collects information about supplier finance in various ways, including monthly financial monitoring RFIs and stress testing which were introduced as part of our response to high prices. It is Ofgem's intention to continue asking for this financial reporting on a regular basis going forward. To make this intention clear and to underpin the overarching financial resilience reporting framework, we are proposing to embed existing stress testing and financial reporting programmes into the enhanced FRP guidance.

2.35 To be clear, Ofgem would maintain its ability to set the scope of the information requirement at each time interval to ensure the information we are asking for is as

relevant as possible and can adapt to changing market conditions. Formalising the reporting requirements in the FRP guidance would have the effect of making it clearer to stakeholders that these reporting requirements will be part of an ongoing, regular reporting drum-beat to inform our overarching picture of supplier financial resilience.

2.36 In the first instance, guidance will set out how suppliers will receive notifications about what information they will be asked to provide. For stress testing, our proposed guidance will suggest suppliers will receive the notification a minimum of four weeks ahead of the required reporting date. For more regular financial reporting, suppliers are provided a timetable in advance. If there are changes to the questions asked, our proposed guidance will suggest that suppliers will generally be provided with this information a minimum of two weeks ahead of the required reporting date.

2.37 Our current intention is to make stress testing a quarterly exercise though these timings could be subject to review in the future. The Stress Testing Working Group[18] will provide opportunities for suppliers to feedback and contribute to the design of information requests.

2.38 As suggested above, the enhanced FRP guidance – including these elements - may be subject to change in the future as our policies in this area evolve. The process for this change is set out in the proposed licence drafting.

Compliance with the enhanced FRP

2.39 We will continue to draw on our range of existing powers to manage compliance and enforcement of the FRP. These include the ability to request and set the terms of reference of an external audit for suppliers, request information from suppliers, the requirement that suppliers are open and cooperative when providing us with information, as well as conducting 'fit and proper' assessments for individuals with 'significant managerial responsibility or influence' where suppliers fail to meet requirements. We may use these existing tools when responding to supplier reporting under the enhanced FRP, including the annual self-assessments and at

[18] A working group has been set up to look at how we can improve the stress testing process and template. The intention is to improve the information being received, make the process easier for all involved and help reduce the number of queries being asked. Participation is voluntary. For more information, stakeholders can reach out to RetailFinancialMonitoring@ofgem.gov.uk.

trigger points. In addition to Ofgem's existing toolbox, we are proposing to introduce requirements to notify Ofgem before issuing certain payments and the ability for Ofgem to direct ringfencing of CCBs. More detail is set out below.

Notification regarding payments

2.40 We are proposing to introduce a requirement into the FRP SLC that if suppliers breach any of the reporting triggers set out in guidance, they must also notify Ofgem 28 days before extracting value from the business (unless the activity is essential to its operation), including, for example, paying dividends, providing loans or transferring assets to a third party. This same requirement would apply if suppliers breached the minimum capital requirement.

2.41 Where we assess it requisite to secure supplier compliance with the FRP or other obligations, we may restrict them from extracting any further value from the business using our existing enforcement powers. This is to ensure that suppliers do not extract assets needed to maintain the solvency of the business, or which should remain in the business to ensure compliance with the resilience requirements in the enhanced FRP, and to ensure suppliers do not increase their costs which could be mutualised.

Direction to ringfence CCBs

2.42 We are also proposing to introduce the ability for Ofgem to direct a supplier to protect their domestic customer credit balances where the supplier does not meet the standards of financial resilience as set out in the licence, including the minimum capital requirement, or where there is a material risk within the next 12 months of the supplier not meeting them.

2.43 Details on how Ofgem would direct a supplier are set out in the SLC and will be further detailed in the FRP guidance. Before directing a supplier to ringfence their customer credit balances, Ofgem would notify the supplier in writing, indicating the date when the direction should take effect. Ofgem would also indicate a time period – not less than seven days – within which representations regarding the direction can be made by the supplier.

2.44 In making the decision regarding the level of required CCB ringfencing to be required, Ofgem will consider consumer interests and have regard to any

supervisory financial data and any other relevant data, in order to direct an amount which:

- Will not have an adverse effect on the licensee's ability to finance its activities such that the level of required ringfencing is likely to cause the licensee to exit the market due to insolvency

- Will minimise any possible mutualised costs that could be caused should the supplier exit the market or have its licence revoked

2.45 The enhanced FRP SLC also provides that Ofgem will have the power to revoke the direction to ringfence CCBs upon notification to the licensee.

2.46 Detail on how suppliers should protect their customer credit balances once they have been directed to do so is set out in the proposed SLC 4D and in chapter 4 of this document.

3. Minimum capital requirement

Section summary

In this chapter we set out our proposals for setting a minimum capital requirement for all domestic suppliers. We set out the feedback we received on our high-level proposals in the June policy consultation, how these views shaped our thinking on a capital adequacy regime and what we are now proposing in response to this feedback. In recognition of challenging market conditions, we propose setting a short-term goal as well as a longer-term trajectory. We welcome views on the practical implementation of the minimum capital requirement and the transition period.

Questions

Question 6: Do you agree with our proposed approach to the minimum capital requirement, including our proposed longer-term trajectory as well as our transition minimum capital requirement for 2025? What is your view on our proposed range for the 2025 minimum capital requirement amount?

Question 7: Do you agree with our proposed approach of setting the minimum capital requirement on a per-customer basis, or do you have a preference for a volumetric approach? In the case you prefer volumetric approach, what calculation method is most appropriate?

Question 8: We set out a range of issues that may need to be considered in the future as we ratchet up the minimum capital requirement, including differences between tariff types and payment types. Do you agree with our proposal to consider these in future consultation, and to treat all tariff and payment types the same in our first minimum capital requirement? Do you have suggestions on how best to reflect the different drivers in the range of competitive tariffs versus SVT tariffs? Are there other elements that you think would be a significant driver of differences in capital needs across tariff offerings that we should consider?

Question 9: What is your view on our proposed approach to considering alternative sources of funding?

What we consulted on

3.1 In our June consultation, we set out that we consider suppliers should be required to maintain sufficient minimum levels of capital to better survive market shocks. The focus of our proposal was on domestic suppliers, given they carry the highest risks around costs mutualisation, though we suggested that we would consider expanding these to non-domestic suppliers in the future on the basis that capital adequacy interventions are likely to benefit non-domestic consumers as well.

3.2 We proposed an approach that would see a minimum Pillar 1 capital requirement across suppliers, underpinned by a Pillar 2 enhanced monitoring framework which would allow us to understand individual suppliers' risks and the need for any further interventions – including possible additional capital requirements – to meet the appropriate level of resilience.

3.3 We proposed that the Pillar 1 minimum requirement would be developed based on what capital a notional efficient and well-hedged supplier needed to ensure they can withstand a certain shock and remain solvent. We proposed that this minimum requirement would be coordinated with work on determining an appropriate return under the price cap as far as it relates to standard variable tariffs (SVTs). We said that for competitive tariff offerings, we expect suppliers to be able to consider capital and risk management as part of pricing. Further, we suggested that any additional specific supplier capital requirement under Pillar 2 would not be explicitly covered under the price cap return.

3.4 We set out the key questions that would go towards defining such a minimum requirement, including target levels of resilience and how capital should be held. We suggested that in the case where rules allowed for a minimum capital requirement to be met using alternative sources of funding (which we called contingent capital), that we would put in some criteria around those sources of funding related to issues such as around maturity, conditionality around access, and subordination. We also suggested that our approach would consider questions around our level of confidence in the access of a licensee to funding needed to absorb losses in a reliable manner, and that any capital adequacy rules would consider existing rules around suppliers' requirements to have sufficient control over material assets.

3.5 We proposed that any minimum capital adequacy requirement would be designed to consider its cumulative impact with any ringfencing proposals, and that we would consider the extent to which an amount of flexibility and scalability between different financial resilience policies combine to ensure a consistent and acceptable level of risk across business models in the most cost-efficient way to maximise outcomes for consumers and competition.

Summary of consultation responses

Views on proposed high-level approach to capital adequacy

3.6 All but one respondent supported the concept of a capital adequacy regime, and almost half of respondents were in support of our proposed high-level approach to a capital adequacy framework alongside ringfencing proposals. However, other responding suppliers raised a range of concerns. Four suppliers wrote that a capital adequacy regime would be complex and time consuming to put in place, and resource-intensive to administer, both for Ofgem and suppliers. One supplier who was in favour of a capital adequacy regime equally suggested any requirements should consider overlaps with external audit processes. Another supplier was completely against a capital adequacy regime, as they wrote they are a publicly listed company already subject to substantive external audits, making such added resilience requirements unnecessary.

3.7 Some suppliers indicated that they agree in principle with some form of capital adequacy but were concerned with the timing considering current market conditions. Many respondents expressed concern regarding the need to understand the impact of the range of financial and operational policies recently introduced before imposing further costs in the form of capital adequacy and were concerned that ringfencing could deliver many of the benefits of a capital adequacy framework, and that introducing both capital adequacy and ringfencing may be disproportionate. These concerns are further developed in the introduction chapter of this consultation, where we explain how this has been taken into account in our approach to the overarching package of measures targeting financial resilience.

Views on segmented approach to Capital Adequacy regime

3.8 The majority of respondents were in favour of taking a segmented approach to our implementation of a capital adequacy framework, 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. One supplier suggested that they did not see how our proposed approach was segmented, and that it actually was a one-size-fits-all approach that favoured vertically integrated, listed companies with investment-grade ratings.

Views on risks that a capital adequacy regime should cover

3.9 The majority of suppliers agreed with the risks we set out in our proposal, saying these broadly matched those they consider in their internal risk assessments. Some additional elements of risk that suppliers highlighted included wholesale cost risk exposure, regulatory risks and risks associated with the supplier meeting obligations such as for Smart, ECO, WHD, ROs, as well as tail-end risk (for example, the recent invasion of Ukraine). One supplier suggested we should go further in considering the impact of credit risk on suppliers caused by the current cost-of-living crisis.

Views on levels of financial resilience a capital adequacy regime should target

3.10 Less than half of stakeholders responded to this question. One supplier suggested the level of financial resilience and time horizon to calculate capital requirements will depend on the risks that the regime targets. Another supplier suggested that capital adequacy requirements should be a function of commercial risk appetite and hedging policy, and that the prevalence of fixed-term contracts of 12-months or more suggests a lower time horizon may be more appropriate.

3.11 Another supplier suggested that no one answer fits all suppliers, and so a capital adequacy regime should support different business models which in turn will improve market resilience. They suggested measures should be proportionate to the market share, organisation, risks and risk management approach of the supplier.

3.12 Respondents highlighted the need for the price cap design and capital adequacy regime to be coordinated. One suggested that the level of resilience depends on the price cap and that Ofgem must consider the best balance between costs and resilience taking into account the allowance in the price cap.

Views on sources of funding that could be considered under a capital adequacy requirement

3.13 The majority of respondents did not answer this question as they felt it was a complex area that needed further consideration. Some chose to discuss this further with Ofgem in bilateral meetings. Those that did respond considered this was an important factor given defining relevant funding sources to meet a capital requirement will be a significant cost driver of the framework and impact on competition. Some suggested that given the range of business models on the market, Ofgem should consider this on a supplier-by-supplier basis.

3.14 Two respondents disagreed, and instead suggested that alternative sources of funding – or contingent capital - referred to in our policy consultation are not loss-absorbing in a regulatory sense. They suggested that sources of funding like credit facilities and Parent Company guarantees are at best a source of liquidity not a source of loss-absorbing capital. They highlighted that capital and liquidity are not synonymous, as a supplier can be well capitalised and low on liquidity. They suggested that regulatory capital should be defined as the financial resources a supplier has available to absorb losses, which is different from liquidity, which is resources the supplier has available to pay amounts when due. They suggested regulatory capital can only absorb losses if it does not diminish in value or have to be repaid to a funding provider before losses are incurred – which narrows what capital should consist of share capital without mandatory dividends and distributable reserves and excludes for example senior or secured debt.

What we are proposing

High level proposal

3.15 As suggested in our June 2022 consultation, the minimum capital requirement we are proposing relates to what capital is needed by an efficient, well-hedged

notional supplier, and is linked – in so far as it relates to SVTs – to the return under the price cap.

3.16 As part of setting the price cap, Ofgem is proposing to set an appropriate rate of return based on the capital employed needed for a well-hedged notional supplier and its cost of capital. Ultimately, it is our view and proposal that suppliers should be required to hold an amount of capital closely informed by what they are compensated for under the price cap return. In relation to competitive tariffs, suppliers should be holding sufficient capital to ensure they are robust to the risks associated with these tariffs, and as set out in our previous policy consultation, we expect suppliers to be able to recover associated costs through pricing.

3.17 However, we are aware of the need for a sufficient transition period considering both the impact of current volatile market conditions on raising finance, and our desire to implement a trajectory that results in improved resilience at the most efficient cost to consumers. We propose setting a shorter-term target for domestic suppliers to have £110-220 per domestic customer of net assets by end of March 2025, with suppliers required to submit transition plans showing clear 'staging posts' or increments for how they intend to reach that target. In addition to balance sheet net assets, suppliers would be able to meet requirements with alternative sources of funding – such as Parent Company Guarantees of long-term liabilities – subject to criteria in the licence and SLC guidance.

3.18 As part of our transition proposal, we suggest to initially use the same assumptions for defining the SVT capital requirement in relation to competitive tariffs and different payment types, which will then be reconsidered through consultation as requirements increase in the future; we set out our more detailed reasoning for this approach below. As suggested in our June consultation and supported by supplier responses, some of the key drivers of risk and so capital requirements relate to specific supplier behaviours, which we propose will be covered by our Pillar 2 Enhanced Financial Responsibility Principle framework.

3.19 It is important to note that the minimum capital requirement is not intended to represent the right answer for the amount of capital or liquidity specific suppliers need to hold against their own business risks. It is a Pillar 1 minimum amount based on a notional supplier, which is a theoretical and efficient supplier that has no direct comparison with existing suppliers but draws from the properties across efficient suppliers in the market. Pillar 1 is supplemented by a Pillar 2 framework

to cover supplier-specific risk, allowing us to take a segmented approach across different business models and different levels of market risk where appropriate. As set out in chapter 2, both the Pillar 1 minimum capital requirement and the Pillar 2 framework will be detailed under the enhanced FRP. The new Pillar 1 elements of the FRP are covered in this chapter, while the Pillar 2 elements are covered in chapter 2. The FRP will be accompanied by updated guidance with further detail on certain aspects of how suppliers are expected to meet expectations under the FRP. The material elements of this guidance are set out in appendix 2.

Approach to defining capital needs for efficient notional supplier

3.20 Details on our proposed approach to an efficient notional supplier to inform the price cap return are set out in detail in our policy consultation on the EBIT allowance under the price cap, which has been published in parallel with this consultation document. Below we set out some of the key characteristics of the notional supplier that will sit beneath our proposal for a minimum capital requirement, including how the notional supplier will address key questions we set out in our June consultation related to defining an appropriate resilience target and risk drivers.

3.21 Under current policy proposals, the efficient notional supplier is based on the assumption that the notional supplier:

- is sufficiently efficient to recover its costs under the cap over a projected two-year period;
- is fully equity financed and does not hold long-term debt as part of its capital structure; and
- hedges according to the wholesale methodology in the cap.

3.22 In terms of resilience, the EBIT consultation describes a model Ofgem may use to inform recommendations on the appropriate level of capital employed to calculate the EBIT allowance. Ofgem would use this model to estimate a range for the level of capital employed under different market scenarios. The model could consider the capital employed needed for a notional supplier to operate, assuming forward wholesale price curves, as applied in our stress testing scenarios. Ofgem would then explore the implications of stress testing the notional supplier’s finances under different market scenarios – like elevated volume risks due to volatile wholesale price and customer churn. Further explanation of the model used to estimate working and risk capital requirements is provided in the EBIT

consultation, which will be followed by a statutory consultation and then a final decision in due course.

3.23 The notional supplier has capital employed that reflects working capital, risk capital and collateral, which are further explained in the EBIT consultation. Risk capital drivers include wholesale price volatility and unexpected demand shock.

3.24 Other risks that were originally considered in relation to the EBIT allowance including backwardation cost, shaping and balancing cost, and bad debt, will not be included because they already have dedicated allowances within the cap, and remunerating them through the price cap could lead to double-counting of costs and over-compensation of suppliers. The current EBIT policy consultation sets out in detail how risks were considered in relation to defining capital employed, and proposes how demand shock and wholesale price volatility will be taken into account.

3.25 The EBIT consultation sets out considerations around including collateral in the capital employed number for the purpose of the price cap return. However, for the purpose of the minimum capital requirement, regardless of the outcome for the price cap return, we propose to exclude any element of capital employed related to trading collateral. This is because given the range in collateral arrangements across the market, we consider this is best dealt with via supplier-specific resilience and capital assessments under Pillar 2 elements of the enhanced FRP. As set out in the EBIT consultation, our understanding is that collateral commitments are mainly met through off-balance sheet sources like letters of credit from a financial institution or Parent Company Guarantees (though some requirements – such as variation margin on exchanges – must be met in cash). Additionally, including this element could result in asking for minimum capital greater than what is needed for a supplier business model where collateral needs are met through a trading arrangement. We are aware that even in those cases, suppliers have told us there are costs associated with trading arrangements that can be material, and sometimes even collateral requirements under certain conditions. Given the above, we propose that these considerations around collateral or the implications of trading arrangements and associated costs, and ensuring suppliers are well positioned to meet those requirements, are best covered under the supplier-specific monitoring framework under the enhanced FRP.

3.26 The trajectory for our final minimum capital requirement will depend on the ultimate outcome of the EBIT work. However, we propose this will be subject to a transition period that sets out an initial, clearly-defined step, after which we will consult on further increases considering the outcome of the EBIT consultation, market conditions, and supplier feedback.

3.27 The other risks we set out in our June FRC consultation – such as counterparty credit risk and operational risk, we consider are better covered through our supplier-specific monitoring under the Pillar 2 elements of the enhanced FRP at this stage. Under the enhanced FRP, we intend to ask suppliers about their specific business models, risks and mitigations over the coming year and for evidence about how suppliers are compliant with the current proposed enhanced FRP requirement for suppliers to ensure they have the capital and liquidity needed over the reporting period to meet liabilities as they fall due. This reporting should reflect suppliers' considerations about the impact of any forecast events on counterparty credit risk, and suppliers will also be expected to notify Ofgem if there is a significant change in the circumstances of a counterparty that could jeopardise their ability to meet the enhanced FRP. Operational risk, which is particularly difficult to quantify in a single measure across entities, will also be covered by FRP reporting, allowing Ofgem to make supplier-specific judgements on this more idiosyncratic risk.

3.28 In our consultation, we also highlighted liquidity risk. In consultation responses, suppliers highlighted that minimum capital requirements tend to address longer-term risks related to absorbing unexpected losses rather than liquidity risk. We acknowledge that our proposed approach for the minimum capital requirement allows suppliers to use funding sources to meet the requirements that are usually considered sources of liquidity. This was not done due to a conflation of the objective of the policy – but rather to achieve the desired outcome in a proportionate way, and at efficient cost, to get the best outcomes for consumers. Our Pillar 1 minimum capital requirement does not seek at this stage to dictate to suppliers how much of each type funding source might be allowed, and so whether any of the minimum capital requirement must be proven to be liquid. Rather, our proposed approach is to specifically address liquidity under Pillar 2 aspects of the enhanced FRP. The proposed new elements of the FRP put a requirement on suppliers to ensure and demonstrate they have enough capital and liquidity appropriate for their business model and associated risks to meet liabilities as they fall due. Ofgem will be able to monitor how suppliers are

meeting this requirement alongside the specific Pillar 1 requirement, to make a judgement on the need for any intervention.

3.29 Other risks suggested by consultation respondents like the impact of tail events – such as the invasion of Ukraine - and risks associated with supplier-specific behaviour like hedging practices and collateral needs, will also be captured under the Pillar 2 elements of the enhanced FRP. This will be, for example, through the detailed reporting on business-specific risks, stress impacts and mitigations, which will include questions on hedging and collateral requirements. Supplier-specific risks will also be captured through other elements of our Enhanced Oversight framework like supplier stress testing, as will tail-risk given the regulator's ability to set stress scenarios and information requests considering latest market conditions. This information will be taken together to understand if additional supplier-specific measures beyond the minimum capital requirement are needed to mitigate the impact of these risks on supplier resilience. This approach will allow Ofgem to take a more segmented approach to suppliers considering specific business models, risks, trading arrangements and costs.

Transition approach

3.30 As above, it is our view that suppliers should ultimately hold an amount of capital closely informed by the full amount of capital employed they are compensated for under the price cap, save for any exceptions as set out above. However, the combination of difficult economic headwinds, the constraints imposed by the price cap, and the current frictions in the financial markets are all contributing to a difficult investment landscape for the energy supply market, meaning we will need a suitable transition towards that end goal. Since the June consultation, we have reviewed data from current financial monitoring and engaged with suppliers as well as other relevant stakeholders in the market regarding current financing conditions to come to a view on appropriate transition approaches.

3.31 As a result, we are proposing to start with introducing licence conditions that set an interim initial minimum capital requirement to be achieved within the first two years of the policy. Our approach to further increases towards the minimum capital requirement would then be subject to consultation.

3.32 We propose by 31 March 2025, domestic suppliers should hold a minimum capital requirement of between £110 and £220 per domestic customer. The higher end

of the range (£220/customer) is based on averaging the level of capital employed suppliers have historically been compensated for under the current price cap methodology[19]. We considered financial data from suppliers and feedback about the impact of current market conditions to inform a proposed lower range.

3.33 As set out in the accompanying impact assessment, we believe the consumer benefits have a net positive value for consumers that increases as the minimum capital requirement increases – from £413 million to £539 million over the next six years for capital requirements between £110 and £220 per domestic customer, respectively. Nevertheless, this needs to be considered alongside current market conditions and feedback that suggests there are challenges in raising capital for challenger and small suppliers in the short-term, which could increase costs for consumers. We assume that over time, greater certainty on return on capital and proposed policies on financial resilience will improve suppliers' investment ratings and reduce costs. In the interim, we need to consider the most beneficial transitional approach to achieve our financial resilience objectives in a way that minimises costs and benefits consumers the most.

3.34 Given current market conditions, we expect the initial requirement to be towards the bottom of the range, but want to test the implications of higher figures with stakeholders. We anticipate using the suppliers' latest stress-testing responses and other financial data from suppliers to further inform our final view.

3.35 We intend to require suppliers to provide a plan setting put how they propose to meet the 2025 target in clear 'staging posts' or increments, and we will use Pillar 2 elements of the enhanced FRP to measure and incentivise progress. So, for example, we would generally expect suppliers to set an initial target of zero net assets on their balance sheet within about one year. More detail on this reporting requirement can be found in chapter 2.

3.36 We propose the 2025 minimum capital requirement is set on a per customer basis, and applies equally to dual fuel and single fuel customers. We believe that this has the benefit of being transparent and easily understood. This in turn may

[19] an average was calculated across the time period since the introduction of the price cap. However, to take account of the recent unprecedented volatility in the market, the two most recent price caps have been excluded to provide a figure that reflects a relatively stable market.

reduce administrative burden and provide greater regulatory certainty, to the extent that it is clearer to comply with and enforce against.

3.37 As an alternative, we are also considering if there should be a different minimum capital requirement associated with a single fuel customer or whether the requirement should be expressed on a £/MWh basis to better reflect different customer types and different customer populations across licensees. To achieve this, we could determine the capital requirement based on the relative share of the bill between electricity and gas. This is more complex because of the changing relative costs and volume assumptions in Typical Domestic Consumption Values (TDCVs). Based on historic averages this would suggest values of around £45/MWh for electricity and around £8/MWh for gas. Using current TDCVs and price cap unit costs would suggest values of around £36 for electricity and around £10 for gas.

3.38 Our proposal sets a flat amount per customer for the minimum capital requirement at this time. We considered the possibility of setting the minimum capital requirement as an actual percentage of the capital employed under the price cap return. However, our view is that using a percentage in the requirement could introduce complexity and a lack of certainty for suppliers. Most immediately, this is because the methodology for calculating the return under the price cap is currently being consulted on and, in the longer term, the price cap is subject to change, which would mean that the number underlying the minimum capital requirement would be subject to small iterative changes based on market fluctuations. In the future as the minimum capital requirement is ratcheted up to cover a greater proportion of the capital employed number, we will consider if a more granular and sensitive measure is most appropriate.

3.39 We are aware that risks will be different for competitive tariffs, and as suggested by suppliers, this will be driven not just by the nature of the tariffs but also by the risk management behaviours of suppliers. We considered whether at this stage there was a case for setting a different minimum capital requirement for competitive tariffs compared to SVTs. Our view is that the main driver of the difference between fixed-term tariffs - currently the most common type of competitive tariff - and SVTs would be backwardation risk. Initial analysis showed that in higher stress scenarios, backwardation had an increasing impact on differences between risk capital needs for SVTs versus non-price capped tariffs.

3.40 Under current market conditions, a much greater proportion of consumers are on SVTs and the nature of future competitive tariff offerings is unclear, making it difficult to derive a robust single figure for the right level of capital employed for competitive tariffs. As noted, the initial minimum capital requirement will be set well below the likely capital employed number for the efficient notional supplier under the price cap return, and below the level of capital that we would expect a supplier to employ in offering fixed-term contracts in the current market. We therefore think that it would be reasonable to require the same level of capital employed for all types of domestic contracts in this initial period.

3.41 However, we plan to review this position when we review the minimum capital requirement. At this point, we will be able to consider the nature of competitive tariffs on offer in the market and how to set capital requirements considering various characteristics such as fixed term contract periods or time of use elements.

3.42 Similarly, we also considered whether the transitional minimum capital requirement levels should be calculated in a way that considered different proportions of customer payment methods across different suppliers. For the initial capital requirement, we propose to not differentiate requirements depending on payment type. As above, the required interim amount is likely to be a fraction of the final trajectory, and so we do not think this payment-types differentiation will be especially impactful at this stage. Our ultimate approach will need to consider how payment methods are taken into account in the EBIT work. Future considerations about payment types will be considered in future consultation on further increases to the minimum capital requirements following our interim target.

How Capital should be held

3.43 In our June policy consultation, we suggested another key question for defining a minimum capital requirement is around how capital should be held. The ability to use a source of funding to meet regulatory capital requirements often relates to the ability of that source of funding to absorb unexpected losses when they arise. The most reliable source of funding for this purpose tends to be equity, derived from shareholder investment and retained earnings and reserves.

3.44 Although most consultation respondents chose not to respond to the question on sources of funding in detail, we considered closely supplier returns to financial reporting RFIs and stress tests to develop a fuller understanding of existing supplier capital structures. We note – as set out in the June consultation – that it is clear different supplier business models rely on different funding sources. While independent suppliers are largely reliant on equity-funding, other suppliers in Group structures have access to other funding sources like inter-company debt facilities and Parent Company Guarantees which can be more cost-efficient. As set out in our consultation, however, these alternative sources of funding vary in quality and reliability as sources to be drawn on, including in times of stress.

3.45 Our proposed approach is to use a metric for the minimum capital requirement of net assets, defined as (Fixed Assets + Current Assets) – (Current Liabilities + Long-term Liabilities). This is often considered a value attributable to equity. This approach is in line with proposals for the notional supplier that will underpin the price cap return, which is equity-financed.

3.46 Where a licensee supplies both domestic and non-domestic consumers, reporting on compliance with the minimum capital requirement required under the enhanced FRP should also seek to explain any split of assets between the supply business for non-domestic supply versus domestic supply, to help shed light on how the net assets calculation for the minimum capital requirement maps across the business and if there are any implications for the impact of the measure on resilience. Both domestic and non-domestic suppliers are subject to the requirement under the enhanced FRP to ensure they hold sufficient capital and liquidity to meet liabilities as they fall due, which we consider mitigates any risk that suppliers will lean heavily on shifting assets to meet requirements related to their domestic customers at the expense of not having sufficient assets on hand to also meet the risks in their non-domestic business.

3.47 We considered the possibility of using a metric for the minimum capital requirement following the more traditional definition of capital employed, which can be described as (Total net assets + Non-Current Liabilities). This approach in practice would have the effect that on-balance sheet long-term debt would be considered as contributing towards the minimum capital requirement. Advantages to this approach would be the greater flexibility to suppliers, and potentially a lower cost to the policy given long-term liabilities would likely be less expensive sources of funding than equity. However, our view is that these advantages could

be outweighed by the risk that licensees could meet a substantial part of the minimum capital requirement using long term debt secured on the other assets held by the licensee, meaning that in the event of failure the capital available may be much lower than the capital employed measure suggests, leading to higher costs for consumers.

3.48 As above, we are aware of the wide range of funding models across the market, and the different costs associated with different sources of funding. To ensure the policy is as efficient as possible, we would allow for suppliers to propose to Ofgem ways to meet the minimum capital requirement using alternative sources of funding – such as long-term debt, inter-company credit facilities and Parent Company Guarantees – subject to defined criteria, and to the extent the supplier could demonstrate those sources of funding result in an equivalent level of resilience as the minimum capital requirement.

3.49 We consider that the above approach addresses the range of feedback from suppliers. Firstly, that the objective of ensuring suppliers are able to absorb unexpected losses is best met through equity-type funding. Secondly, that the policy needs to consider and be proportionate to the wide range of business models.

3.50 Taking this all together, we consider that our approach maximises consumer outcomes incentivising more investor "skin in the game" to create a more robust sector less subject to moral hazard, while also reducing probability of default and cost mutualisation; and all at an efficient cost to consumers.

3.51 Suppliers that choose to propose meeting the minimum capital requirement using alternative sources of funding will need to consider criteria set out in the SLC as well as in the guidance. We propose that those criteria would include:

- Overall, the alternative source of funding must be sufficient to ensure that the licensee can meet any risks or liabilities that the licensee reasonably anticipates.

- Where alternative sources of funding are held by the licensee, such as debt or similar financial instruments, it must not be secured on licensee assets by a fixed or floating charge or other security arrangements. Long-term debt and other liabilities often benefit from contractual agreements which

provide the lender with preferential rights over the other assets held by the licensee in the event of the debt or the associated costs not being repaid in accordance with the contractual terms and conditions. Where a lender exercises such rights, the net assets held by the licensees may end up being much lower than indicated by a net assets measure which does not deduct long-term liabilities. However, where a licensee can demonstrate that lenders do not benefit from these type of contractual arrangements - often referred to as fixed or floating charges - we will consider such sources of funding in relation to the minimum capital requirement.

3.52 For alternative sources of funding held by a third party:

- Suppliers must have robust, legally enforceable, and clearly defined arrangements in place to ensure that they can draw on the source of funding at all times, including in times of financial stress.

- Arrangements should not be capable of termination without good cause and without sufficient notice to enable the licensee to put in place arrangements to meet the minimum capital requirement in an alternative way.

- The third party must have, and maintain, a long-term credit rating of not less than BBB by Standard and Poor's or equivalent rating by either Moody's or Fitch Ratings.

3.53 If a supplier plans to use sources of funding held by a third party, to provide an equivalent degree of assurance, we propose that they will also be required to obtain a legally enforceable undertaking from the external entity which states that the external entity will refrain from any action that would be likely to cause the licensee to breach any of its enhanced FRP obligations. This would need to be accompanied by evidence demonstrating how the funding will be legally transferred to the supplier, the terms and conditions of any funding (including payment terms of loans/ debt instruments) and satisfy Ofgem that the supplier is legally and readily able to access these funds.

3.54 We considered how our proposed approach would work alongside the price cap return. As currently proposed, the notional supplier for the purpose of the return

is equity-funded, and without any long-term liabilities. We will continue to consider the extent to which suppliers propose successfully to use alternative sources of funding to meet their minimum capital requirement to understand if and how this should be taken into account in the future price cap return.

Implementation and Future trajectory beyond transition

3.55 The minimum capital requirement would in practice be set out as an element underneath the enhanced Financial Responsibility Principle SLC – set out in appendix 2 of this document. This SLC would cover the Pillar 2 elements of the capital adequacy proposal alongside the Pillar 1 minimum capital requirement. Guidance underpinning the SLC would give some further detail on aspects of the requirement, including as mentioned above. Material elements of this guidance are set out in appendix 2. The proposed guidance document itself will be published following this consultation, within the consultation period.

3.56 As above, it is our view that suppliers should, in the longer term, hold the full amount of capital employed they are compensated for under the price cap, though the exact manner in which we will ratchet up the requirement following our proposed initial steps will be the subject of further consultation.

3.57 Subsequent consultation on minimum capital requirements will consider the value of further granularity in future requirements related to considerations outlined in this consultation, such as the difference between types of tariffs, consumer consumption profiles and payment types.

3.58 The future trajectory will also continue to be coordinated with how suppliers will be compensated under the price cap, in order to ensure a proper return for those requirements driven by price-capped tariffs.

4. Ringfencing RO receipts and CCBs

Section summary

In this chapter we set out our proposal to ringfence RO receipts and explain why we are not proposing to require market-wide ringfencing of CCBs as well. We set out the feedback we received to the June policy consultation, how it informed our thinking and what our proposals are as a result. We welcome views on our proposals to implement ringfencing, in particular to understand the impact on suppliers.

Questions

Question 9: Do you agree that suppliers should protect 100% of their RO (attributable to domestic supply) from the 2023/24 scheme year onwards on a backwards-facing basis? If not, what do you consider to be the optimal implementation period, and why?

Question 10: How, and to what extent, might our proposals for RO ringfencing impact the way in which your company interacts with other Government schemes?

Question 11: Would you envisage ringfencing your RO using a Protection Mechanism, protecting ROCs, or using a mixture of the two?

Question 12: Do you agree that the proposed price cap allowance is appropriate to account for the costs that an efficient supplier might incur in ringfencing their RO receipts? (See appendix 1)

RO ringfencing

What we consulted on

4.1 In our policy consultation we proposed that suppliers should be required to protect RO receipts attributable to domestic supply using one of three approaches:

- Option 1 was a 'report or protect' obligation where suppliers would be required to report quarterly on their strategy to meet their RO obligation or protect an equivalent amount. This approach would have a minimal impact on suppliers' working capital but would mean RO receipts remaining unprotected if suppliers chose to report.

- Option 2 was a 'protect obligation' where suppliers would be required to protect the equivalent amount of their RO liabilities using a Protection Mechanism, irrespective of the ROCs they have purchased. We discounted this as we believe it would disincentivise participation in the ROC market.

- Option 3, our preferred option, was the 'protect or discharge through ROCs' obligation. Suppliers would be required to evidence that their accruing RO is being met by holding ROCs; protecting funds equivalent to their liability in a Protection Mechanism; or a mixture of the two.

4.2 In addition, we proposed that Ofgem would be the beneficiary of a trust that would hold proceeds from the sale of ROCs so that in the event of insolvency we can draw down these sums or have the right to be paid any funds realised by the sale of ROCs in an insolvency.

4.3 We set out our view that Option 3 best protects consumers from the costs of mutualisation and reduces mutualisation risk while still supporting the ROC market (and therefore renewable generation).

4.4 We also sought views on the length of the protection period, and whether stakeholders favoured a forward- or backward-facing forecast for protection (i.e., whether suppliers would put protections in place ahead of the RO period or after it). We set out how we favoured quarterly protection periods, as this approach appears to strike an appropriate balance between managing mutualisation risk

and granularity. We also explained why we preferred a backward-facing approach because it mirrors the existing Feed-in Tariffs (FIT) Levelisation scheme.

4.5 We also proposed requiring an interim reporting phase which would run from the end of the publication of the policy consultation in two phases (1a and 1b) until the beginning of the 2023/24 RO scheme year. After that point it would be superseded by ringfencing. Reporting would rely on suppliers demonstrating how they plan to comply with their RO using a forward-facing, quarterly reporting cycle.

4.6 We also asked stakeholders whether they supported our proposed implementation date of April 2023.

4.7 We focused on domestic supply only. We took this approach at the time because the prevalence of risky business models and instances of default, and therefore contribution to cost mutualisation from the non-domestic market has historically been significantly lower than in the domestic market. Latterly we also engaged specifically with non-domestic suppliers to canvass their views on the concept of extending coverage to non-domestic supply (we comment further on this later in this chapter).

Summary of responses

4.8 Overall policy consultation respondents recognised there was a need to act where RO receipts are concerned, and a majority supported our proposals. Some respondents set out reasoning supporting the need to implement changes as soon as practicable, such as the fact that RO protections have been consulted on twice in recent years without action being taken. Where we presented options, respondents generally supported interventions which preserved or promoted flexibility and catered to different business models. Respondents resisted proposals which they considered would restrict liquidity or access to the ROC market.

Assessment of protection options

4.9 Of those who provided a view, the clear majority preferred Option 3, a ‘protect or discharge through ROCs’ obligation. They particularly valued the flexibility this option offered, namely being able to either protect RO receipts or buy ROCs.

4.10 Many said that Option 1 (a 'report or protect' obligation) would not be a stringent enough defence against further mutualisation risk.

4.11 The small minority who preferred Option 1 (a 'report or protect' obligation) had different reasons for supporting it. One suggested it was the option that could be in place the fastest, which was necessary to curtail further mutualisation risk. Another noted that Option 3 (protect or discharge through ROCs) would be overly onerous given the riskiest suppliers had left the market since the wholesale gas price spike and because the risk of mutualisation had fallen.

4.12 One stakeholder stated that they did not support any options as the policy would in their view weaken supplier financial resilience overall and increase costs to customers.

Potential impact on the ROC market

4.13 The majority of stakeholders did not comment on the potential impact of a protection scheme on the ROC market. However, some asked that we conduct further analysis into the potential impact of the policy. Several consultation respondents stated that they did not expect to see a negative impact while some other respondents did anticipate a negative impact. Their concerns focused on the liquidity of the ROC market. They flagged that suppliers – particularly large, well-financed ones – might change their ROC purchasing behaviour to buy earlier in the year, thereby restricting the availability of ROCs and reducing the liquidity of the ROC market.

Introducing a trust over sale of ROC proceeds

4.14 Of those that engaged with this proposal, the majority objected to the policy on the grounds it would make it difficult to engage with the ROC market, could disincentivise participation, and change the nature of ROCs as a tradeable asset. They argued it would be too complex and cumbersome to implement as suppliers and generators both benefit from the ability to buy or sell ROCs at different points in time.

4.15 Several respondents implied that this option would lead to unintended negative consequences for all ROC market participants. One supplier pointed out that a trust over the proceeds of ROC sales would be new and unfamiliar territory for

SoLRs. Another suggested an alternative notification-based solution where suppliers would notify Ofgem when they had made a sale although, overall, they felt the option should be analysed in much more detail.

4.16 Only a very small number supported the concept of introducing a trust over the sale of ROC proceeds. They believed it would provide additional transparency and visibility.

Backward- or forward-facing protection methodology

4.17 Only a small number of consultation respondents expressed a preference on whether a backward- or forward-facing methodology should be used for the calculation of RO receipts to be protected. These respondents were evenly split concerning their preferences. Those in favour of a backward-facing approach agreed with our position that it would align with existing schemes and be easier to implement. One of those favouring a forward-facing approach noted that backward-facing protection would be inconsistent with our proposed approach for CCB protection.

Interim reporting phase

4.18 Under half of consultation respondents engaged with our proposal to introduce an interim reporting phase. Several supported a regular reporting requirement, stating that it would minimise the risk of mutualised costs; strikes the right balance between administrative burden and suitably robust reporting; and aligns with both the proposed protection period and FIT scheme.

4.19 A small number of suppliers disagreed with a regular interim reporting requirement, citing the additional administrative burden it would create.

Implementation timeline

4.20 Under half of the consultation respondents engaged with the topic of implementation timelines. Of those who did, several agreed with the proposed implementation date of April 2023, with most commenting that the policy should be brought in as soon as possible.

4.21 One supplier suggested that there should be a phased implementation with 50% being protected from April 2024, and 100% being protected from April 2025.

4.22 The minority of those who engaged with this topic expressed concern at the proposed implementation date of April 2023. They raised concerns that suppliers would struggle to find alternative working capital within the proposed timeline and that it would not provide enough time to prepare for restricted RO cashflow. One suggested that we should be taking a sequential approach to introducing proposals (i.e., protecting RO monies first, then CCBs).

Excluding non-domestic supply

4.23 Some stakeholders requested clarification on whether non-domestic supply was included in scope. One respondent raised concerns that excluding non-domestic supply could create a distortion in the ROC market and also noted that cost mutualisation attributable to RO is spread across both non-domestic and domestic supply.

4.24 To help broaden our evidence base we requested consideration of this specific issue from non-domestic suppliers as a supplementary part of the consultation process, recognising that some had not engaged with the main policy consultation on the basis of our description of scope. In the interests of consistency, we asked the same questions as we had for the domestic market in the original policy consultation but asked these questions in relation to extending the proposal to the non-domestic market. We also conducted an impact assessment20 to aid our view as to whether extending the scope of coverage would be appropriate.

4.25 Of the additional responses we received from non-domestic suppliers, some requested more detail on the proposals rather than providing a definitive view on inclusion or exclusion. Several anticipated that including non-domestic supply would have a negative impact on the ROC market. Only one supplier explicitly said they would support extension to non-domestic supply to minimise the risk of distortion. They didn't view the thus far low mutualisation costs for non-domestic supply as sufficient justification to not extend the scope.

[20] Our findings are summarised in the impact assessment published alongside this consultation.

What we are proposing

4.26 Having considered stakeholder views and evidence and conducted further analysis, we continue to believe that proceeding with market-wide ringfencing of RO (attributable to domestic supply) represents an important component of our wider strategy for improving suppliers' financial resilience.

4.27 We acknowledge and agree with a view that is widely held among stakeholders (including almost all domestic suppliers) that action needs to be taken to reduce the level of risk posed by current RO payment arrangements.[21] We continue to believe that government legislating for more regular payment of RO receipts would be the optimal solution to address misuse of RO receipts by suppliers[22]. In the absence of such legislation, we consider that ringfencing is an appropriate and proportionate approach to tackling a long-standing issue that has contributed to the 'moral hazard' we have identified and added to mutualisation costs where suppliers have failed.

4.28 In the absence of capital adequacy requirements, our impact assessment estimates that ringfencing of RO receipts attributable to domestic supply would have a consumer benefit of £242m over 6 years[23], equivalent to an annual average benefit of £3 per consumer per year.

4.29 We recognise that the monetised consumer benefits of our proposed combination of ringfencing of RO receipts and capital adequacy, £483m over six years according to our impact assessment, are less than our estimates of those benefits for capital adequacy on its own (£413m to £539m). However, we see a principled case for ringfencing money that was never intended to support suppliers' business operations and is instead a clear 'pass through' arrangement which

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[21] Suppliers accrue an obligation ("the Renewables Obligation") over each 12-month obligation period and are given 5 months to settle it with ROCs or alternative cash payments. A further 2 months are available for permitted late payments, but these attract interest charges. This infrequency has contributed to payment default where suppliers have used RO funds for other purposes.

[22] https://www.gov.uk/government/consultations/renewables-obligation-ro-addressing-electricity-supplier-payment-default-under-the-ro-scheme

[23] Net present value over 2023-2028 at 3.5% discount rate.

could easily circumvent suppliers altogether were the scheme designed in a different way.

4.30 We also believe that the combined package of capital adequacy and ringfencing of RO receipts has the greatest long-term benefits for consumers, since our impact assessment shows that it has the highest annual benefit run-rate by 2028 (£167m per year compared to £140m for only capital adequacy).

4.31 Finally, we note that there may be further evolution or reform of the RO to adapt it to today's market24. Ringfencing RO receipts will remove access to the free working capital which the RO has provided to date, avoiding any potential future ‘cliff edge’ scenarios when future reforms are implemented, and suppliers are no longer able to rely on RO receipts.

Assessment of protection options

4.32 We propose proceeding with Option 3 of the protection options (an obligation to protect or discharge through ROCs) for RO ringfencing. We agree with the majority of stakeholders who view this option as clearly more viable than the alternative option we sought views on, namely a ‘report or protect’ obligation. The former imposes ‘harder-edged’ requirements whereas the reporting option creates the risk that shortcomings would only come to light at an advanced stage, by which time action to protect the relevant funds may be significantly more challenging.

4.33 A ‘protect or discharge through ROCs’ obligation also allows suppliers the flexibility to continue to purchase ROCs, and therefore preserves the tradeable nature of the ROC market which supports renewable generation. We received little evidence of our proposed approach having negative impacts on the ROC market. If a supplier’s business model is better suited to setting aside equivalent funds, then our preferred approach also allows for this. As with all new policies, we will monitor the outcomes and take further action if required.

[24]https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1070241/ro-addressing-supplier-payment-default-consultation-responses.pdf

Trust over proceeds of sale of ROCs

4.34 A majority of respondents objected to the option of introducing a trust over sale of ROC proceeds and we do not propose proceeding with a trust over the proceeds of ROC sales. We acknowledge the concerns raised by stakeholders around the significant complexity and administrative burden associated with implementing this requirement. Instead, the supply licence drafting accompanying our preferred option (an obligation to protect or discharge ROCs) is designed to ensure that suppliers continually protect the full amount of their obligation while providing suppliers with the flexibility as to the approach they take to do this.

Backward- or forward-facing protection

4.35 We propose proceeding with a backward-facing approach for RO ringfencing. By doing this, suppliers would be protecting what they receive from consumers to pay for their RO. This approach also avoids having to estimate the protection amount and therefore removes the need for any true-up or reconciliation. A backward-facing scheme also aligns with the approach currently taken for the FIT scheme so will ease administration for suppliers and Ofgem.

Interim reporting requirement

4.36 We do not plan to proceed with an interim reporting requirement for RO ringfencing. Originally, we consulted on an interim reporting requirement to cover the period between the end of statutory consultation and ringfencing taking effect. Based on the adjustment to our timeline, this requirement could only be in place for as little as a month. We do not believe it is proportionate or efficient to introduce a new reporting requirement with the accompanying administrative burden when it will be in place for such a short period of time and bring minimal benefits.

Implementation

4.37 Our preferred approach remains to introduce RO ringfencing on and from 1st April 2023 to coincide with the start of the 2023/24 RO scheme year. The requirements of the RO scheme and design of our draft supply licence conditions will facilitate a gradual increase of the protection requirement, smoothing the transition for those

suppliers that need to acquire alternative working capital to replace RO receipts. We also believe that clearly signalling our intent now should allow suppliers sufficient time to initiate commercial arrangements with a view to securing appropriate Protection Mechanisms and any other arrangements needed to successfully implement RO ringfencing.

4.38 However, we recognise that, when combined with our proposal to set a minimum capital requirement, the cumulative amount of capital that suppliers would have to raise over the next one to two years may be challenging, and we may need to consider trade-offs between the transition periods for these different interventions. We will consider any relevant feedback on the optimal implementation period for the RO in light of our wider package of measures.

4.39 Applying RO ringfencing attributable to domestic supply, market-wide, will maximise the benefits of this measure. We believe it is unlikely that permitting an individual supplier to deviate from this requirement would be in the consumer interest. However, we recognise that our proposals will require some suppliers to make substantial changes to their business models by being required to ringfence significant sums. In turn we note that the impact this will have on cashflow may pose significant challenges for these suppliers, challenges that may become especially acute at particular times of year. We therefore welcome views on whether any approach other than a market-wide application could be warranted, and if so under what specific circumstances.

Supply coverage

4.40 As noted above, we continue to propose requiring ringfencing of RO receipts attributable to domestic supply. Those suppliers that serve both domestic and non-domestic consumers will need to ringfence their domestic RO but will not need to ringfence RO associated with their non-domestic supply.

4.41 As described earlier in this chapter, we conducted some additional analysis following our policy consultation to assess the benefits case for ringfencing RO receipts attributable to non-domestic supply. This assessment identified that ringfencing RO supply attributable to non-domestic supply would result in a net disbenefit to consumers. We recognise the lower failure rate of non-domestic suppliers historically compared to those pre-dominantly serving domestic consumers.

Accounting for RO protection in the price cap

4.42 We set out our proposal on how to account for the ringfencing requirement via a change to the price cap in appendix 1 of this document. Detail on our rationale and economic modelling can be found in that appendix.

Customer Credit Balances

What we consulted on

4.43 In our policy consultation we proposed that domestic suppliers should ringfence CCBs and outlined two potential approaches for doing this.

4.44 We explained how our preferred approach would require suppliers to use one or more Protection Mechanisms (a Parent Company Guarantee, a Third-Party Guarantee, a Letter of Credit, a Trust account, and/or an Escrow account) to ringfence their CCBs.

4.45 We also set out our consideration of a second approach, where suppliers would use a 'client account'. Here, suppliers would pay into a separate bank account, as landlords do under the Deposit Protection scheme, with very specific drawdown conditions. We noted our view that this approach could add significant complexity and cost and so we believed it would be sub-optimal.

4.46 We described how in either scenario the amount protected would be subject to a Protection Amount Calculation. This calculation would include the definition of the value to protect; the frequency of updates to the calculation (monthly/quarterly/yearly) and whether it was based on historic or forecast data. We favoured protecting gross credit balances net unbilled consumption25, protected quarterly, based on forward-facing data, and sought views from stakeholders on all aspects of the Protection Amount Calculation.

4.47 We stated that we were minded to introduce protections as soon as possible, particularly as CCBs are expected to rise throughout the summer and with the Government's Energy Bills Support Scheme (EBSS) expected to be implemented in autumn 2022. However, we recognised that some suppliers use CCBs as an important source of working capital and we wished to better understand the risks of requiring suppliers to ringfence 100% of their CCBs. We therefore sought views on what transitional arrangements might look like.

[25] 'Gross credit balance" means the forecasted aggregate of all of the licensee's Domestic Customer Credit Balances. "Unbilled consumption" means the value of the energy forecast by the licensee to likely be consumed by all Fixed Direct Debit Domestic Customers and calculated in accordance with the terms of the relevant Domestic Supply Contracts, but not yet included in a Bill or deducted from that Fixed Direct Debit Domestic Customer's Domestic Customer Credit Balance.

4.48 We proposed a monitoring framework which required confirmation of protection arrangements together with quarterly submission of a forecasted calculation of the required protected amount. To minimise costs to the supplier and simplify the process of securing and submitting details of protection arrangements, we considered the introduction of a templated approach to securing protection and the use of existing information provision vehicles to collect protection data.

Summary of Responses

4.49 Overall, policy consultation respondents were split in their responses and suppliers presented polarised views. Some suppliers welcomed the proposals and urged Ofgem to go further and faster. Others were more cautious in their responses, recognising the importance of regulation in this space while raising strong concerns around the additional costs it would bring to consumers.

4.50 A small number of suppliers did not support the policy at all as they felt it was untargeted and costly to deliver. They highlighted the different circumstances of large and small suppliers, with one noting that it would be hard for challenger brands to compete against legacy suppliers benefiting from a low cost of capital, leading to an unearned advantage for legacy suppliers. They also claimed that a reduction in competition could reduce the incentive to improve service, innovate and drive to net zero.

4.51 Other suppliers felt that the removal of access to CCBs as a source of working capital would weaken financial resilience at a time when the cost of replacing that capital is significant and investor confidence is low.

Defining customer credit balances

4.52 The majority of stakeholders that provided a view on the CCB definition preferred 'gross credit balance net unbilled consumption'. They viewed this definition as being more impactful on reducing mutualisation costs and in addition would be more effective in removing access to CCBs as risk-free working capital. They considered that the 'net credit balance net unbilled consumption' approach would fail to prevent the use of CCBs for risk-free working capital and be less effective in reducing mutualisation costs associated with CCBs. Several suppliers noted that a 'gross credit balance net unbilled consumption' approach aligns with the

SoLR process whereas the debt book would be allocated to the administrator in the event of failure and would not therefore support the consumer interest.

4.53 A small number of suppliers preferred ‘net credit balance net unbilled consumption’. They believe it is more reflective of the suppliers’ own overall position and would be effective in stopping suppliers growing unsustainably. One supplier noted that a ‘net credit balance net unbilled consumption’ would represent the least cost option and for that reason it would be their preference. Another highlighted the compounding effect when taken with other policies, that could mean that lower levels of CCB protection would be sufficient to address a perceived reduced risk.

4.54 The view that the majority of the market is served by suppliers that would be too large to enter the SoLR process if they failed was also presented. It was noted that these suppliers would likely be placed into a SAR regime instead, where they would see the credit and debit balances moving together rather than the credit balances being subject to mutualisation, and for this reason any debit balances held by the supplier should also be factored into the calculation methodology for the protection of CCBs.

Frequency of calculation

4.55 Although we didn’t receive a large volume of comments on calculation frequency, the majority of stakeholders preferred a quarterly review cycle. These suppliers felt this would strike the right balance between accuracy and regulatory burden and would align with existing internal processes.

4.56 The minority view was that a monthly review cycle would provide a more accurate view of the CCB amount to be ringfenced, reducing the risk of over/under protection. It was noted that a monthly review cycle should not be too burdensome once up and running.

Nature of calculation

4.57 We received mixed views concerning the nature of the Protection Amount Calculation, although the majority of stakeholders preferred a backward-facing approach. They felt the use of actual data would give an accurate basis for setting protection amounts compared to forecasting ahead and would be easier to report

against. The main concern with a forward-facing forecast was the potential for under forecasting or other errors leading to inefficient over/under protection related costs.

4.58 Those stakeholders that favoured a forward-facing approach did so because they felt this approach would be more relevant to the period of operation immediately ahead and would account for factors such as tariff prices and seasonal variances instead of using data that could be considered outdated.

Implementation/transition period

4.59 Several suppliers raised concerns around not being suitably able to implement proposals for Winter 2022, as per the aspiration we set out in our policy consultation. The majority of stakeholders stated that we need to consider the implementation process of our proposals further to ensure we are not over saturating suppliers with numerous requirements around financial resilience in a short time period. One supplier noted that the introduction of CCB ringfencing should not be implemented alongside the Energy Bills Support Scheme (EBSS).

4.60 Conversely a minority of suppliers see no case for transitional arrangements maintaining that there is an overwhelming consumer benefits case for moving swiftly. We also received a number of suggestions from suppliers on the transition time-period they may be able to achieve that would suitably reduce the cost impact on their business. Implementation suggestions ranged from July 2023 to Spring 2024 with a multi-year transition to full protection.

What we are proposing

4.61 In chapter 1 we acknowledge that it will take some time for the supply market to fully transition to the improved state of financial resilience that we believe is in the consumer interest. We naturally wish to use the most effective combination of interventions to achieve this transition. Our revised impact assessment shows that we would expect a minimum capital requirement alongside market-wide RO ringfencing to have net consumer benefits of £74m-£93m per year on average

over the next six years26, £34m-£53m more than market-wide CCB and RO ringfencing.

4.62 We also recognise the views presented by some stakeholders that market-wide CCB ringfencing would be untargeted and impose costs on all suppliers – including efficient suppliers – in a way that on balance we do not believe to be in the interests of consumers. It may also result in 'inactive' capital that could be more effectively deployed – particularly in the short term – as capital reserves that would directly increase supplier resilience.

4.63 We recognise the view that it is generally in consumers interests for suppliers to appropriately use some CCBs as working capital, noting the analogies in some other industries (e.g., travel, durable consumer goods) that suggest consumers should expect credit balances to be part of an efficient business.

4.64 Further, we believe that concerns relating to over-reliance on CCBs can be addressed by building on the existing requirements, which have not been extensively leveraged to date. For instance, we recently strengthened rules around how suppliers can set Direct Debits which should help avoid the excessive accrual of CCBs. Coupled with the requirements we are proposing in this consultation - including more detailed expectations on the use of CCBs for working capital set out in the enhanced FRP and the ability to direct CCB ringfencing where our monitoring and assessment of the supplier's circumstances suggests taking this action would be in consumers' best interests – this should reduce excessive reliance on CCBs for working capital and the amount of CCBs at risk of mutualisation. We do, however, propose to keep this under review.

4.65 On these grounds, we are no longer proposing introducing market-wide CCB ringfencing.

Bespoke ringfencing

4.66 Earlier in this document we set out our proposals for an enhanced Financial Responsibility Principle. These proposals include the concept of directing individual suppliers to ringfence their CCBs in certain circumstances (described in

[26] Range of benefits given for the requirement between £110 and £220 per customer, respectively.

that chapter). In the following section we set out detailed proposals for how this ringfencing would be put into practice once a supplier has received a direction, as reflected in the supply licence conditions on which we are also consulting on.

Defining customer credit balances

4.67 Our original proposal recommended basing the CCB protection calculation on "gross credit balance net unbilled consumption"27. We believe this remains the most appropriate approach for bespoke ringfencing. This definition is more impactful on reducing mutualisation costs and is more effective in removing access to CCBs as risk free working capital than "net credit balance net unbilled consumption" where a significant proportion of CCBs could remain unprotected, when debt levels are high.

Frequency of calculation

4.68 Under our revised proposals we propose directing suppliers to ringfence CCBs where our monitoring and assessment of the supplier's circumstances suggests taking this action would be in consumers' best interests. As a result, we maintain there is a need for a frequent, simple and accurate re-calculation cycle. We believe a monthly approach would support this more effectively than the quarterly cycle previously proposed under a market-wide obligation given the specific context, namely our identification of a supplier being in financial distress.

4.69 We note that a monthly calculation, compared to a quarterly calculation will mean that fluctuation is limited to changes during the course of a month, rather than during the course of a quarter and the risk of over or under calculation is therefore significantly reduced.

[27] "Gross credit balance" means the aggregate of all of the licensee's Fixed Direct Debit Domestic Customer Credit Balances. "Unbilled consumption" means the value of the energy by the licensee to likely be consumed by all Fixed Direct Debit Domestic Customers and calculated in accordance with the terms of the relevant Domestic Supply Contracts, but not yet included in a Bill or deducted from that Fixed Direct Debit Domestic Customer's Domestic Customer Credit Balance.

Nature of calculation

4.70 A key consideration with CCB ringfencing is how to best align the protection calculation with the inevitable fluctuations of CCBs across the year to keep the levels of protection closely aligned to the amount of CCBs held by a supplier.

4.71 Aligned to a more frequent monthly calculation cycle, we believe it is appropriate to base the calculation on actual data as at the close of business on the last day of each calendar month. This approach removes the risk of forecasting error and simplifies the calculation methodology for the licensee while ensuring that any disparity between actual CCBs held and level of protection in place is minimised.

Implementation

4.72 Under our revised CCB ringfencing proposals we intend to implement a requirement for CCB ringfencing to be set up, validated by Ofgem and made live within 28 days from the issuance of a direction. We believe this is an appropriate timeframe given any direction will be triggered by concerns over financial resilience and the resulting CCB ringfencing protection therefore needs to be in place as quickly as practicable to secure CCB funds are protected.

Timetable for implementing bespoke CCB ringfencing

	Initial cycle	Subsequent cycle
Direction issued	Day 1	NA
Representation to the Authority	Day 1 to Day 7	NA
Calculation data from close of business	Day 2	Last day of month
Support arrangements & calculation submitted to the Authority	Day 14	Day 14 of month
Support arrangements live	Day 28	Day 1 of month

Termination of CCB ringfencing

4.73 We propose that the obligation for CCB ringfencing under direction will continue until revoked by the Authority.

5. Protection Mechanisms

Section summary

In this section we set out how we consulted on requiring suppliers to choose from a 'menu' of Protection Mechanisms for the purposes of ringfencing. We set out stakeholder views in response to our proposals, and our revised proposals on the mechanisms suppliers should use to ringfence RO receipts (and potentially CCBs if directed in the event of aspects of the enhanced FRP are not met).

Question 13: What are your views on the minimum requirements that should be set for the Protection Mechanisms, including our proposals around minimum credit ratings?

What we consulted on

5.1 In our policy consultation we proposed that suppliers should protect both their domestic RO liability and CCBs by using one or more Protection Mechanisms from an approved 'menu' of options. The five proposed mechanisms were a Trust Account, Escrow Account, Third Party Guarantee (TPG), a Parent Company Guarantee (PCG), and a Standby Letter of Credit.

5.2 We recognised that while each mechanism had advantages and disadvantages, we described how providing a 'menu' of options would allow suppliers to select the mechanism that best suits their business. We described in detail the pros and cons of each (see table below for a summary) and the technical detail of how each option would work in practice. We set out these details, including suggested minimum requirements. We also shared detailed draft supply licence conditions (SLCs) with suppliers in workshops in July focused primarily on gaining feedback around these technical requirements.

Table 1

Mechanism	Pros	Cons
Trust Account	• Sufficiently insolvency remote • Can accommodate fluctuating funds • Less costly than other mechanisms	• Will require collateral from the supplier and create a barrier to market entry • Transfers made when a supplier enters the zone of insolvency could trigger subsequent insolvency • May be inconsistent with directors' duties

Mechanism	Pros	Cons
Escrow Account	• Sufficiently insolvency remote • Can accommodate fluctuating funds • Ofgem would set the conditions for drawdown	• Transfers made when a supplier enters the zone of insolvency could trigger subsequent insolvency • May be inconsistent with directors' duties • Some risk of supplier non-compliance as the agent isn't regulated by Ofgem • Will require collateral from the supplier and create a barrier to market entry
Third Party Guarantee (TPG)	• Sufficiently insolvency remote • Supplier can still access working capital without passing the costs on to customers	• Time-limited; rolling arrangement would be very costly • Cap on liability • Can't readily accommodate fluctuating amounts • Will require collateral from the supplier and create a barrier to market entry
Parent Company Guarantee (PCG)	• Insolvency remote from acquiring supplier • Supplier can still access working capital without passing the costs on to customers	• Not insolvency remote from parent supplier • Only available to large suppliers with creditworthy parent company
Standby Letter of Credit (LoC)	• Supplier can still access working capital without passing the costs on to customers • Irrevocable for validity period (but may not be renewed)	• Time-limited; rolling arrangement would be very costly • Burdensome to monitor

5.3 We also set out how we would be open to suppliers using any equivalent mechanism that meets the requirements of the policy and which we have approved.

5.4 We stated that we were minded to discount an insurance option. This was because we thought it would either not be available or be prohibitively expensive to acquire.

5.5 We also considered templates for mechanisms, as we thought this may make the scheme aligned and uniform across the sector and provide clarity on the process. We sought views on whether this might inhibit flexibility and/or increase administration costs.

5.6 We noted that Protection Mechanisms might be combined across RO and CCB ringfencing. This might mean suppliers using a single mechanism for combined monies or using multiples of the same mechanism for separate monies.

Summary of responses

Optionality

5.7 The majority of policy consultation respondents strongly supported the proposed ability for suppliers to choose from a 'menu' of options. They welcomed the flexibility it afforded suppliers, and also that it caters for a number of different business models.

5.8 Some stakeholders questioned the suitability of some of the individual mechanisms. PCGs were seen as being less secure than other options like a trust or escrow account because the parent company could itself have limited financial standing. Another suggested that they should be held to the same standard as TPGs.

Insurance

5.9 Several respondents agreed with our view that the option of purchasing insurance should be discounted and no respondents supported it. Respondents noted either that insurance was too costly, or that the market doesn't yet exist.

5.10 Several respondents commented on the concept of an alternative approach, namely an ATOL-style scheme[28] where all suppliers would pay into a fund to minimise the costs of mutualisation. While a small minority advocated the concept, several suppliers objected to an ATOL-type scheme and one highlighted that the policy consultation contained a note which stated that the CAA is reviewing this scheme and intending to replace it with an approach like ringfencing. These respondents argued that this approach does not address the moral hazard of suppliers using customer money as free working capital and funding potentially unsustainable business practices.

Detailed design issues

5.11 Several respondents explicitly supported having minimum standards for each mechanism. However, the majority of respondents were unsure or did not comment on this. Only a very small number did not support having minimum standards but none of those explained why they objected to the proposal.

[28] The Civil Aviation Authority (CAA) manages the ATOL financial protection scheme for holiday makers. This ATOL Protection Contribution (APC) is funded via a flat levy applied to each traveller.

5.12 A small number of suppliers set out in detail what they thought the minimum requirements for each of the mechanisms should be, such as credit ratings aligned to existing rating levels used with other Ofgem schemes.

5.13 A very small number of respondents argued that the requirement for PCGs should be lower than for TPGs, consistent with industry schemes. They thought that TPGs should be subject to an A- rating by S&P or an A3 rating by Moody's, whereas PCGs would need to be with a company with an S&P BBB- rating or a Baa3 rating from Moody's. One supplier was less specific, suggesting any surety should be with a "creditworthy" provider with either a BBB+ or A- rating.

5.14 A small number of suppliers suggested that we should reconsider our position on excluding international lenders from providing the Protection Mechanisms. They contended that we should allow non-UK banks to finance ringfencing mechanisms as appropriate for non-UK companies.

Templates

5.15 There was some appetite for standardisation of the Protection Mechanisms using templates. A small number of respondents emphasised significant benefits, such as making it easier to find banks to issue. They argued that without some sort of standard approach, the additional complexity and due diligence Ofgem would need to carry out frequent and routine PCG checks that would be hard to manage and costly to administer. One supplier suggested we could look to their existing sureties as examples.

Availability

5.16 Many smaller and independent suppliers noted that the cheapest mechanisms like PCGs are only available to the large legacy suppliers. They stated their view that smaller and independent suppliers would be left with the expensive options of trust/escrow, which would significantly increase their operating costs.

5.17 They also pointed to higher costs of capital for non-investment grade rated suppliers and suggested the impact assessment had underestimated this. It was noted that to improve their credit rating Ofgem would need to ensure energy suppliers could achieve a reasonable rate of return over several years.

5.18 One supplier cautioned that relying on a single figure to represent the cost of capital in the price cap would not capture the diversity of the market. They noted that a high cost of capital priced into the cap would hugely benefit those that can borrow cheaply, whereas a low cost of capital assumption in line with that of the large legacy suppliers could lead to all other suppliers exiting the market. We

provide further commentary concerning this topic in the IA accompanying this document.

Views from commercial lenders

5.19 Alongside the policy consultation we discussed the Protection Mechanisms with a range of commercial lenders. These lenders had similar views, noting that the energy retail market is one which was challenging to raise equity or debt in prior to Covid-19 and the energy price inflation. They noted how the recent economic context has worsened these factors. Given this, lenders had a very conservative perspective on lending to suppliers to replace the working capital provided by RO and CCBs at this time.

What we are proposing

Optionality

5.20 We continue to believe that suppliers should have the option to choose from a range of mechanisms for ringfencing. This will give them sufficient flexibility to minimise consumers costs and cater to the wide range of business models in the market. The alternative would be to force suppliers to only use a narrower set of options, or a single mechanism which could be inaccessible for many. Each mechanism has its own pros and cons and will be priced differently according to the company's risk profile.

Insurance

5.21 We have not received sufficient evidence to suggest that an ATOL-style insurance scheme would address the moral hazard currently evident in parts of the energy retail market. The moral hazard is that suppliers lack strong incentives to guard against risk since they have little equity at stake and may even be able to collect dividends upon failure of the business after transfer of customers and their credits (i.e., major liabilities) to a SoLR. An ATOL-style scheme would not require suppliers to replace free working capital from customer money with some from sources better able to scrutinise the business. It would also result in the customers of well-financed and well-run suppliers subsidising the business models of less efficient or poorly capitalised suppliers.

Minimum requirements

5.22 We propose introducing minimum standards for each Protection Mechanism. Doing this will provide maximum assurance of continued protection. We believe

that the levels of minimum standards should be set as high as possible, while recognising that they also need to be realistically achievable.

5.23 We are mindful that several factors need to be accounted for when setting minimum standards. For example, we recognise that the sums of money requiring protection and the level of risk being taken by lenders will have a bearing on what is realistically attainable for suppliers. We also recognise that there may be benefits in mirroring requirements for other similar arrangements, at least for some Protection Mechanisms.

5.24 We propose that First Demand Guarantees (covering both Parent Company Guarantees and Third Party Guarantees), will need to be issued from companies with a credit rating of:

- Fitch short-term debt rating of "BBB" or better;
- S&P long-term debt rating of "BBB" or better, or
- Moody's long-term debt rating of "Baa2" rating or better.

5.25 In setting the minimum requirement for First Demand Guarantees we aim to account for the clear degree of interest a parent has in a subsidiary compared to a financial institution and believe this level is likely to strike an appropriate balance between achieving a high standard while averting excessive cost.

5.26 For Letters of Credit we propose to align with the requirements for the Green Gas Levy (GGL), recognising that this approach has worked well for GGL scheme participants to date. This means that Letters of Credit will need to be issued from companies with at least credit ratings of:

- Fitch short-term debt rating of "F1" or better;
- Moody's short-term debt rating of "P-1", or a long-term debt rating of "A3" or better, or
- S&P short-term debt rating of "A-1" or better.

5.27 As noted above, we received relatively limited feedback regarding minimum standards including credit ratings in responses to the policy consultation. We would therefore welcome further views on our proposed approach to help refine our proposals.

Templates

5.28 We are minded to require that suppliers use templates provided by Ofgem for each of the Protection Mechanisms. This aligns with the approach that has been

taken for the Green Gas Levy[29] which requires ringfencing through a letter of credit. Guidance for the GGL provides a template letter of credit[30] which ensures the protection is adequate, compliant with the GGSS regulations 2021 and insolvency remote, and in line with the policy intention. It has also helped streamline administration both for suppliers and Ofgem. Engagement with stakeholders indicated that the provision of templates would be welcomed since the use of templates would help simplify and streamline the process of securing cover, saving both time and cost. The provision of templates would also ensure a consistent approach to Protection Mechanisms across the supplier base.

Availability

5.29 A key theme of consultation feedback is that access to capital markets is particularly challenging at present. Some suppliers are likely to face as much as 100% collateral requirements to set up a Protection Mechanism in the current climate with these significant costs being passed on to consumers and likely to affect the competitiveness of these suppliers.

5.30 In previous sections we have set out our rationale for continuing to pursue market-wide RO ringfencing. We acknowledge that in pursuing this requirement some suppliers will face the challenges we have identified regarding the availability of Protection Mechanisms, including that the costs of ringfencing capital will weigh differently on suppliers depending on, among other things, their business model.

5.31 We also believe that the package of reforms we are pursuing will in time create a more resilient market, ultimately leading to greater investor confidence and a reduction in the costs associated with procuring the Protection Mechanisms.

[29] Green Gas Support Scheme and Green Gas Levy | Ofgem
[30] Green Gas Levy Guidance | Ofgem

Appendices

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Appendix 1 – Price cap allowance for ringfencing of RO receipts

Context

A1.1 We are considering whether to include an adjustment allowance to allow suppliers to recover costs associated with ringfencing RO receipts within price cap period 10a (1st April– 30th June 2023) should the new license condition be introduced. The costs associated with ringfencing may not be accounted for under existing allowances, and the measure may effectively increase the capital employed of an efficient supplier.

A1.2 Given the on-going consultation on changes to EBIT allowance (and the implied capital employed) under the price cap, we expect any allowance to be for a single cap period before a longer-term change can be made through the EBIT allowance and/or another mechanism.

A1.3 We do not think the potential adjustment would be sufficiently significant to require building a new model and it is likely to be time limited. Hence, we propose to make the RO ringfencing adjustment allowance through the methodology defined in the adjustment allowance workbook, referenced in 'Annex 8 – methodology for adjustment allowance' of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD).

A1.4 Since RO receipts only relate to electricity consumption, we propose to provide this adjustment for electricity only, and the consumption-based nature of the receipts means we are considering the adjustment to both electricity meter types, namely single-rate or multi-rate metering arrangements. It is therefore appropriate to define the adjustment at benchmark consumption only (and not at nil consumption), meaning that it would apply to the implied unit rate within the cap.

A1.5 Given our proposal to apply the adjustment through the Annex 8 model, there would normally be a small consequential increase in the size of the EBIT and headroom allowances. We propose excluding the compounding effect of the EBIT allowance. On the other hand, we propose to retain the compounding effect of the headroom allowance given the potential for additional one-off costs. If this

adjustment is extended or becomes enduring, then further consideration is required towards removing compounding of headroom allowance.

Options Considered

A1.6 To determine an appropriate level of adjustment, we have considered the following options:

- **Option A:** No adjustment is made to the price cap.
- **Option B:** Adjustment based on peak incremental capital employed through complying with the 'protect or discharge through ROCs' obligation funded at the notional Weighted Average Cost of Capital (WACC) assumed in the existing EBIT allowance.
- **Option C:** Adjustment based on the impact on the overall capital employed of a notional supplier, funded at the notional WACC assumed in the existing EBIT allowance.
- **Option D:** Adjustment based on the actual additional costs incurred by efficient suppliers.

Considerations

A1.7 Whilst RO receipts were never intended to fund supplier businesses, as they represent money collected by suppliers on behalf of government, we recognise they have formed part of suppliers' working capital. We are therefore minded to reject Option A.

A1.8 Given the on-going consultation on changes to the EBIT allowance, we think that there is a relatively high degree of uncertainty in Option C, which we would have to account for this in setting the level of the allowance. We are therefore minded to reject Option C as not proportionate for effectivity for a single cap period.

A1.9 We are considering introducing this allowance ex-ante to enable suppliers to recover the costs during the same period in which they are incurred. Whilst we recognise that suppliers may face different costs in complying with the RO ringfencing obligation, we would have to make a single cap adjustment that reflects our view of efficient costs. We think this approach may not be proportionate for a single price cap period if there are less complex alternatives available to us. We are therefore minded to reject Option D.

A1.10 On the basis that this is a short time-limited allowance, as the adjustment is intended for one quarter, we are minded to proceed with Option B as being most in the consumer interest and the most proportionate approach. Whilst we have some evidence that a few suppliers may be able to achieve the ringfencing protections at lower cost than implied by the notional WACC that forms the basis of our current EBIT allowance, we believe that setting the level at a notional level provides a strong incentive for efficiency, which will ultimately be in consumers' interest.

A1.11 If this adjustment becomes enduring, then we will seek more evidence to support our view of the efficient costs. We will also have to consider further in the future the compounding of the headroom allowance in the longer term as we move past implementation.

A1.12 On that basis the adjustment allowance for option 2 for an electricity consumer with typical consumption (stated in annualised terms), allowing suppliers to recover per customer for price cap period 10a for the two metering types are in Table 2 below. These values will form an input into Annex 8.

Table 2: Ringfencing RO adjustment values

	Single-Rate Metering Arrangements	**Multi-Rate Metering Arrangements**
Annualised terms (£ per customer)	7.90	10.70
Price cap period 10a (£ per customer)	1.80	2.27

A1.13 If for whatever reason the license condition requiring ringfencing of RO receipts is not introduced, then we would not introduce this cost allowance into the price cap. Furthermore, if the timing of its introduction changes from 1st April 2023 then we would consider making an ex-post cost allowance in a subsequent price cap period.

Calculations for input into Annex 8

A1.14 For the adjustment based on peak incremental capital employed (option B), we use the current RO obligation rate (ROR) and RO buy-out price (RO price) to determine a suitable allowance value for RO ringfencing within the Price Cap.

For 2022/23 scheme year, these figures are 0.491 ROCs/MWh and £ 52.88, respectively. We intend to base our final decision on the updated values for the 2023/24 RO scheme year when they are available.

A1.15 To calculate the amount of working capital required to replace the amount from RO ringfencing we take into consideration the electricity demand shares for cap period 10a (Demand) and also the typical consumption values for each single-register and multi-register metering arrangements (CV).

Additional capital required (£ per customer) = ROR x RO price * Demand * CV

A1.16 To convert the amount of working capital into a cost that the supplier will need to raise an equivalent amount of capital for its operational costs, we applied the 10% cost of capital used in the 2018 cap decision to get the cost of RO ringfencing for this quarter.

Detailed model modifications to Annex 8

A1.17 In this section we summarise the modifications to 'Annex 8 – methodology for adjustment allowance' of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD). This allows us to illustrate how RO ringfencing will be accommodated within the Price Cap. We have published a revised draft 'Annex 8 - adjustment allowance' model alongside this statutory consultation. This version includes our amendments to the Annex 8 model which was published alongside our announcement of the cap period 9a default tariff cap level on 26 August 2022.

Inputs: new sheet '3j RO Ringfencing'

A1.18 This includes the calculated cost for the quarter from the calculation in the above section 'Calculations for input into Annex 8', obtained from the current RO obligation rate and RO buy out price. Other inputs are the electricity demand shares for each quarter and the EBIT margin percentage.

Calculations: new sheet '2e RO Ringfencing adjustments'

A1.19 The RO ringfencing cost for April 2023 - June 2023 from the input sheet is then converted to annualised terms.

A1.20 This annualised cost will include the EBIT amount, but since Annex 8 feeds into the price cap model where the EBIT amount is added on, the EBIT is removed from the annualised cost to avoid it being compounded. This figure of annualised cost (Reversing EBIT uplift) is then used to add to the adjustment allowance due to RO ringfencing.

A1.21 The Price Cap 10a (Q2 2023) figures are included for indicative purposes only. We are not incorporating electricity losses, since RO payments relate only to metered electricity supplied to the customers.

Outputs: sheet '1a Adjustment Allowance'

A1.22 Outputs from calculation on sheet '2e RO Ringfencing arrangement', namely Electricity – Annualised cost (Reversing EBIT uplift) is then added to typical consumption values for cap period 10a (April 2023 – Jun 2023), for electricity only, single- and multi-meter arrangements.

Appendix 2 – Elements of Guidance for the enhanced FRP

Context

A2.1 In our chapter 2 of our consultation, we set out how we are proposing to enhance the existing Financial Responsibility Principle (FRP) set out in supplier licences. It will embed the minimum capital requirements for domestic suppliers, as well as introduce a positive obligation on all supply licensees to evidence that they have sufficient business-specific capital and liquidity so that their liabilities can be met on an ongoing basis.

A2.2 Throughout chapters 2 and 3, we make reference to elements of policy detail that will be captured by the guidance that sits beneath the enhanced FRP. Below, we set out these proposed elements of detail so that stakeholders have the full context of how our proposals would be implemented. We intend to publish the actual draft guidance document incorporating these elements shortly after the publication of this statutory consultation to allow stakeholders time to consider it alongside our proposals within the consultation period. Detail around pro-active supplier reporting:

Annual Adequacy Self-Assessment

A2.3 Suppliers must provide an annual self-assessment on their ability to meet the enhanced FRP requirement to have sufficient capital resources and liquidity resources to ensure they are able to meet their reasonably anticipated financial liabilities as they fall due on an ongoing basis.

A2.4 The report must be accompanied by a signed declaration of financial and operational adequacy which has been approved by the licensee's Chief Financial Officer, or senior official with equivalent responsibility, affirming that they have a reasonable expectation that the licensee meets its obligations under the FRP. This ensures the supplier's directors are responsible for properly assessing that they have adequate resources.

A2.5 The annual self-assessment reporting must cover:

Business-specific arrangements and risks

A2.6 Evaluation and explanation of the supplier's business plan and business-specific risks over the coming 12 months. This should include the supplier's risk appetite, hedging strategy, reliance on the balancing market, presence (and conditions) of purchasing agreements, collateral requirements, commentary on risk management based on tariffs offered, and internal processes for identifying and mitigating risks. The assessment should distil key strategic messages focusing on the drivers of risk and how the supplier does (or plans to) manage and mitigate that risk. The business plan and projections should illustrate how the supplier will remain compliant with the enhanced FRP requirements to ensure they maintain sufficient capital and liquidity throughout the reporting period to meet reasonably anticipated financial liabilities as they fall due.

Testing projections/assumptions

A2.7 Suppliers should demonstrate how they have subjected their business plan to sufficiently severe but plausible internal stress testing that considers the risks specific to the business. Suppliers should test their financial projections against stresses consistent with their risk profile, business model and complexity of the business. Suppliers should consider all types of material risks with respect to on and off-balance sheet assets and liabilities.

A2.8 We would expect to see suppliers test against a range of stresses, including market volatility, extreme weather, collateral/trading risks, and the impact of both slower and/or faster than anticipated growth. Suppliers should evidence they have made reasonable assumptions, and how they manage potential downside risk.

Supplier Capitalisation Plan

A2.9 The supplier should set out its trajectory for how it plans to meet the minimum capital requirement by 2025. We would expect this plan to be credible and that suppliers should show how they will be above zero net assets within approximately one year. The plan should explain how the supplier will mitigate the impact of projected business-specific and market risks on their trajectory.

A2.10 Where a licensee supplies both domestic and non-domestic customers, it should explain any split of assets between the domestic and non-domestic supply businesses to highlight any implications for the financial resilience of the business.

A2.11 Where a supplier intends to use alternative sources of funding to meet the minimum capital requirement, it should seek to explain this plan and how it intends to ensure alternative sources of funding will meet the criteria set out in the SLC, and how it proposes dealing with the questions set out in the section below on alternative sources of funding. Ultimately, the supplier will also need to formally notify Ofgem at least 12 weeks ahead of the date it is required to comply with the minimum capital requirement to explain how it intends to meet the minimum capital requirement using alternative sources of funding as set out below.

Ensuring Orderly Market Exit and minimised mutualisation costs

A2.12 Suppliers should evaluate their arrangements and explain how they meet the enhanced FRP requirement to ensure that their operational and financial arrangements allow for an Orderly Market Exit, including explaining how they are ensuring that any exit will not result in material mutualised costs.

Asset Control

A2.13 The self-assessment should also include an explanation of how the supplier meets requirements to ensure it has sufficient control of material economic and operational assets, including sources of funding it claims will be available to meet the enhanced FRP requirements.

Supplier governance

A2.14 Suppliers should provide detail on relevant governance arrangements overarching its business planning and risk management, including:

- An explanation of core business functions and how they will be resourced, including details of outsourced functions. This must include statements of responsibility for each core function, the names of those responsible for each area and how they are suitable to manage those responsibilities. The

reporting should also include projected growth and the number of staff forecast for each function, as well as an overview of any internal audit capability and processes.

- Arrangements between licence holder and parent/investor or relevant equivalent relevant to financial and operational resilience.

Triggers

A2.15 The trigger points where they occur, are when suppliers must notify us of changed supplier circumstances between reporting periods.

A2.16 Licensees must notify Ofgem when they anticipate a trigger point will occur, or as soon as reasonably practicable once they become aware a trigger point has occurred. Suppliers are required to notify us in writing where there is any change in their circumstances or projections that could have a material impact on their financial situation and their ongoing ability to meet the EFRP. We would expect suppliers to consider seasonality when assessing whether a change may have a sustained or material impact on:

- Projected or actual material changes to access to sources of funding identified as the basis for the supplier's ability to meet the FRP. This could be actual or projected instances where the licensee identifies challenges in access to funds from investors / parent company / banks / lenders, or if funds or borrowing allowances have been reduced or subject to additional conditions in any way.

- Projected and/or actual changes to profit levels, where outflows are not matched by cashflows, or if there is a drop in revenue over a period leading to sustained losses, potential breaches of debt, or financial covenants.

- Change and/or potential failure of counterparties which may have a material impact on suppliers' ability to meet their obligations as they fall due (eg the likelihood of failure of a significant counterparty which might lead to liquidity shortfalls or for the supplier to default on their own obligations)

- Significant unwinding of hedges, or a change in the hedging position that may have a material or sustained impact on whether a supplier can continue to meet its obligations under the FRP.

- Changes in net assets/net liabilities which may have a material impact on the supplier's ability to meet the FRP, including loans, dividends, and value redistribution within a group.

A2.17 Suppliers must also notify us when Gross Domestic Credit Balances net of Unbilled Consumption represent the equivalent of 50% or more of their Total Assets, as well as when they project or anticipate this occurring. This applies only to domestic CCBs. Where a licensee supplies to both domestic and non-domestic customers, they must explain in their self-assessment reporting (as outlined above) how they split assets between their domestic and non-domestic supply. This will help us understand the implications of supplier notification and make an assessment on the appropriate response.

A2.18 Where a trigger point does occur, our intention is to use it to engage with a supplier. Where we have concern about a supplier's compliance following notification, we may decide to undertake further assessment and engagement, request an independent audit, consider whether a direction to protect its CCBs is appropriate, and/or move to consider enforcement action where appropriate.

Formalised Enhanced Oversight reporting

A2.19 Guidance will make clear that we expect that suppliers will be subject to regular stress testing and monthly financial information requests and will set out the time interval suppliers can expect between receiving notifications about what information they are being asked for and when the deadline for submitting this information. For stress tests, the proposed guidance will set a minimum of four weeks; for more regular information requests, suppliers will be provided a timetable in advance. If there are changes to the questions, proposed guidance will set out that suppliers will generally be notified a minimum of two weeks ahead of the required reporting date.

Considerations for alternative sources of funding to meet the minimum capital requirement

A2.20 Suppliers that choose to propose meeting the minimum capital requirement using alternative sources of funding will need to consider criteria set out in the SLC clarifications and further detail set out in guidance. Those criteria will include:

- Overall, the alternative source of funding must be sufficient to ensure that the licensee can meet any risks or liabilities that the licensee reasonably anticipates.

- Where alternative sources of funding are held by the licensee, such as debt or similar financial instruments, it must not be secured on licensee assets by a fixed or floating charge or other security arrangements.

- For alternative sources of funding held by a third party:

  - Suppliers must have robust, legally enforceable, and clearly defined arrangements in place to ensure that they can draw on the source of funding at all times, including in times of financial stress.

  - Arrangements should not be capable of termination without good cause and without sufficient notice to enable the licensee to put in place arrangements to meet the minimum capital requirement in another way

  - The third party must have, and maintain, a Standard & Poor's long term debt rating of at least BBB or equivalent.

A2.21 If a supplier proposes to use sources of funding held by a third party, it must acquire a legally enforceable undertaking from the external entity which states that the external entity will refrain from any action that would be likely to cause the licensee to breach of its FRP obligations regarding the minimum capital requirement. This must include evidence explaining how the funding will be legally transferred to the applicant, the terms and conditions of any funding (including payment terms for loans/debt instruments) and satisfy Ofgem that the supplier is legally and readily able to access these funds.

A2.22 When explaining plans to use alternative sources of funding in the Annual Adequacy Self-Assessment, and then in the formal notification to Ofgem about this intention, suppliers should consider the following questions regarding these sources of funding:

Source of funding	Considerations
On balance sheet long-term liabilities	Does the long-term unsecured debt benefit from a fixed of floating charge or any other additional security arrangements?
Other undrawn credit facilities or similar off-balance sheet funding arrangements	Is it committed facility supported by a formal agreement? What is maturity of the facility or arrangement? Is there a minimum notice period for change to the facility or arrangement? Are there any covenants or conditions that could lead to the facility/ arrangement being withdrawn/ repayment being immediately due? What are the repayment conditions? If held by the licensee, what is it secured on? If intercompany facility: Does the parent company have access to sufficient funds to cover capital difference considering overall group requirements? Is the parent financially stable? What is the risk of the facility being overdrawn?

Source of funding	**Considerations**
Parent Company Guarantees	Are there any impediments to drawing on the funds available through the guarantee? Is the guarantee revocable and under what notice period and conditions – e.g., is the parent required to pay the sums in the guarantee at any termination point? What is the maturity of the guarantee or the notice-period for non-renewal? What is the financial situation of the parent company? Does the parent company have sufficient funds available considering other group stresses?
Letters of Credit	Is the LoC revocable on the part of the issuing financial institution (if conditions are complied with?) Is the LOC transferable and what are the rights of the subsidiary to readily draw on it? What is the bankruptcy risk of the issuing bank or financial institution and mitigations for this event? Is the LoC a non-subordinated payment obligation of the issuing financial institution?

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

None.

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 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"