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Date: 19 July 2022

“Policy Consultation: Strengthening Financial Resilience” – So Energy Response

Dear David,

So Energy is a leading energy supplier providing great value 100% renewable electricity to homes across England, Wales and Scotland. We have consistently been recognised by our customers and the wider industry for our outstanding customer service since we were founded in 2015, including being a Which? Recommended Provider in 2020. In August 2021, So Energy merged with ESB Energy, and our combined business now supplies over 300,000 domestic customers. As one of the last challenger suppliers left in the market, So Energy is able to provide a unique view on the energy market and future reform.

We welcome the opportunity to respond to this consultation. Our key points are as follows:

1. Ofgem’s impact assessment (IA) is **materially flawed** in the information it considers and as a result it dramatically underestimates the cost to operators of implementing ringfencing at the proposed pace due to an assumption of control over pricing in a price capped market. It is a core assumption of the NERA report that accompanies the IA that supply markets are competitive and changes in costs for suppliers ultimately feed through to customers¹. This assumption is wrong. The market is price capped with operators almost invariably operating at or very near to the top of the cap. As the wholesale price of electricity and gas in the last [7] months has shown, fluctuations in costs cannot meaningfully be passed through to customers and that the market does not allow for price competition in such circumstances. This was vividly evidenced by Martin Lewis telling customers not to switch energy supplier and price comparison websites, such as Compare the Market, switching off the energy comparison tool. The price cap looks set to remain in place during any period of implementation of the proposals and therefore this is an issue that must be addressed and considered prior to the policy consultation moving further. Ofgem will need to use a different approach than the proposed ‘weighted average’ in order to cater for the proposed additional costs that will be incurred by suppliers. For these reasons, if Ofgem were to proceed on the basis of the IA, it would be proceeding on the basis of a material error of fact. Moreover, Ofgem’s has a duty to have regard to the need to secure that licence holders are able to finance their licenced activities. Our modelling shows an increase of £38 per customer is necessary². Anything less will *damage the financial resilience of the majority of suppliers in the market*. We consider that extending the proposed implementation period for the proposals would mitigate some of the cost³.

¹ NERA Report, Page 2, Introduction and Context

² Calculation based on a 20% Weighted Average Cost of Capital. If tariffs continue to rise, the cost of ringfencing will rise beyond £38.

³ We advised on a prudent implementation period in our response to your open letter.

2. Most of the benefits from Ofgem's IA stem from the assumptions that ringfencing will force suppliers to internalise risk and act more prudently, causing the risk of supplier failure in the event of a market shock to fall substantially. At the same time, Ofgem is progressing capital adequacy proposals due to a concern that suppliers are not capable of withstanding future market shocks. This contradiction in assumptions must be resolved and reconciled in any implementation of the policy.
3. We support steps to improve financial resilience and reduce moral hazard in the market. However, we are also under no illusion that this will cost consumers a substantial amount of money in the short term. We are especially aware that *a market cannot be financially resilient without a reasonable expectation of return for investors*. Given Ofgem accepts the Oxera report's recommendations, it must acknowledge and make explicit the relationship between the cost of financial resilience, the distributional impact of that cost and the level of the price cap. Only then can the impact on the consumer interest and effective competition be addressed.

Ofgem's engagement with suppliers

The Consultation runs to over 100 pages and refers to a separate NERA report which also runs to over 100 pages. Both documents raise complex questions of economics and operation. However, the Consultation has provided no more than four weeks for responses.

That is an inadequate period of time for us to assess properly the content of the Consultation. To assess properly would require us to conduct detailed analysis and modelling and four weeks is not enough time to do this. Moreover, the Consultation may have significant impacts on the way that a supplier is able to run its business and requires careful and considered thought on the options and responses.

The Principles of Good Regulation set out that stakeholders should typically be given at least 12 weeks, and sufficient information, to respond to consultation documents. This Consultation has four major concepts to be considered and with the other issues in the market, there is not the time to properly consider these concepts. The Principles of Good Regulation also acknowledge that regulation can have a disproportionate impact on small businesses, and this seems especially true in this scenario for 'small suppliers'.

We fear the consequences of this lack of an adequate period will lead to ineffective scrutiny in terms of the potential impact on both consumer interest and effective competition. For the avoidance of doubt, we have made clear which proposals we object to because we have not had the opportunity to properly examine them and consider whether they have merit. Other suppliers may choose simply not to comment for the same reason. Any policy proposals where Ofgem receives a lack of engagement should be treated as a 'cause for concern', rather than as an acceptance that the policy is sensible and in the consumer interest. There is no clear rationale provided that explains why there is not time to allow this policy change to be properly considered and for it to be considered alongside any changes to the price cap. We urge you to give stakeholders more time to engage on this fully.

Consultation Proposals

The consultation has [three] main elements:

1. Limiting Direct Debit payments to one month in advance. We support this initiative.
2. Limit the amount of customer credit balance and RO money mutualised under Supplier of Last Resort (SoLR) through limiting access.
3. Introduce a capital adequacy regime to ensure suppliers are capitalised enough to weather future crises. Proposals here are in an early stage of development.

There is a tension between [2 and 3]. Financial resilience means having more capital flexibly on hand to manage unexpected shocks, but ringfencing means putting existing sources of capital beyond the supplier's reach, necessitating its replacement with more expensive alternative sources of capital. To do this, and as acknowledged in the NERA report, **the only way of resolving this tension is by increasing prices.** The NERA report is based on an assumption that price increases are capable of being passed through to customers and that they will be so passed on. This is clearly inconsistent with the current price cap design and looking at the implementation period this will continue to be an issue as the Government seeks to extend the price cap past 2023. Ofgem is seeking to commence ringfencing from this winter, which means prices will need to rise to accommodate this when they're already projected to reach a record high. The policy cannot work, and should not be implemented, unless the price cap is amended in a way that allows for full cost recovery from customers. If not, the impact assessment carried out in relation to the Consultation is not fit for purpose, as its underlying assumptions are wrong. A policy Consultation seeking to fix one problem is likely to create another issue from its implementation. If the policy is implemented in a way that allows the costs to be recovered properly, and in a transitional manner, then it will allow the energy retail sector, which has had to weather a range of market shocks in recent years⁴, the ability to improve its capital adequacy, either through retaining profits or attracting investment.

Ofgem must ensure that it acts in accordance with its duties and within its powers, and does not have regard to irrelevant considerations such as any desire to effect a decrease in inflation, which are outside its remit.

Ringfencing proposal

The recent NERA report makes clear that the cost of raising additional capital in order to facilitate the ringfencing of credit balances and money for RO payments will vary dramatically between suppliers. Across the report, their estimates range from a Weighted Average Cost of Capital (WACC) of 20% for a supplier with a CCC credit rating to 1.12% bond yield for a supplier with an investment-grade BBB rating.

Ultimately, NERA assumes the cost of ringfencing the RO money and credit balances will fall as suppliers become more financially resilient. Suppliers that have a CCC credit rating will obtain a B credit rating and the WACC will fall. **However, NERA doesn't appear to indicate how long this might take to achieve.**⁵ Our understanding is that adjusting a company's credit rating is a gradual process and would likely take several years of sustained profitability. A transition period must match this.

The NERA report acknowledges that tariffs will need to rise to meet this cost. In section 5.4.2 of their report, they discuss the possibility of suppliers raising their tariffs by more than the cost of implementing ringfencing, and returning additional profits to shareholders:

"Competition between non-failed suppliers may be sufficiently healthy that tariffs are already driven by underlying costs, in which case their tariffs would not increase beyond the level required to comply with the proposed interventions...we assume no impact on the tariffs of non-failed suppliers beyond the increases in costs that they would experience."

The NERA report presumes that suppliers have the freedom to adjust their pricing, up to the extent that they're constrained by competitive pressure. It also assumes that customers switch, a characteristic that is not being seen in the current market environment. NERA assumes in Section B4 "that small suppliers are able to increase their tariffs above the cost of compliance by a greater extent, because the potential cost of a new risky entrant is higher than in the main results." In other

⁴ We note that Ofgem has acknowledged that the 1.9% rate of return allowed under the price cap may not be appropriate and has committed to a review, however, no timeframe has been provided.

⁵ This is the NERA 'Partial Effectiveness' scenario, which Ofgem have adopted for their impact assessment.

words, smaller suppliers will have the freedom to increase their tariffs by more than larger suppliers which is useful in meeting the greater cost of ringfencing.

However, the energy retail market doesn't work that way. All suppliers are constrained by a single price cap for the entire market. In effect, Ofgem sets the amount of revenue a supplier can draw in through the price cap and is the main driver of a supplier's cost to serve, through the obligations set out in the supply licence. This includes the financial responsibility principle and the operational capability principle.

At the current level of the price cap the market is loss-making and lacks financial resilience. Therefore, it appears there are two options for Ofgem:

- Option 1: Provide a price cap allowance that allows all suppliers to cover the cost of implementing RO money and credit balance ringfencing. This will need to be a substantial allowance and for some suppliers [this allowance] will be more than they need [to cover this cost due to [x]]. In principle, suppliers that are overfunded could choose to price below the cap but that seems unlikely to occur – or at least to be sustainable beyond the short term - given the overall lack of profitability in the market. Following the logic of the NERA document, the size of the allowance could be reduced over time as the creditworthiness of suppliers improve but this will take several years. Ofgem will obtain the full benefits set out in their IA but at a far greater cost than they have assumed.
- Option 2: Provide an allowance that covers only the cost of ringfencing RO and credit balances for a limited number of suppliers. As a consequence, the financial resilience of suppliers who do not receive adequate funding may get worse because they may not be able to fund an alternative source of capital. The worst affected suppliers will be faced with difficult decisions about whether it is appropriate to continue to trade in light of rising costs and capped revenues. Ofgem will save on implementation costs, but the assumed benefits of this policy will not be realised. The risk of this approach pushing further suppliers into SoLR or special administration is substantial. Our understanding is it is this latter option Ofgem intends pursuing by providing a 'weighted average' allowance.

At no point in Ofgem's consultation is there a recognition of these tensions and how it should be implemented. It is a consultation that does not take into account the price cap's impact. Ofgem's impact assessment, which is based on the NERA report, does not address this issue – it assumes the cost of Option 1 and the benefits of Option 2. The assumption seems to be that if difficult trade-offs can be ignored, they no longer exist. This flies in the face of the [Oxera report's](#) recommendations, which calls for Ofgem to explicitly account for impacts on consumer interest and effective competition when making policy trade-offs.⁶ Ofgem's assessment of the impact is fundamentally flawed, not fit for purpose and needs to be complexly re-engineered.

The proposals in the Consultation would be made through licence modifications, Ofgem has a duty under S. 3A(2)(b) of the Electricity Act to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed on them under that Part (the "**Finance Duty**"). Similarly, under the Domestic Gas and Electricity (Tariff Cap) Act 2018 also states that the Ofgem must exercise its functions under that section having regard to "*(a) the need to create incentives for holders of supply licences to improve their efficiency; (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts; (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts; (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence*".

It is not clear to us from the Consultation that the Finance Duty and the matters that Ofgem needs to take into account in relation to the price cap have been considered fully, either in isolation or

⁶ See section 5, 'Recommendations and lessons learnt' of the Oxera report.

together. It holds that these policies cannot be considered in isolation and the NERA report is drafted (presumably) on the assumption that they will work perfectly in tandem. The industry needs to be confident that the NERA report takes into accounts all costs for suppliers and that it is based on the current outlook and what is likely to happen from a policy perspective, including in relation to the price cap. We set out in our responses the considerations we think are necessary from a transitional standpoint subject to our caveat that we have not had enough time to review the proposals fully.

Our proposals

We believe that financial resilience and minimising mutualisation costs are laudable goals for the industry, but they cannot be achieved without proper financial underpinning. There is going to be a substantial cost to consumers but ultimately, this is necessary to provide confidence in energy and build a foundation for the transition to net zero. There are prudent steps that could be taken to lessen the cost of implementation, but these have been disregarded by Ofgem in the Consultation in favour of what we consider to be unworkable proposals which of brought into force are likely to be highly detrimental to the industry and to consumers.

Our proposals are outlined below:

- **Phase in ringfencing over time:** Suppliers have faced substantial losses in recent times. The suppliers that have survived the current crisis have had their finances severely tested. Investor confidence in suppliers is therefore low. Phasing ringfencing requirements in over a longer period of time than is proposed will lower the initial cost of raising capital and allow suppliers to rebuild investor confidence, while at the same time sending clear signals to potential new entrants on the level of capital needed to participate in the supply market. It also allows for the possibility of consumer bills falling from their current record levels before further price cap allowances are added.
- **Prioritise the RO over credit balances:** We have provided evidence to Ofgem making clear that, in terms of moral hazard, the RO money is far more of a material risk than credit balances, especially in the context of Ofgem's proposed ban on limiting up-front Direct Debit payments to 1 month (a proposal we support). Ofgem's proposal to stack the funding requirement of the RO money and credit balances on top of one and other, substantially increases the cost of the policy for little added benefit.
- **Ensure capital adequacy requirements do not stack on top of RO money and credit balance ringfencing unnecessarily:** Most of the benefits of the impact assessment for ringfencing derive from suppliers internalising risk, behaving more prudently and consequently being more resilient to market shocks. The capital adequacy checks are designed to check that suppliers are prepared for potential market shocks. Both pieces of work appear to be trying to solve the same problem. It implies that Ofgem does not have clarity on what interventions achieve its overarching objective and how. Ofgem should pause and re-assess how capital adequacy fits with ringfencing. Consumers risk paying for redundant regulatory interventions.

We have set out our responses to your consultation questions in the Appendix, below.

We hope you find this input helpful. As we stated at the beginning of our response, we would welcome the chance to engage and work with you on a set of protections that delivers in today's volatile markets. Please don't hesitate to contact us should you require any additional information or clarity on our views.

Yours Sincerely,

Paul Fuller
Head of Regulation



Appendix: Answers to 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?

No.

We are concerned that the Impact Assessment and the NERA report that underpins that assessment do not reflect present-day market dynamics. The current key dynamics are as follows:

1. The energy supply market has been loss making for several years now.
2. Ringfencing of credit balances and RO money will increase cost to serve as suppliers will have to secure alternative sources of capital.
3. Our understanding is that Ofgem plans to provide a 'weighted average' allowance in the price cap to account for these costs.
4. For the majority of suppliers in the market this will mean that the cost of implementing the proposals will substantially exceed the cost allowance given in the price cap. As a consequence, they will be less financially resilient. The risk of supplier failure will increase.

This is precisely the opposite of Ofgem's overarching objective of developing "a more resilient energy supply market in which consumers, energy suppliers and investors can have confidence going forward". It also means that Ofgem cannot have had regard to the ability of licensees to finance their activities, as it does not reflect the current market conditions and the financial burden faced by suppliers.

If Ofgem wishes to meet its overarching objective within the timeline it has set out, it must provide a substantially increased allowance over a 'weighted average' calculation in order to fully cover the costs of implementation.

In addition, a longer implementation period would allow Ofgem to meet its overarching objective at a lower cost to customers. Suppliers have faced substantial losses in recent times and the finances of suppliers who remain in the market have been tested through a "once in a generation event"⁷. Investor confidence in suppliers is therefore low, as they have been tested as well. Phasing ringfencing requirements in over a longer period of time than is currently proposed will lower the initial cost of raising capital and allow suppliers to rebuild investor confidence, while at the same time sending clear signals to potential new entrants on the level of capital needed to participate in the supply market. It is acknowledged in the NERA report that equity may be needed as a source of financing these measures and it is therefore important that suppliers can access equity markets appropriately. This will only come with rebuilding investor confidence. This approach would also allow for the possibility of consumer bills falling from their current record levels before further price cap allowances are added.

Similarly, the overarching objective could be met at a lower cost by prioritising the implementation of RO over credit balance ringfencing. We have provided evidence to Ofgem

⁷ Ofgem Chief Executive, 25 May 2022, <https://www.ofgem.gov.uk/news-and-views/blog/how-ofgem-responding-energy-crisis>

making clear that, in terms of moral hazard, the RO money is far more of a material risk than credit balances, especially in the context of Ofgem's proposed ban on limiting up-front Direct Debit payments to 1 month (a proposal we support). The proposals consulted upon will stack the funding requirement of the RO money and credit balances on top of one and other, substantially increasing the cost of the policy for little added benefit.

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.

The proposals as included in the Consultation would have an unacceptable impact on our business - and we understand other suppliers - and need to be revised.

Our current understanding of the proposals is that a 'weighted average' allowance will be provided in the price cap to cover the cost of implementing the ringfencing proposals. A weighted average allowance will not meet the cost of implementing the ringfencing proposals. This will make So Energy and the majority of suppliers in the market less financially resilient than prior to implementation of the proposals, which runs counter to Ofgem's aims. Given the level of financial resilience in the market has been judged to be inadequate, this means that the proposals as set out cannot achieve the objective that they are intended to. Ofgem must have regard to the ability of licensees to finance their activities, this clearly needs to be looked at in more detail here. We note that the NERA report does not even consider the cost of implementing the proposals.

Steps can be taken to alleviate these concerns and reduce the cost of implementation:

- **Phase in ringfencing over time:** Suppliers have faced substantial losses in recent times. The suppliers that have survived the current crisis have had their finances severely tested. Investor confidence in suppliers is therefore low. Phasing ringfencing requirements in over a longer period of time than is proposed will lower the initial cost of raising capital and allow suppliers to rebuild investor confidence, while at the same time sending clear signals to potential new entrants on the level of capital needed to participate in the supply market. It also allows for the possibility of consumer bills falling from their current record levels before further price cap allowances are added.
- **Prioritise the RO over credit balances:** We have provided evidence to Ofgem making clear that, in terms of moral hazard, the RO money is far more of a material risk than credit balances, especially in the context of Ofgem's proposed ban on limiting up-front Direct Debit payments to 1 month (a proposal we support). Ofgem's proposal to stack the funding requirement of the RO money and credit balances on top of one and other, substantially increases the cost of the policy for little added benefit.

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.

No.

The proposals will make So Energy and other suppliers less financially resilient due to the planned allowance in the price cap not meeting the cost of implementation. The allowance in the price cap needs to be increased or else a less costly method of ringfencing, such as Net Credit Balance needs to be applied.

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.

No.

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

Chapter 3: Renewables Obligation

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

No, we cannot endorse the suggested approach at this time.

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

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 stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

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

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond.

We note that the ROC market is now mature, and agreements have been entered into based upon the status quo. Suppliers are not the only parties involved in transactions within the market and therefore will not be the only ones impacted. We would welcome understanding what feedback Ofgem has from generators. It is important to note that some suppliers have large generation portfolios as part of their business, the responses are likely to differ between those who do and those who do not. If the final proposals are poorly designed, the proposals could be extremely detrimental to the market and have serious unintended consequences.

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?

No. We consider that there is further work to be done on considering the transition and implementation once feedback in relation to the rest of the design has been considered. A rushed transition and implementation could be exceptionally disruptive following the crisis of 2022. Ofgem's goal is stated as being about reducing risk, this can only come about through careful and considered proposals.

Ofgem must implement RO and credit balance ringfencing sequentially as both proposals require suppliers to raise additional capital from alternative sources. Running the implementation of the RO and credit balance ringfencing in parallel with one another unduly increases the amount of capital to be raised at any one time and, therefore, the cost of implementation. This is especially concerning in the context of our understanding that Ofgem intends to provide an inadequate 'weighted average' allowance in the price cap to account for this increased cost. To preserve what financial resilience that exists in this industry, Ofgem must provide for an allowance that allows all suppliers to meet the implementation cost.

If Ofgem wishes to reduce implementation costs, then we refer to our recommendation from our previous consultation. Ofgem should sequence the implementation of the RO and credit balance ringfencing one after the other, with the RO taking precedence in terms what is protected first as that is the greater source of moral hazard.

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

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

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 are supportive of suppliers being able to select from a menu of protection mechanisms. Any mechanism that achieves the intended outcome should be allowable and suppliers should be able to choose the mechanism they deem most appropriate to their business and customers that achieves the proposed aim.

We note that once a supplier fails, the supply licence is revoked and Ofgem's powers are greatly diminished. Ofgem needs to carefully consider the enforceability of each mechanism. If a loophole was to be found that led to increased mutualisation costs, it would be damaging to Ofgem's reputation as a competent regulator.

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?

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

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 have not been able to adequately assess the insurance market to provide a full response to this, but we anticipate that any supplier that would be able to obtain suitable insurance would otherwise be able to utilise one of the other options, such as parent company guarantee or letter of credit, at a lower cost. Given the recent supplier failures, the level of risk suppliers must manage and the ongoing lack of profitability and financial resilience in the industry, we cannot see a competitively priced insurance product being made available.

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?

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

With regards to the licence change option, we are concerned about the implications of placing the proceeds of liquidated hedges in an insolvency-remote account and the implications that would have on a supplier's capital adequacy in a business-as-usual scenario. It is normal practice that Suppliers liquidate hedges to adapt to the changing profile of their customers and as part of their work to match supply with forecasted demand. This is especially true in the electricity wholesale market, which is suffering from an acute and increasing shortage of liquidity. Regulation should be proportionate and targeted and whilst we support measures targeted at stopping steps being taken that push a business into insolvency (such as the unwinding of hedges and extraction of value), we consider that this should not prevent a business being run effectively.

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

As stated in our accompanying letter, further time for consideration is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

It would appear that changes related to insolvency law would be required to achieve these aims.

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 cannot support these proposals until Ofgem accepts that, in an unprofitable market, offering a 'weighted average' allowance to account for the cost of suppliers improving their capital adequacy will leave the majority of suppliers in a financially weaker position. Until Ofgem accepts that it has difficult decisions to make with regards to this, and considers the trade-offs it faces in funding additional capital adequacy, work on this matter should not

progress. We would gladly work with Ofgem in this regard. It is a point that the NERA report and the Consultation (including the IA) do not consider, the reason for which is not clear.

With regards to the interaction between capital adequacy requirements and the ringfencing proposals, the NERA report assumes that, in addition to preventing credit balances and RO accruals from being mutualised, ringfencing would reduce the likelihood of suppliers failing and mutualisation being triggered in the first place. The assumption made is because more of a supplier's own capital would be at risk (or because they would need to persuade an outside investor to provide capital), ringfencing would drive more prudent behaviour and reduce, not just the consequences of bankruptcy but the likelihood of bankruptcy. Indeed, Ofgem's impact assessment calculates that 47-71% of the total benefit of ringfencing is due to mutualised hedging costs being avoided due to fewer suppliers failing and going into SoLR.⁸

However, Ofgem acknowledges in the risk section of that same impact assessment that suppliers may not change their behaviour in response to ringfencing being put in place. The entire impact assessment stands up or falls down on this assumption. The fact that Ofgem has felt the need to pursue capital adequacy controls points toward Ofgem lacking confidence in the key assumption that underpins their impact assessment.

Either the impact assessment for ringfencing makes sense and capital adequacy is not needed or the impact assessment is flawed and the case for ringfencing must be re-assessed. There appears to be an inherent conflict in Ofgem's thinking with regards to what is needed to bring financial resilience to the market. Given the potential impact on consumer interest and effective competition in the market, it is essential that Ofgem resolves the contradictions in its thinking.

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 cannot agree to this suggestion at this time. Ofgem must explain how a segmented or any other form of capital adequacy regime interacts with a single price cap with all suppliers in the market. We welcome Ofgem's commitment to review the 1.9% rate of return in the price cap, but this appears work appears to be taking the lowest priority. It is difficult to see how suppliers will be able to improve their financial resilience without profitability and a reasonable expectation of a return on investment.

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 stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

We would note that in terms of our risks we have observed, volume risk owing to unanticipated SVT demand remains one of the most severe So Energy faces owing to its

⁸ See Table 7 of the consultation. £41/£81m for the 'low' scenario of the benefits case and £332/£467m of the 'high' benefits case is ascribed to mutualisation related hedging costs.

magnitude and our inability to control the risk due to price cap restrictions. We welcome Ofgem's move to a quarterly cap – this has partially limited the severity of the risk. Nevertheless, we would welcome an explanation from Ofgem of how they would assess risks that exist and cannot be controlled due to the design of the price cap.

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?

Ofgem must acknowledge and explicitly state the relationship between the price cap and the level of financial resilience the energy retail sector can hope to achieve. Only then can an informed discussion take place on how to best balance cost and financial resilience in the context of the consumer interest and the impact on effective competition.

We note that Ofgem discusses having capital available to meet unexpected shocks but there is no mention of suppliers being able to raise additional capital in the event of an unexpected shock. This is as important and potentially more efficient method of weathering crises but is only really a viable option in an industry with a track record of profitability and a reasonable prospect of future profitability.

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?

As stated in our accompanying letter, further time for analysis and modelling is required prior to us being able to comment on this question. We are a small supplier and therefore require the time set out in the Principles of Good Regulation in order to be able to respond. We cannot agree to a proposal without having further considered the impact of this on our business.

We note that 'sufficient loss-absorbing capital' is not simply a matter of having capital but also a matter of being able to raise additional capital should the need arise.

Chapter 7: Impact Assessment

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

Ofgem's impact assessment draws heavily upon the NERA report, but the NERA report is a retrospective exercise examining what supplier failures could have been avoided if ringfencing policies were introduced years ago. The present-day market bears little resemblance to the pre-crisis energy market. Consequently, fundamental features of today's energy market, are ignored in the NERA report and, consequently, in Ofgem's IA.

The most egregious of these oversights is the assumption in the NERA report that suppliers have control over pricing, which is not the case. Consequently, the Impact Assessment cannot be delivered, as we will explain below.

The recent NERA report makes clear that the cost of raising additional capital in order to facilitate the ringfencing of credit balances and money for RO payments will vary dramatically between suppliers. Across the report, their estimates range from a Weighted Average Cost of Capital (WACC) of 20% for a supplier with a CCC credit rating to 1.12% bond yield for a supplier with an investment-grade BBB rating.

Ultimately, NERA assumes the cost of ringfencing the RO money and credit balances will fall as suppliers become more financially resilient. Suppliers that have a CCC credit rating will obtain a B credit rating and the WACC will fall. However, NERA doesn't appear to indicate how long this might take to achieve.⁹ Our understanding is that adjusting a company's credit rating is a gradual process and would likely take several years of sustained profitability.

The NERA report acknowledges that tariffs will need to rise to meet this cost. In section 5.4.2 of their report, they discuss the possibility of suppliers raising their tariffs by more than the cost of implementing ringfencing, and returning additional profits to shareholders:

"Competition between non-failed suppliers may be sufficiently healthy that tariffs are already driven by underlying costs, in which case their tariffs would not increase beyond the level required to comply with the proposed interventions...we assume no impact on the tariffs of non-failed suppliers beyond the increases in costs that they would experience."

The NERA report presumes that suppliers have the freedom to adjust their pricing, up to the extent that they're constrained by competitive pressure. NERA also assumes in Section B4 "that small suppliers are able to increase their tariffs above the cost of compliance by a greater extent, because the potential cost of a new risky entrant is higher than in the main results." In other words, smaller suppliers will have the freedom to increase their tariffs by more than larger suppliers which is useful in meeting the greater cost of ringfencing.

However, the energy retail market doesn't work that way. All suppliers are constrained by a single price cap for the entire market. In effect, Ofgem sets the amount of revenue a supplier can draw in through the price cap and is the main driver of a supplier's cost to serve, through the obligations set out in the supply licence. This includes the financial responsibility principle and the operational capability principle.

At the current level of the price cap the market is loss-making and lacks financial resilience. Therefore, the price cap must rise in order to meet the cost of ringfencing. Ofgem have acknowledged this fact in meetings with industry. Determining how much the price cap should rise in order to meet the cost of ringfencing presents dilemma for Ofgem:

- Option 1: Provide a price cap allowance that allows all suppliers to cover the cost of implementing RO money and credit balance ringfencing. This will need to be a substantial allowance and for some suppliers will be more than they need. In principle, suppliers that are overfunded could choose to price below the cap but that seems unlikely given the overall lack of profitability in the market. Following the logic of the NERA document, the size of the allowance could be reduced over time as the creditworthiness of suppliers improve but this will take several years. Ofgem will obtain the full benefits set out in their IA but at a far greater cost than they have assumed.
- Option 2: Provide an allowance that only covers the cost of ringfencing RO and credit balances for a limited number of suppliers. As a consequence, the financial resilience of suppliers who do not receive adequate funding will get worse because they won't be able to fund an alternative source of capital. The worst affected suppliers will be faced with difficult decisions about whether it is appropriate to continue to trade in light of rising costs and capped revenues. Ofgem will save on implementation costs, but the assumed benefits of this policy will not be realised. The risk of this approach pushing further suppliers into SoLR is substantial. Our understanding is it is this latter option Ofgem intends pursuing by providing a 'weighted average' allowance.

⁹ This is the NERA 'Partial Effectiveness' scenario, which Ofgem have adopted for their impact assessment.

It is clear that Ofgem cannot deliver the benefits set out in the IA for the cost set out in the IA.

At no point in Ofgem's consultation is there a recognition that a difficult decision needs to be made regarding what suppliers Ofgem is willing to save and what suppliers Ofgem is willing to see fail through setting a single price cap allowance. Ofgem's impact assessment, which is based on the NERA report, does not address this issue – it assumes the cost of Option 1 and the benefits of Option 2. The assumption seems to be that if difficult trade-offs can be ignored, they no longer exist. This flies in the face of the [Oxera report's](#) recommendations, which calls for Ofgem to explicitly account for impacts on consumer interest and effective competition when making policy trade-offs.¹⁰ Ofgem's assessment of the impact is fundamentally flawed, not fit for purpose and needs to be complexly re-engineered.

The impact assessment also appears to be inconsistent with the proposals for capital adequacy set out elsewhere in the consultation.

With regards to the interaction between capital adequacy requirements and the ringfencing proposals, the NERA report assumes that, in addition to preventing credit balances and RO accruals from being mutualised, ringfencing would reduce the likelihood of suppliers failing and mutualisation being triggered in the first place. The assumption made is because more of a supplier's own capital would be at risk (or because they'd need to persuade an outside investor to provide capital), ringfencing would drive more prudent behaviour and reduce, not just the consequences of bankruptcy but the likelihood of bankruptcy. Indeed, Ofgem's impact assessment calculates that 47-71% of the total benefit of ringfencing is due to mutualised hedging costs being avoided due to fewer suppliers failing and going into SoLR.¹¹

However, Ofgem acknowledges in the risk section of that same impact assessment that suppliers may not change their behaviour in response to ringfencing being put in place. The entire impact assessment stands up or falls down on this assumption. The fact that Ofgem has feels the need to pursue capital adequacy controls points toward Ofgem lacking confidence in the key assumption that underpins their impact assessment.

Either the impact assessment for ringfencing makes sense and capital adequacy is not needed or the impact assessment is flawed and the case for ringfencing must be re-assessed. Ofgem's intent to pursue capital adequacy requirements indicates the impact assessment is flawed and needs to be re-assessed.

¹⁰ See section 5, 'Recommendations and lessons learnt' of the Oxera report.

¹¹ See Table 7 of the consultation. £41/£81m for the 'low' scenario of the benefits case and £332/£467m of the 'high' benefits case is ascribed to mutualisation related hedging costs.