

Sent via email to RetailFinancialResilience@ofgem.gov.uk

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Ecotricity Response to Strengthening Financial Resilience

Dear Mr Hall

Introduction

Ecotricity were the world's first green energy company when we established in 1995 and we now have over 175k domestic and non-domestic supply accounts, alongside almost 90MW of self-developed renewable generation capacity. We continue to invest in new sources of renewable generation, with 32MW of assets under construction, including our first green gas mill.

We understand the principles being proposed by Ofgem, in order to increase the financial resilience of energy suppliers and our overarching view is that the some of the aspects covered are positive.

We would, however, highlight the importance that the regulation doesn't go too far, making it punitive for those suppliers remaining in the sector. Due consideration needs to be taken as to the operating business models of suppliers, who will have been working within a robust, risk based, market approach in order to remain in operation following the recent market challenges.

It is our view that the 'race to the bottom' price strategy of a number of recently failed market players, was fundamentally predicated on a strategy of gambling in the wholesale market and that without robust frameworks and strategies they were always destined to fail in an event such as the one we have both witnessed and continue to navigate as an industry.

Whilst not addressed as a component of this consultation proposal, we would further highlight that a long term, UK wide strategy to provide greater support for the development of renewable generation will fundamentally benefit the UK energy sector as it will minimise exposures to wider wholesale market impacts and volatility, whilst also supporting net zero targets and reducing the cost to consumers.

We propose that the changes detailed within this consultation document need to be considered on a bespoke basis, to align the financial resilience of a business, with its operational business plan and would welcome a bi-lateral discussion with Ofgem in relation to this.

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 broadly agree with your analysis of the problem and highlight that it has some positive aspects, but we are concerned that you have signalled an intention to move too far, making it punitive for those suppliers remaining operational following the recent wave of market failures. We see this as potentially having a counterproductive impact on the market, with the risk that the measures could place too much strain on suppliers, leading to more market failures in the short term, which would further increase costs to consumers.

On this basis, we would propose that any measures are implemented on a bespoke basis to align with business operation models, and we would welcome the opportunity to discuss this further.

The proposals outlined, in their current form, are likely to have a disproportionate impact on smaller suppliers, irrespective of the strength and sustainability of their operating model, governance and risk strategy; as such we would point to the need for a level playing field.

As a final consideration, we would also highlight that the current cost-of-living crisis is likely to have an adverse impact on customers propensity to pay in the short to medium term, which needs due consideration in line with the proposals outlined within the consultation.

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.

Under our current assumptions, the two approaches (ringfencing or client account) have very similar working capital implications. Under Ofgem's proposed approach we would highlight that a number of the approved protection mechanisms are suited to larger suppliers with a strong credit history, hence not providing a level playing field.

Our current view is that a standby letter of credit provided by a Bank would need to be cash-backed, probably on a matched basis, as such creating the potential of introducing a two-fold cost of finance impact that would need to be passed onto customers to protect margins.

We have not entered discussions with our relationship bank to understand their appetite for providing a third-party guarantee or letter of credit. It should be noted that was this to be a requirement it would constitute an additional cost that should be passed to customers through an increase in the price cap.

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.

We agree with this recommendation. The value of energy used by a customer since their last bill was issued is a debit balance in the accounts of any energy supplier. The costs of supplying that energy

to the customer will mostly have been borne by the supplier. The gross credit balance is overstated only because the operational step of issuing a customer bill has not yet been performed.

For completeness, we do not agree with any proposal that would allow the use of a net credit balance in place of the Gross Credit Balance. In the event of a supplier default, there is no protection to the SoLR if the debt is non-performing or challenging to recover.

We would also raise the point of debt provision and propose that this is considered as part of bespoke discussions. In the current climate, with prices at record levels, the propensity to pay for customers is reduced, as such increasing the potential debt profile of suppliers and impacting cashflow.

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.

A quarterly settlement does appear sensible, and it should allow a more accurate quantification of CCBs to be factored into pricing discussions with Banks; however, we would propose that this is operated flexibly in line with the operating business model of the supplier. We would also highlight the need to consider the increase in operational demand to satisfy this.

A forward-facing calculation would consider changes in factors such as seasonality, the planned size of the customer book or the approach to the calculation of direct debits. This would need to be balanced against the operational complexity of setting up the reporting processes. If input stability suggests that backwards facing data might be a reasonable proxy, this could be used instead. We doubt that inputs will be that stable.

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?

We understand the proposal to 'protect or discharge' and agree that this provides a mechanism that ensures the RO obligation for any given supplier is tracked and should any issue arise, this is known or addressed ahead of time. That said, we propose that bespoke arrangements are agreed in order to align the aims proposed by Ofgem with the business operation model.

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?

As both a renewable generator and supplier, we benefit from having direct contractual agreements for ROCs for an element of our supply, as such it is our residual ROC requirement that we obtain through wider market access.

Under this premise we would propose that directly contracted ROC agreements should be considered against the unhedged proportion for a given period.

We do not have a specific view on the correct mechanism, however, would suggest that any proposal needs to align the bespoke business operating model of a given supplier.

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

Due to the nature of the RO obligation on suppliers and the unknown recycle benefit post RO submission, the ROC market can be challenging to navigate and the impact of cash outlay for the ROC, plus potential recycle benefit top up, can act as a barrier to purchasing ROCs opposed to opting for the buy-out.

In order to mitigate this challenge, we would propose that a quarterly or bi-annual settlement period, which offers flexibility to the supplier in line with the operational business model, could increase the attractiveness of purchasing ROCs opposed to submitting funds through buy-out.

A contracted ROC facility offers greater risk mitigation and as such any changes to encourage this, will in turn help achieve Ofgem's aims. We would also draw attention to the seasonal demand and the consideration of how this would impact on a quarterly settlement.

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 believe it is important to align the consultation proposals and key aims with supplier business operation models, as such we would seek further discussion on this point.

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

A quarterly settlement would allow for greater clarity in reporting and minimise the potential at risk value, on the proviso that it can work flexibly as per the requirements of the supplier to align with the operating business plan. On this premise we foresee that it should work for both suppliers and Ofgem.

Alongside this, it is important to draw attention to the logistics of a settlement period on this timeframe and in particular how this would impact the timelines for recycle benefit calculations and payments.

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 are in favour of protections being applied to suppliers that enable the preservation of a level playing field, at present a number of the protection mechanisms proposed will favour those suppliers with access to investment grade credit lines.

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 have not performed detailed due diligence on the range of protection mechanisms. We can see that allowing suppliers to use Parental Company Guarantees or standby letters of credit will favour those suppliers with access to investment grade credit lines. That will favour larger suppliers as the impact to their business model is minimised in comparison with other suppliers who have to put up cash backed protection. For that reason, the playing field should be level.

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 anticipate that most banks will expect letters of credit to be cash-backed. That will place significant strain on working capital.

As such, our view is that insurance would be hard to obtain, unless specific legislation was put in place to ensure this as an option. Even so, we would anticipate this being a high-cost option with the impact being passed onto consumers.

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?

Hedging policy needs to be fluid and shaped around future demand, which changes over time. Suppliers must retain full flexibility to trade “business as usual” as they see fit, including trading out of ‘in the money’ positions from time to time.

We have not explored whether either change would have a negative impact on a typical bank or other creditors’ willingness to extend credit to a licenced supplier. Our anecdotal view is that in a time of volatile wholesale energy prices, it would have a detrimental impact and could result in challenges with credit.

Intuitively, the contractual change option feels cleaner and more achievable.

In our opinion, the bigger issue is the market gamble that many suppliers operated through not having a robust and risk-based trading policy. It stands to reason that those suppliers that remain in the market do operate on a risk-based approach and as such have a clearly defined hedging strategy.

We note that you see this only operating in “one way”. The mark to market positions with various counterparts may not all have a positive or negative mark to market at the same time, as such we would encourage you to reconsider this point. Should a SOLR event occur, the net value of the trades should pass to the SoLR not the aggregate value of all in the money trades.

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

We agree that it is unfair to have shareholders benefit from liquidation of a failed energy supplier through the windfall associated from the trades. We would therefore propose a route to disincentivise the ability to wind a company up on this basis, in order to mitigate the lack of jeopardy that is normally associated with corporate failure.

Alongside this, we would propose an increase in support for the development of renewable generation assets. An increase in UK based renewables, will help de-couple prices from the wider European wholesale market, not only helping support our net zero ambitions, but also reducing costs.

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 broadly agree, namely that ringfencing and capital adequacy imposed together would double up protections designed to mitigate the same risks to the customer through the mutualisation process. We would propose this is explored further through a bi-lateral discussion.

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?

Yes. We are advocates of the risk-based approach allied to more active monitoring and regulation by Ofgem, on the proviso that the administrative burden and timelines to deliver this are at an effective cost and aligned with the business operating model.

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?

The most relevant risks to the stability of the energy supply industry are market risk, credit risk and the knock-on impacts into liquidity risks. Counterparty credit risk is a significant but remote risk given our trading partners. Operational risk and legal risks are not high-risk factors in supplier failures. As you identify in your report, market risks have had an adverse effect on liquidity in most of the failed suppliers. It is our view that we are yet to see the impact of increased credit risk on suppliers arising from the cost-of-living crisis and as such, this impact needs to be considered by Ofgem, to support suppliers, in line with the proposals detailed.

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?

Like financial services regulation, a capital adequacy regime should target those suppliers with the highest potential impact to the energy supply industry (including other suppliers) and to customers through mutualisation unless mitigated by management, governance and capital and liquidity.

We believe it is important to determine this against the bespoke nature of a supplier's business operation model, to understand the ability to manage challenging market conditions.

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?

There are a range of capital types that could be adopted or utilised to meet a capital adequacy requirement, however we propose that these are reviewed on a bespoke basis in line with the respective supplier, based on their operating model.

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

We do not have any specific views on the analysis undertaken, however would highlight the need to align proposals against business operating models. We would welcome a bi-lateral discussion with Ofgem on this.

We would also highlight the risk of creating punitive regulations for a supplier base that has shown prudence in operation, particularly when focused against the backdrop of the current market challenges, including the cost-of-living crisis and in turn potential impacts from customers propensity to pay.

We would welcome any further contact in response to this submission.

Yours sincerely,



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