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19 July 2022

By email to: RetailFinancialResilience@ofgem.gov.uk

Dear David

Policy consultation: Strengthening Financial Resilience¹

Centrica welcomes the opportunity to respond to this consultation. We have long called for appropriate protection to prevent misuse of customer money by under-capitalised suppliers treating customer credit balances (CCBs) and renewables obligation (RO) payments as interest free, risk-free working capital. The consequences of a regulatory regime that fails to adequately protect all consumers from the systemic risk of failure caused by financially irresponsible energy suppliers are now plain for all to see. Since September 2021, we have seen 29 supplier failures and the resulting disappearance of more than £400 million of UK consumers' money. These consequences have also been well documented in Oxera's recent report for GEMA.²

Ofgem's proposals to require protection of CCBs and RO payments as part of a broader move towards prudential regulation encompassing capital adequacy and liquidity are an essential and urgent step in the right direction. It is imperative that Ofgem moves swiftly to address the moral hazard that leads to excessive risk taking with all customers' money. It is therefore regrettable that the current 'Spring' consultation is not the statutory consultation previously signalled³ necessitating a further round of statutory consultation in the Autumn, prior to implementation. After years of inconclusive regulatory consultation, effective CCB and RO protection must now be implemented as a priority without further slippage in Ofgem's timetable.

Given the overwhelming evidence of benefits to consumers that would result from such protections, it would not be in the interests of consumers for Ofgem to allow a long transition period for the implementation of these proposals. If some suppliers contend that they cannot finance their operations without recourse to CCBs and RO payments – and so cannot implement Ofgem's proposals immediately - this raises serious questions about those suppliers' compliance with the Financial Responsibility Principle, and the commitment of their

¹ [Policy Consultation: Strengthening Financial Resilience | Ofgem](#)

² [Ofgem publishes report into its regulation of the energy market | Ofgem](#)

³ [Open Letter to domestic energy suppliers - Financial Resilience | Ofgem](#)

shareholders to a responsible business model. Accordingly, Ofgem should step in as necessary to prevent non-compliant suppliers from acquiring new customers until Ofgem is satisfied their finances are on a sound footing. It should not postpone the introduction of prescriptive rules or dilute them in such a way that allows suppliers with insufficient capital and poor business models to continue to enter the market and / or grow unsustainably.

We agree with the NERA analysis on competitive impact of the proposals – and notably the view that current market arrangements effectively subsidise market participants with high-risk business models and distort competition by disadvantaging lower risk business models. In this vein, we note that some stakeholders have sought to propagate baseless views suggesting that a more robust regulatory regime would have a dampening effect on competition. We have commissioned an independent report from Frontier Economics (appended to this response) that demonstrates this is patently untrue and we urge Ofgem to disregard this false claim in moving forwards to provide the energy supply market and consumers with the stability that is urgently required.

We are concerned at the suggestion that protection of customer credit balances might initially be limited to 30% given the diluted impact on moral hazard and incentives on suppliers to behave responsibly.⁴ Such limited action belies Ofgem's public statements regarding the need to take urgent action to protect consumer interests⁵ and falls short of what is required to deliver the consumer benefits outlined in NERA's cost benefit analysis, namely 100% protection.

We see no evidence in the consultation document or the NERA analysis to suggest that the 30% requirement is more appropriate for consumers than an immediate requirement for 100% protection. If Ofgem has such evidence, this needs to be made public to ensure the Authority's subsequent decision making is transparent on this critical point.

Ofgem should also resist calls to pursue capital adequacy instead of CCB/RO protection, recognising this for the delaying tactic it is. Given the current starting point (i.e. Ofgem has not yet advanced any specific proposals) a broader capital adequacy framework of prudential regulation will inevitably take longer to put in place. A capital adequacy framework complements near term protections to address moral hazard concretely and directly but is not a substitute for them; CCB/RO protection has a different purpose to capital adequacy. CCB/RO protection is necessary to ensure that – should a supplier fail – then the prospect for the costs of that failure being borne by all energy consumers is minimised. Capital adequacy requirements should instead be designed to bolster the integrity and functioning of the market by reducing risk of supplier failure in the first instance.

Ofgem should also not be distracted by suggestions that ATOL style co-insurance provides a suitable alternative way of addressing the problems that Ofgem perceives. Such schemes are wholly inappropriate in a market such as retail energy, given they fail to address the underlying market failure, exposing customers to systemic risk and offering no advance on existing cost-mutualisation.

An independent report by Oxera on this subject (appended to this response) concludes that compulsory co-insurance models, such as the ATOL in transport and the FSCS in financial services would not be appropriate for dealing with the specific market failures of the UK energy supply market. It also concludes that a failure to mitigate moral hazard in the market would tend to result in an increase in the market shares of suppliers with riskier business models. It is

⁴ Consultation document paragraph 2.37: *"Our assessment is that domestic suppliers could be able to accommodate ringfencing at least 30% of their Gross Credit Balance net of Unbilled Consumption by Winter 2022."*

⁵ [Ofgem announces tough new financial measures to ensure energy suppliers can withstand future shocks - including protection for customers' credit balances | Ofgem](#)

therefore understandable why financially irresponsible energy suppliers who are unable or unwilling to commit to protecting the credit balances of their customers are seeking to promote such schemes.

Beyond CCB and RO protection, Ofgem's focus should be on ensuring that suppliers are operating in a way that ensures that they can meet their commitments to their customers in a variety of scenarios. In practice, this should mean that suppliers are either sufficiently hedged or sufficiently capitalised (or both). We see this as part and parcel of a holistic approach to prudential regulation encompassing capital adequacy and liquidity requirements which should be taken forward in preference to separate hedging requirements which are likely to prove unworkable.

Any supplier that cannot demonstrate appropriate financial resilience without recourse to customer credit balances and RO payments should be prohibited from acquiring new customers until such time as the supplier in question has (to Ofgem's satisfaction) hedged its commodity risk effectively or demonstrated that it has unfettered access to the requisite level of capital to mitigate the risk appropriately. To the extent that such action is not taken within a designated period, then Ofgem must assess whether that supplier's participation in the market presents a risk to the stability of the market and energy consumers, consider enforcement against individual directors of energy suppliers and/or initiate the process for licence revocation.

While implementation of appropriate protections for CCB/RO should be Ofgem's immediate priority, we would also reiterate the importance of increasing momentum in the capital adequacy workstream. Effective CCB/RO protections combined with ongoing stress tests are essential in mitigating moral hazard and protecting against CCB and RO mutualisation. But capital adequacy requirements are also needed to ensure that suppliers can meet their commitments to their customers in a variety of scenarios, thereby mitigating the risks and costs of failure, including protecting consumers against costs of hedging the customers of failed suppliers. It is therefore disappointing to see that Ofgem's proposals on capital adequacy remain at a very high level, and we would reiterate the need for Ofgem to bring forward changes or requirements as soon as possible (and certainly no later than Q2 2023 given the obvious customer benefits that such a framework would deliver).

Our responses to Ofgem's specific consultation questions are set out in the attached appendix. As noted above, we also append a report from Oxera on the inappropriateness of co-insurance models to protect CCBs, and a report from Frontier Economics describing how frameworks for prudential regulation are compatible with effective market entry, expansion by new entrants and innovation.

Yours sincerely



Tim Dewhurst
Director of Regulatory Affairs & Policy
Centrica plc

Appendix 1: Consultation Questions

Chapter 1: Introduction

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

We have long called for appropriate protection to prevent misuse of customer money by under-capitalised suppliers treating customer credit balances and RO payments as interest free, risk-free working capital which is effectively insured by other suppliers' customers. The consequences of a regulatory regime that fails to adequately protect consumers from financially irresponsible energy suppliers are now plain for all to see and are well documented in Oxera's recent report for GEMA.⁶

Until recently, Ofgem's approach has been to prioritise low barriers to market entry, but this has been at the expense of requiring an appropriate level of financial resilience to systemic risks. We welcome this consultation as Ofgem is clearly committed to reallocating the risk of supplier failure away from all consumers, and onto the businesses that are responsible for creating this risk. However, all customers remain exposed to systemic risks so long as effective action is not taken to ensure energy suppliers are appropriately capitalised, sufficiently resilient to market shocks and bear their own risks rather than passing them off to all customers in the UK.

We regard Ofgem's proposals to require protection of customer credit balances and RO payments as part of a broader move towards prudential regulation encompassing capital adequacy and liquidity as a step in the right direction. It is imperative that Ofgem addresses the moral hazard that leads to excessive risk taking with customers' money. Requiring suppliers to protect customer credit balances and RO payments is at least as much about incentivising responsible behaviour and reducing the risk of mutualisation in general as it is about providing insolvency remote funds for particular classes of liability.

We are concerned at the suggestion that protection of customer credit balances might initially be limited to 30% given the diluted impact on moral hazard and incentives on suppliers to behave responsibly.⁷ Such limited action belies Ofgem's public statements regarding the need to take urgent action to protect consumer interests⁸ and falls short of what is required to deliver the consumer benefits outlined in NERA's cost benefit analysis, namely 100% protection. We reiterate that Ofgem needs to take immediate steps to prevent suppliers from misusing customer money and treating it (in Ofgem's words) *"like an interest free company credit card"*.

We see no evidence in the consultation document or the NERA analysis to suggest that the 30% requirement is more appropriate for consumers than an immediate requirement for 100% protection. If Ofgem has such evidence, this needs to be provided to ensure the Authority's decision making is transparent on this critical point.

To the extent that Ofgem is concerned that immediate implementation of 100% protection may leave some suppliers unable to raise the necessary capital it is more appropriate to include measures that prevent undercapitalised suppliers exploiting the moral hazard than having an extended transition period. Such action could include direct intervention to prevent

⁶ [Ofgem publishes report into its regulation of the energy market | Ofgem](#)

⁷ Consultation document paragraph 2.37: *"Our assessment is that domestic suppliers could be able to accommodate ringfencing at least 30% of their Gross Credit Balance net of Unbilled Consumption by Winter 2022."*

⁸ [Ofgem announces tough new financial measures to ensure energy suppliers can withstand future shocks - including protection for customers' credit balances | Ofgem](#)

undercapitalised suppliers acquiring new customers until their finances are put on a sound footing. We note that there is precedent for these types of approaches in the financial markets where the Basel Regulations undercapitalised financial institutions are not immediately forced out of the market but are prevented from paying dividends until they are adequately capitalised.

Chapter 2: Customer Credit Balances

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

As a financially responsible energy supplier, we already protect customer credit balances and believe this should be a universal requirement across industry.⁹ Consequently we do not envisage any significant impact on our business and see no case for transitional arrangements.

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

Yes, we strongly agree that the appropriate definition of customer credit balances to protect is gross credit balances, net of unbilled consumption. As Ofgem correctly observes, only this definition will ensure that the amounts protected are appropriate and meaningful across the whole year (given there will be some periods across the year when a 'net credit balance' amount will drop to zero or be negative). Further we believe the definition should be consistent with the definition of customer balances which are effectively insured through mutualisation as part of the Supplier of Last Resort (SoLR) process.

A net credit balance definition would therefore not be appropriate since it would fail to prevent the use of CCBs as risk-free working capital, and therefore fail to disincentivise excessive risk taking. Nor would it necessarily reduce CCB cost mutualisation materially when a supplier fails given that only credit balances are mutualised whilst debit balances are for the creditors of the failed supplier.

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

We agree that Ofgem must prescribe both the *methodology* for determining the amount to be protected and the *frequency*. On balance, we favour monthly calculations based on backward facing data. As Ofgem notes, forward looking data are inherently subject to forecast error. While we note Ofgem's concern about backward looking data not reflecting increasing risks in Q3 potentially leading to under-protection with quarterly updates, monthly frequency would substantially mitigate this risk without the additional complexity of relying wholly or partly on forecasts that may not prove reliable.

While Ofgem has not included specific questions on monitoring, enforcement, and compliance it will clearly need to put in place appropriate arrangements to ensure new protections are effective. These will need to cover assurance that the protection mechanisms themselves meet Ofgem's specified requirements (discussed in Chapter 4) and enable credit balances to be repaid on demand at all times without qualification.

Chapter 3: Renewables Obligation

⁹ [Centrica announces it will protect customers' credit balances | Centrica plc](#)

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

Yes, we agree that ROCs must count towards protection to maintain incentives and avoid double counting. This would be consistent with the obligations which would be mutualised across all UK customers on supplier failure, and therefore needs to be protected.

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

We do not currently foresee material impacts on our engagement with the scheme, providing ROCs themselves count towards the required protection and assuming the availability of parent company guarantee (PCG) as sufficient protection mechanism given our investment grade credit rating.

While we understand Ofgem may wish to consider trust arrangements over ROC sale proceeds for suppliers who do not qualify for protection via PCG we do not consider this necessary in respect of suppliers who qualify for the PCG protection mechanism. Rather, we envisage that any sale of ROCs within a particular period would automatically require a commensurate increase in protected credit cover so that the value of protection never falls below the cumulative amount.

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

As per Q6 above, we do not envisage a major impact on our engagement with the ROC market (assuming ROCs count towards the required protection).

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

We agree the proposal should be fully effective from April 23 and support the transitional phasing proposed.

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

A quarterly reporting mechanism would fit with the proposed quarterly protection period. It would be accurate for the reporting to be backward looking (as proposed for quarterly) rather than forward looking (as proposed for annual).

Chapter 4: Protection Mechanisms

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

We agree in principle with suppliers being able to select from a menu of approved protection mechanisms reflecting that different business models have inherently different levels of risk. However, the economic effect or outcome must be the same in all cases. In the case of credit balances this requires that they can be repaid on demand at all times without qualification and be subject to formal approval by the regulator; for instance, parent company guarantees should be dependent on public commitment and an investment grade credit rating and in a form prescribed by the regulator.

We also note that Ofgem welcomes views on whether an insurance scheme such as ATOL or the FSCS would be appropriate for the energy supply market (para 4.31). We consider that such schemes are wholly inappropriate in a market such as retail energy, given they fail to address the underlying market failure, exposing customers to systemic risk and offering no advance on existing cost-mutualisation.

An independent report by Oxera on this subject (appended to this response) concludes that compulsory co-insurance models, such as the ATOL in transport and the FSCS in financial services would not be appropriate for dealing with the specific market failures of the UK energy supply market. It also concludes that a failure to mitigate moral hazard in the market would tend to result in an increase in the market shares of suppliers with riskier business models. It is therefore understandable why financially irresponsible energy suppliers who are unable or unwilling to commit to protecting the credit balances of their customers are seeking to promote such schemes.

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

We note that Ofgem anticipates eligible PCGs will need to comply with the same requirements as an eligible third-party guarantee, namely:

- a) minimum credit rating requirements for the guarantor on its issue and throughout the duration of the guarantee;*
- b) the guarantee to be an irrevocable, primary, first demand guarantee and on terms consistent with good UK banking practice (meaning that the guarantor will pay on demand any amounts claimed under the guarantee, without raising any defence to payment, without set-off or counterclaim, and notwithstanding, for example, the supplier's insolvency);*
- c) issued in favour of the Authority as beneficiary, with amounts payable under the guarantee being payable to the Authority or in favour of any other beneficiary that the Authority may nominate;*
- d) the guarantee must either be available for drawing on demand for the full duration of the guarantee or, during the full term of the required period, automatically renew (unless the guarantor issues a non-renewal notice at least [90/120] calendar days before the date upon which the guarantee would otherwise renew);*
- e) subsequent licence drafting will set out what law the guarantee will be governed by – likely English or Scots law with an exclusive jurisdiction clause in favour of the English or Scottish courts.*

We underline the vital importance of requirement a), recognising that PCGs rely on the solvency of the parent company in question. Providing this condition is met, we think the remaining conditions obviate the need for additional trust arrangements (such as those suggested for RO sales proceeds in Chapter 3 and mooted for hedges in Chapter 5).

We would welcome further clarity from Ofgem regarding requirement c), not least as it may be challenging to confer a PCG upon a beneficiary whose identity is uncertain.

We reserve the right to comment further on this or other menu options in due course as Ofgem's proposals develop.

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

We see no evidence that it would be possible (or economic) to obtain insurance to protect CCB or RO funds. As noted above, our views on co-insurance scheme such as ATOL or the FSCS are detailed in an Oxera report appended to this response. This report concludes that such schemes would be ineffective and/or complex and costly to introduce in energy.

Chapter 5: Hedging

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

We appreciate that Ofgem is wrestling with how to transfer the value of 'in-the-money' hedges to SoLRs with customers with the aim of reducing reliance on levy claims. Ofgem also acknowledges likely difficulties in presenting its early stage thinking.¹⁰ As Ofgem concedes, this is a complex issue involving the interaction between insolvency, company structures, the commercial arrangements between a supplier and a counterparty and Ofgem's licensing regime.

Assuming the availability to British Gas of an Ofgem-approved PCG, we are sceptical about the need for either option Ofgem presents as described in turn below:

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

Ofgem's Option 1 proposal to require trusts to be set up when hedges are taken out appears inconsistent with its acceptance in the context of customer credit balances and RO liabilities that: a) guarantors are strongly incentivised to scrutinise a supplier's business plans to assure themselves of its prospective and ongoing viability,¹¹ and; b) unduly restricting the 'menu' of protection mechanisms may not effectively deliver the overarching aim of minimising the cost of mutualisation on the consumer.¹² Consequently, we are concerned that overlaying option 1 on

¹⁰ See in discussion at paragraphs 5.17 and 5.23 of the consultation document.

¹¹ See e.g. discussion at 2.11

¹² See e.g. paragraph 4.6

top of other proposed protection requirements may add additional cost and complexity without delivering commensurate consumer protection benefit.

More generally, we doubt the practicality of this option given the ongoing need to liquidate and re-hedge, and ambiguity about scope. For example, we presume Ofgem is not seeking to require basis spread hedges and subsequent liquidation to be administered via a trust but fail to see how such routine transactions would be carved out. On balance, we consider the evident difficulties are likely to far exceed potential benefits. Suppliers' hedging policies should be considered in the context of a broader risk-based framework for capital adequacy and liquidity requirements once the moral hazard of using customer money as risk-free working capital has been addressed. Indeed, the practical difficulties in directly protecting the value of in-the-money hedges in the event of supplier failure underlines the importance of capital requirements and prudential regulation to reduce the number of supplier failures.

Similarly in relation to Option 2 we see numerous difficulties that are likely to outweigh potential benefits, including but not limited to i) the strong likelihood that insolvency practitioners will resist debt claims on the basis of customer contracts and ii) the fact that even if claims succeed the residual value of assets and competing claims from other creditors will dilute available funds so there can be no expectation of sufficient funds to obviate the need for SoLR levy claims. Our recent experience as a SoLR dealing with administrators suggests these concerns are well founded and should not be underestimated.

In summary, we have significant practical and legal concerns over the implementation of this proposal which must be addressed before progressing thinking further, not least given the criticality of ensuring this framework is legally robust to prevent challenge in the event of future supplier failures.

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

We think Ofgem should prioritise effective protection of customer credit balances and RO in the short term to address the moral hazard currently giving rise to systemic risks. Additionally, any supplier that cannot demonstrate appropriate financial resilience without recourse to customer credit balances and RO payments should be prohibited from acquiring new customers until such time as the supplier in question has (to Ofgem's satisfaction) hedged its commodity risk effectively or demonstrated that it has unfettered access to the requisite level of capital to mitigate the risk appropriately. To the extent that such action is not taken within a designated period, then Ofgem must assess whether that supplier's participation in the market presents a risk to the stability of the market and energy consumers, consider enforcement against individual directors of energy suppliers and/or initiate the process for licence revocation.

Chapter 6: Capital Adequacy

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

We agree that Ofgem should work towards a framework that specifically targets capital requirements as part of a wider strategy to manage financial resilience risks. As Ofgem notes, this is particularly important given the clear role that insufficient capital and financial resilience played in supplier failures during the recent price volatility as set out in Oxera's report for GEMA.

We broadly agree with the desired outcomes Ofgem sets out, namely:

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

We also agree that the intention should not be to eliminate entirely the possibility of supplier failure, but rather to better align supplier incentives with more sustainable business models that can withstand reasonable stress.

We do not see medium term imposition of capital adequacy requirements as a substitute for the near-term protection of customer credit balances and RO payments Ofgem is now prioritising. We agree that the introduction of any capital adequacy regime should be designed to complement CCBs and RO reforms in a dynamic way, to ensure the full range of policies operate together efficiently to deliver improved supplier financial resilience for the benefit of consumers. However, it is important to reiterate that CCB/RO protection is necessary to ensure that – should a supplier (even if with access to capital) fail – then the prospect for the costs of that failure being borne by all energy consumers is minimised. Instead, capital adequacy requirements should be designed to bolster the integrity and functioning of the market by reducing risk of supplier failure in the first instance.

We strongly disagree with the suggestion attributed to some stakeholders that Ofgem should deprioritise or abandon protection of customer credit balances and RO payments to pursue capital adequacy as an alternative. This will further delay effective action to combat the systemic risks facing consumers, and we urge Ofgem not to be deflected from introducing effective near-term protections that are already long overdue.

We agree that the capital adequacy framework Ofgem develops should be informed by an appropriate impact assessment that encompasses impact on all consumers, competition, and achievement of net zero. Equally, we note that a deliberate policy of lowering entry barriers in the hope it would deliver good consumer outcomes conspicuously failed to sufficiently consider the risks inherent in such a policy. The lack of a balanced view grounded in evidence has allowed systemic risks to build to a point where the lack of financial resilience, and resulting consumer detriment, is plain for all to see.

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

We agree in principle that the approach Ofgem ultimately takes should be informed by underlying risk and incentivise appropriate risk management. We recognise that this may require some form of segmentation, although at this stage it is not clear precisely what Ofgem has in mind, so we reserve the right to comment further on the detail as it emerges.

We disagree, however, with the suggestion attributed to some suppliers that increased regulation should only be applied to new suppliers. The regulatory framework should apply to existing suppliers as well as new entrants even if its detailed application differs to reflect different underlying risk profiles and business models.

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

As Ofgem notes at 6.35, the most material risks facing energy suppliers currently relate to the procurement of the commodity to meet retail demand, notably in the form of a) price risk and b) churn/volume/demand/weather risk - particularly in the context of a price cap. While we welcome recent moves by Ofgem to address some of these risks through changes to the price cap wholesale methodology, treatment of backwardation and via the market stabilisation charge we note that policy is still subject to ongoing review and adjustment.

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

In relation to market risk, capital adequacy (and liquidity) requirements are a function of suppliers' commercial risk appetite and hedging policy.

Ofgem notes that, all else being equal, the longer the time horizon, the greater the value of potential loss, making it more expensive to insure against a risk over a longer period. It then suggests time horizons should reflect the holding period on investments (in this case tariffs) and notes that under a quarterly price cap with an associated lag, the average holding period would be 4.5 months, and it may expect suppliers to hold capital commensurate with the risk over this period.

We note, however, that this would only reflect the average holding period across a supplier's portfolio if all its tariffs mirrored the quarterly cap – which has not been the case historically. It seems unlikely that the exposure of suppliers pursuing the 'timing model' discussed in Oxera's report for GEMA was limited to 4.5 months. The prevalence of fixed term contracts of 12 months or more suggests a longer time horizon may be appropriate. Additionally, we note that the proposed move to a quarterly price cap is relatively recent and has yet to come into effect. It is not known whether an enduring price cap will retain this structure so it will be important to ensure price cap design and capital adequacy workstreams are appropriately joined up.

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

It is important to consider liquidity alongside capital adequacy, though the two are not synonymous.

In the context of capital adequacy, we see regulatory capital as the financial resources a supplier has available to absorb losses. Capital absorbs losses only if it does not diminish in value or has to be repaid to a provider of funding before those losses are incurred. So, capital of this kind includes share capital without mandatory dividends, and distributable reserves, but would not, for example, include senior or secured debt. The 'quality' of capital describes how likely it is to be available to absorb losses when they arise. Licence conditions should make clear what kinds of capital suppliers may use to meet the minimum capital requirement.

Alongside capital requirements, liquidity is a critical element at the heart of prudential regulation, given its importance to financial resilience at times of market stress. By liquidity, we mean the resources that the supplier has available to pay amounts when due. If a firm's capital resources are invested in illiquid assets – assets that cannot be readily realised in cash – then it risks not being able to pay its debts (including customer credit balances) when required. As a point of reference, some of the bank failures that took place in the financial crisis of 2007-9 were driven by insufficient liquidity rather than inadequate capital.

Liquidity requirements are necessary to ensure suppliers' capital is not tied-up in assets that are difficult to realise in times of stress. Minimum liquidity and capital requirements should therefore complement each other, and both are required to achieve appropriate levels of financial resilience.

The minimum liquidity requirement should be met with liquid assets (e.g. cash at bank and/or gilts). PCGs and third-party credit facilities can act as an offset if they meet certain criteria and should be subject to minimum standards as to the financial resilience of the counterparty and the terms of the arrangement (e.g. credit rating, minimum term, prohibition on obstacles to the free flow of funds, and availability period).

Any system of prudential regulation must allow firms to use minimum capital and liquidity reserves if a severe stress materialises, and they must then be given time to build up their capital and liquidity again afterwards. If this isn't the case then firms would have to raise capital and liquidity in or shortly after an actual stress scenario, which might prove difficult and exacerbate the stress¹³. In any event, a prudential regime in energy should define absolute minimum levels of capital and liquidity below which Ofgem would intervene.

Chapter 7: Impact Assessment

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

We fully agree with the main finding of the Impact Assessment (IA), that the proposed changes are likely to lead to net benefits to consumers. There is considerable evidence that the current arrangements are leading to socially inefficient risk-taking by some suppliers, that is imposing costs on consumers, and undermining effective competition in the market. It is clear that proposals to ensure that suppliers, rather than customers, bear the costs of their decisions will lead to changes in supplier behaviour, which will in turn reduce failure rates and result in net benefits for customers.

We note that estimating the precise impact on supplier behaviour and hence supplier failure rates is challenging. However, we do not think it is unreasonable to expect that policies requiring suppliers to invest their own capital – as opposed to their customers' capital – should be expected to result in more prudent behaviour and thus a reduction in supplier failure rates for small suppliers. We note that even a modest improvement in supplier failure rate from reducing moral hazard, could reasonably be expected to lead to net consumer benefits and is highly unlikely to result in net costs. We note and support that this is reflected in the IA's analytical logic which means that the policy cannot result in an ongoing net consumer cost and will always lead to a net consumer benefit provided there is some reduction in failure rates.

Moreover, we consider that in a number of areas the IA may in fact be conservative, and may not have fully accounted for, or quantified the full benefits that are likely to arise as a result of the

¹³ Note that the Basel regulations allow banks to fall below certain adequacy ratios but require the banks to stop paying dividends if they do so.

change in policy. In particular, we consider that the IA has been conservative in identifying benefits in relation to the following areas:

- distributional benefits;
- dynamic benefits of competition; and
- customer credit balances.

For each of these areas we explain in more detail below why we consider that the IA appears to be overly conservative.

Finally, we note that the impact assessment assumes there are no transitional costs from implementation. We consider this is appropriate given that a sensible implementation of the policy that is effective, whilst mitigating the risk of supplier insolvency, could bring about the assessed benefits with minimal transition costs. In particular, implementation coupled with measures that allow suppliers to keep trading, but not acquire new customers until they have fully protected the relevant liabilities, should prevent transitional disruption to the market.

Distributional benefits

The IA shows that the policy results in significant transfers between different customer groups and uses distributional weights to estimate quantitatively the social benefit from these transfers.

The IA states that a £1 benefit for disengaged customers is worth £1.04 in terms of social benefit, whilst a £1 benefit for engaged customers is worth £0.96 in social benefit and that this is based on 'Ofgem guidance and an Ofgem survey. We do not have sufficient data to replicate Ofgem's derivation of its +/-4% distributional weightings but given the information that is available it appears that they may be too low relative to those reported in other Ofgem publications. Given the distributional impacts of the policy, distributional weights that are too low will result in an understatement of the benefits.

In its 2020 report on assessing the distributional impact of economic regulation,¹⁴ Ofgem appears to show equity weights that are much larger than those used in this IA. Specifically, comparison of Figures 2 and 3 from the report (reproduced below) shows that for the bottom income decile a £1 saving in energy bills is worth around £5 on an equity weighted basis, whilst for the top income decile a £1 saving in energy bills is worth around 30p. Whilst these income deciles do not correspond directly to the categories of engaged and disengaged customers relevant for the IA we note that the 2020 Ofgem survey on engagement in the energy market¹⁵ shows that disengaged customers were 38% more likely to experience financial difficulties¹⁶ and 28% more likely to be of a C2DE social grade¹⁷ than engaged customers. Based on these sources together, and absent further information or explanation from Ofgem, we would have expected to see larger distributional weights used in the IA.

¹⁴

https://www.ofgem.gov.uk/sites/default/files/docs/2020/05/assessing_the_distributional_impacts_of_economic_regulation_1.pdf

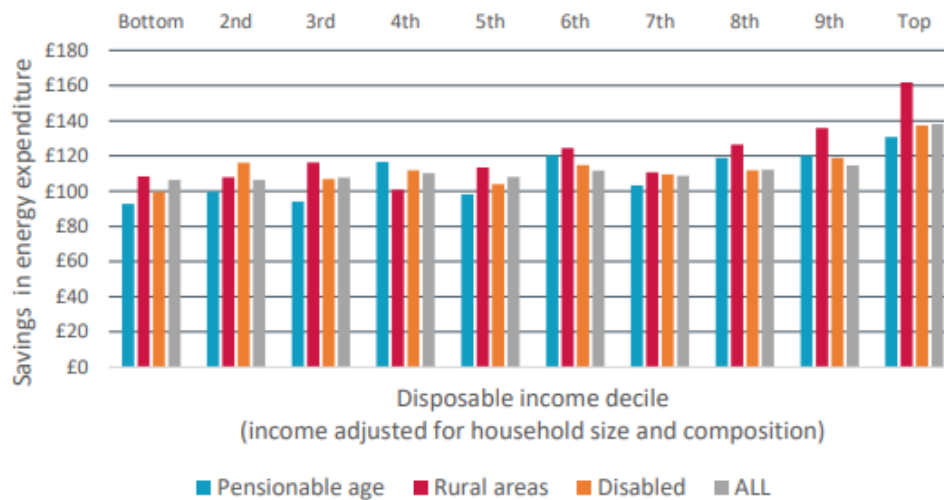
¹⁵

https://www.ofgem.gov.uk/sites/default/files/docs/2021/04/consumer_survey_2020_update_on_engagement.pdf

¹⁶ 18% of disengaged consumers experienced financial difficulty compared to 13% of engaged consumers

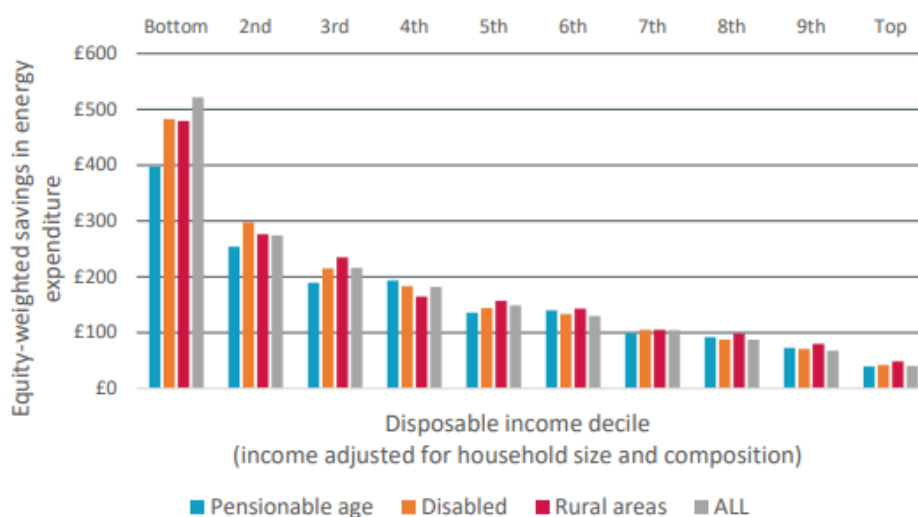
¹⁷ 51% of disengaged consumers were C2DE compared to 40% of engaged consumers

Figure 2: Absolute £ savings in household bills



Source: Ofgem analysis of data from ONS Living Costs and Food Survey

Figure 3: Equity-weighted savings



Source: Ofgem analysis of data from ONS Living Costs and Food Survey.

Dynamic benefits of competition

The IA recognises that current policies subsidise unsustainable entrants and that this may undermine efficient entry and investment in the sector. However, the IA does not articulate the importance of this point.

As described by the CMA's guidance, "*Competition is a process of rivalry between firms and, where it is effective, encourages firms to deliver benefits to customers in terms of lower prices, higher quality, and more choice.*"¹⁸ In the context of the retail energy market, effective competition means that firms that are more efficient¹⁹ or otherwise offer greater value to customers should be able to attract customers to switch to them.

¹⁸ CMA (2015) [Competition Impact Assessment – Part 1: Overview](#)

¹⁹ i.e. can sustainably serve customers at a lower cost

Historically, instead of competing on efficiency and innovation, some suppliers have been able to attract customers by offering unsustainable deals, which do not reflect any underlying efficiencies or additional consumer value. This has led to a worsening of the competitive process described above since customers have switched to firms which have failed and imposed costs on the wider market.

As customers have not been able to differentiate between firms which have lower prices due to operating unsustainable business models, and those which are truly more efficient, this has also made entry and expansion more difficult for firms which may be able to bring in *true* efficiencies and innovation. Furthermore, higher levels of supplier failure may reduce consumer confidence in switching and encourage greater customer inertia to the detriment of long-term competition in the market.

We accept that quantifying the consumer detriment arising from a market which inefficiently excludes innovative and efficient entrants (in favour of unsustainable entrants) or has greater customer inertia is difficult. Nonetheless, Ofgem should qualitatively recognise the benefit that prudential regulation can have in terms of providing a foundation for a stronger competitive process focused on offering sustainable customer value.

As part of this response, we provide a report prepared by Frontier Economics that assesses the impact of prudential regulation on the financial services sector. The report concludes that such a framework has proven to be entirely compatible with effective market entry, expansion by new entrants and innovation.

Customer Credit Balances

Large supplier credit balances

For large suppliers, the IA assumes that the policy would result in an increase in peak customer credit balances from £72 to £77 per customer. No explanation is provided for why large supplier credit balances should be expected to increase as a result of the policy. Absent a justification for why large supplier credit balances should increase they should be assumed to remain the same. This would have the effect of reducing the costs of the policy intervention, and increasing the calculated net benefits.

Small supplier credit balances

For small supplier customers, the IA assumes that the policy would result in a reduction in peak customer credit balances from £102 to £77 per customer. The explanation for this assumption appears to be reasonable. However, the IA fails to capture the direct benefit to customers of lending less money to their energy suppliers.

If customer credit balances held by energy suppliers reduce, then customers will benefit from having this cash in their possession. The magnitude of this benefit will depend on customers' cost of capital.

The IA reports 5.6m small supplier customers. Therefore, the £25 per customer reduction in customer credit balances would be worth £140m per year. Typical short-term loan or credit card rates for customers suggests that customers' cost of capital, and therefore benefits from the freeing up of differences in balances, can be quite high. Conservatively, assuming a 10% customer cost of capital would imply £14m per year worth of additional customer benefits from the reduction in cash loaned to energy suppliers by energy customers. Given that the IA defines all small supplier customers as engaged customers, the equity weighted value of this benefit will be slightly less than this value.