

Cathryn Scott
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19 July 2022

Dear Cathryn,

POLICY CONSULTATION – STRENGTHENING RETAIL FINANCIAL RESILIENCE

Thank you for the opportunity to comment on Ofgem's consultation on policy proposals relating to strengthening financial resilience of suppliers and in particular ensuring that suppliers bear the appropriate cost of risk-taking, are more resilient to market shocks and that customers are shielded from the impact of supplier failures as far as possible.

The consultation is seeking stakeholder views on the following:

- Protections for customer credit balances (CCB) and Renewable Obligation (RO) payments
- Protections relating to the value of wholesale energy hedges
- Proposals relating to capital adequacy more generally

Ofgem has set a period of four weeks for consultation on each of the above proposals. We are pleased that Ofgem is moving quickly regarding the protection of CCB and RO payments as we have been concerned regarding the lack of progress in this area after several rounds of consultation starting in late 2018.

For the latter two categories, as these relate to new policy proposals of a significant scale and impact to the market, we consider that a four week consultation period is insufficient to support robust stakeholder review and response, and welcome the extension until 2 August that Ofgem has granted us for the questions within this consultation on these areas. This response therefore relates only to those questions on CCB and RO protections within Chapters 1 to 4 and 7. We will follow up with our substantive response to the remaining questions on hedging and capital adequacy proposals by the extended deadline. In advance of this, where we are able, we have provided some initial thinking in response to some of the questions, though note that any views expressed in this response on these points are therefore subject change.

Our responses to the specific questions in Sections 1 to 4 and 7 are set out in the annex to this letter. We would like to highlight the following points.

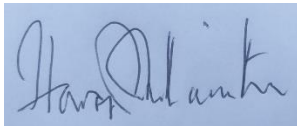
- Within our response we note the need for early sight of licence drafting to allow suppliers to review and comment ahead of statutory consultation. We note that Ofgem has now issued this for comment, which we welcome, and we will follow up with comments.
- We note that for each of the interventions, Ofgem states that the requirements would be limited to domestic suppliers only. While we agree that this makes sense for CCB protections, for the RO protections, we see no reason why the RO protections would not apply to non-domestic suppliers in the same manner as domestic suppliers. If it is Ofgem's intention that it only applies to domestic suppliers, then it will be important that it considers those suppliers who supply both segments within the design of the scheme to avoid market distortion.
- We agree that for each option, a quarterly frequency for protections presents an appropriate balance between protection and administrative burden for suppliers and Ofgem. We also agree for the need for a transitional approach for each of the interventions. In this regard, we would make the following observations:
 - o For CCB, the consultation document is not particularly clear regarding either the proposed timeline for implementation of the initial phase of the new policy requiring suppliers to protect 30% of peak credit balances, or regarding how Ofgem intends transitioning from 30% of peak CCB to 100%. We think it important that protections are in place as quickly as possible, while balancing the need to allow suppliers to implement protections as efficiently as possible. We understand Ofgem's intention is to have complete protections in place ahead of Winter 2023. We are supportive of this and consider Ofgem should be aiming that suppliers are protecting 100% of the CCB (as defined) by the quarter commencing 1 July 2023
 - o We consider Ofgem's approach to transition to full protection of RO payments by April 2023 seems sensible
- For CCB protections, Ofgem is considering both forward-facing and backward-facing options, with its current preference for a forward-facing option. We note that this option would create significant periods of over-protection, which could add costs to the scheme without associated consumer benefit. We would encourage Ofgem to use supplier data from the current RFI to fully assess the potential costs and benefits of each option and include a further alternative for example an "average" approach in addition to the current detail in the IA.
- For RO protections, we have a number of concerns regarding the proposals Ofgem is considering in relation to requiring a trust to protect the proceeds from any sale of ROCs.
 - o Firstly the proposals appear similar to those proposed relating to protections for "in-the-money" hedges, yet Ofgem has not presented the same level of consideration of the risks and issues associated with these proposals as it has done for hedging at this point
 - o Aside from the above point, while we understand the risk Ofgem is intending to address, we think this option would create costs for any such proposal with no benefits to consumers

We think as an alternative to address this risk, Ofgem should place an obligation on suppliers to notify Ofgem of any intra-quarter sale of ROCs and state which of the approved insolvency remote protections it has used to cover the outstanding RO obligation left by the sale. This would then allow Ofgem to follow up with suppliers where it has concerns

- Both the IA and consultation document reference the need for the cost of these policy proposals to be reflected within the methodology of the Default Tariff Cap, and we look forward to engaging with Ofgem regarding its proposed approach to ensuring suppliers are able to recover the costs of these additional interventions.

If you would like to discuss any aspect of our response, please do not hesitate to contact me. We will of course follow up with our response to Sections 5 and 6 on the hedging and capital adequacy proposals.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Richard Sweet', is displayed on a light blue rectangular background.

pp Richard Sweet
Director of Regulatory Policy

**POLICY CONSULTATION – STRENGTHENING RETAIL FINANCIAL RESILIENCE –
SCOTTISHPOWER RESPONSE**

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 agree with Ofgem's summary of the need for intervention in this space.

We agree with Ofgem taking action in relation to the protection of CCB and RO payments. We have raised concerns in previous engagement with Ofgem around the lack of progress by Ofgem despite consulting on protections in this area over a number of years. In the absence of requirements to protect CCB and RO payments, a number of suppliers have operated unsustainable and, in some cases irresponsible, business models. These companies were unable to survive the financial challenges presented by the recent rising wholesale energy costs, and with no protections in place, the costs ultimately fall to customers. We do not consider this to be an appropriate regulatory framework, and Ofgem must take action to ensure all suppliers, whether existing market players or new entrants, are sufficiently capitalised, are resilient to market shocks, and are able to meet their financial responsibilities in circumstances where they exit the market.

We will provide detailed comment on the hedging and capital adequacy proposals in follow up to this response as agreed with Ofgem. At this point we would note our support for the principle of Ofgem giving further consideration to requiring suppliers to hold minimum levels of risk capital in their businesses. We agree that this will be inter-linked with other policy proposals on financial resilience, including the protections of CCB and RO payments, and agree that Ofgem must assess this to ensure no double counting of protections that add cost to suppliers and consumers with no benefits.

We consider that a minimum capital requirement could potentially have a twin benefit. First, the holding of risk capital will be set off against and reduce any costs that are mutualised on failure. So, for example, if the risk capital is sufficient to cover customer credit balances, there will be less need for prescriptive rules around ringfencing and the current rules could be reviewed in the future. Second, whoever is providing the risk capital, be it the parent company or capital markets, will have a strong incentive to monitor the supplier risk management practices – and may be able to do so more effectively than Ofgem.

In relation to the proposals to protect the value of “in-the-money” hedges, we understand the risk Ofgem is aiming to address, however our initial review of the policy proposals being assessed by Ofgem suggests real challenges in implementation, as well as risk of unintended consequences. We look forward to providing more detailed comments to Ofgem on its proposals regarding capital adequacy and hedging in follow up once we have fully considered the proposals internally.

Finally, we agree with Ofgem that policy proposals in this area must be reviewed in the wider context of policy development and supplier monitoring, including stress testing, price cap methodology and supplier return, and the future retail market design activity.

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.

Method of Ringfencing

Ofgem has considered two approaches to implementing the protection of credit balances:

1. “Ringfencing” – suppliers insure or otherwise protect an amount of money using an “Approved Protection Mechanism”; and
2. A “client account” approach - with drawdown rules where supplier must collect all existing and future Direct Debit payments from customers into an account held on trust, with drawdown only for specified purposes such as billing/reconciliation.

We agree with Ofgem’s conclusion that the client account option would present significant operational challenges for both suppliers and Ofgem, and we are supportive of Ofgem’s proposal to implement a policy requiring suppliers to use ringfencing options (based on an agreed menu of protection options) for the purpose of protecting CCB.

Impact to ScottishPower of Approach 1: Ringfencing

Based on the proposals within this consultation document around the ringfencing approach, and the proposed menu of options available to suppliers for the purpose of protecting CCB, we do not consider that, save for the additional costs of putting in place the additional measures, that there would be any material impact to ScottishPower of implementing the scheme.

We will need time to put in place the necessary protections, and there will be a cost of doing so which Ofgem must ensure is factored into the Default Tariff Cap methodology to ensure suppliers can recover these additional costs. We welcome Ofgem’s recent request for information on credit balances covering the cost of protections in this regard.

The consultation document is not particularly clear regarding the proposed timeline for implementation of the initial phase of the new policy requiring suppliers to protect 30% of peak credit balances, with both “end of the year” and “winter” referenced. From our bilateral engagement with Ofgem, we understand that the end of the year is the earliest that the new policy could be in place and to allow full policy and statutory processes to complete, it may be more likely that implementation is early in the new year.

Assuming Ofgem is able to make the necessary changes to allow recovery of costs, we see no insurmountable challenges to ScottishPower having the necessary protections in place for 30% of CCB by the end of the year.

We understand that there may be a need for a transitional approach to implementation to ensure existing suppliers in the market are able to recapitalise to meet the new requirements where needed and without any negative impact on their financial position, and that the costs of implementation of these protections can be reflected within the Default Tariff Cap methodology.

However, the consultation document is silent regarding how Ofgem intends transitioning from 30% of peak CCB to 100%. We consider that this transition should be completed as quickly as possible, but understand that Ofgem will need to find the right balance in increasing protections without materially impacting suppliers’ approach to capitalisation through the

transitional period. We look forward to engaging with Ofgem around the appropriate timescales for completing the transition to full protections.

From our bilateral engagement, we understand that Ofgem's intention is to have complete protections in place ahead of Winter 2023 which we are supportive of. We therefore consider that Ofgem should be working towards suppliers being required protect 100% of the CCB (as defined), by the quarter starting 1 July 2023. In this way suppliers can transition to full protection of their credit balances at time of year when it is least onerous to implement given the relatively lower financial amounts involved.

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 agree that Ofgem should require CCB protections to be applied to Gross Credit Balance net of Unbilled Consumption.

Ofgem defines this level of CCB as:

"The total payments made by each customer to the supplier less the total cost of energy billed to date by the supplier, and less the value of energy used by that customer since their last bill was issued."

We consider this to be the only real option available to Ofgem that would protect the level of CCB at risk of mutualisation on supplier failure. The other options being considered would either over-protect (increased cost with no additional benefit), or under-protect (and leave continued mutualisation risk) CCB, and we do not consider either option to be reasonable in the context of Ofgem's policy intent.

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 the Protection Amount Calculation should be updated quarterly as we think this presents the right balance in relation to administrative burden on suppliers and Ofgem of more frequent updates, and ensuring the level of protection is granular enough to allow suppliers to reduce costs of protection in periods of lower CCB.

To define the required Protection Amount, Ofgem is considering the use of forward-facing data which would require suppliers to forecast the peak CCB within the forthcoming quarter, and/or backward facing data where suppliers are required to protect the CCB at the beginning of the quarter. Ofgem notes that its current preference is for a forward-facing approach, but is seeking stakeholder feedback on this.

Ofgem sets out a number of pros and cons of each of the approaches. We are generally in agreement with Ofgem's assessment which we summarise and expand on in the table below.

Approach	Benefits	Challenges
Forward-facing	- Little or no costs will be mutualised on supplier failure	- Relies on supplier projections - Requires more effort from suppliers to evidence their approach, and from Ofgem to check - Will over-protect CCB for reasonable periods of time resulting in increased costs for suppliers and ultimately consumers but with little benefit

Back-facing	<ul style="list-style-type: none"> - Relies on actual supplier outturn data - Less effort to extract, evidence and review by suppliers and Ofgem 	<ul style="list-style-type: none"> - Will both under-protect and over-protect CCB for reasonable periods of time. - For those periods of over-protection, suppliers will incur higher costs with no benefit to consumers, and for periods of under-protection will lead to a level of CCB being mutualised on supplier failure
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We understand the attraction that a forward-looking approach has to Ofgem in almost eliminating risk of mutualised costs (assuming accurate supplier forecasting of the peak CCB), and the particular concern it has flagged in relation to the risk of supplier failure during Quarter 3 when CCB increase across the full period. We are not convinced however that the benefits of this cost mutualisation elimination outweigh the costs to suppliers and ultimately customers of always having the maximum CCB protected in any period.

Given that in many ways this policy is intended to partly act as a deterrent to inappropriate supplier behaviour in treatment of CCB, which should incentivise more responsible supplier behaviour and reduce supplier failure, we think there is a strong argument to use an approach with lower than peak protections for some periods. Such an approach would see some level of costs mutualised on supplier failure, but would see lower costs overall requiring passed to consumers.

In defining such an approach, we expect Ofgem will need to understand the costs and benefits within each of the quarterly periods, and assume that it will be able to do this using the data requested of suppliers in the recent RFI.

Whilst inherently simpler, we understand the risk identified by Ofgem regarding the backward-facing approach significantly under-protecting CCB in Quarter 3, and also note that it would create significant periods of over-protection within other quarters. We think there may be merit in Ofgem considering alternative approaches based on suppliers protecting an “average” level of CCB during each quarter, which while it would not necessarily take into account the peak, it would certainly mitigate the significant risk of using backward facing data during Quarter 3.

Like a forward-facing approach, an “average” approach would require suppliers to provide Ofgem with forward estimates of credit balances along with the balance at the start of the period. This would then require the same level of evidence and scrutiny to ensure the average protected amount is reasonable. We do not consider it to be too challenging or burdensome for suppliers to be able to provide such projections using historic trends alongside the CCB level at the start of the quarter and for Ofgem to review them.

We expect Ofgem will be better placed to assess the relative costs and benefits of each of the options.

Chapter 3: Renewable 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?

Preferred approach

We remain of the view that amending the legislation underpinning the RO would have been the most efficient and effective way to prevent RO liability being mutualised across consumers

following supplier insolvencies. Addressing deficiencies in the current RO scheme design through supplier licence obligations is less effective, requiring considerable compliance and monitoring activity from Ofgem to ensure the policy intent is achieved.

Ofgem has set out three licence-based options within this consultation document:

- Option 1 – a ‘report or protect’ obligation
- Option 2 – a ‘protect’ obligation
- Option 3 – a ‘protect or discharge through ROCs’ obligation

Of the three options Ofgem is considering we agree that Option 3 (‘protect or discharge through ROCs’) is the best approach. This option would require suppliers to evidence that their accruing RO obligation is being met on a quarterly basis either via holding ROCs, or protecting equivalent funds via an insolvency remote vehicle, or a combination of the two options. We think this option offers a number of benefits compared to the other options considered, including aligning more closely to the ROC scheme. We are not however convinced of the need for Ofgem to require suppliers to create a trust for the proceeds of the sale of any ROCs and we set out more detail of our thinking in response to Question 6 below.

Of the other options:

- Option 1, whereby suppliers are required to ‘report’ to Ofgem on a quarterly basis how they intend to meet their RO obligations, or ‘protect’ their obligation via an insolvency remote mechanism, is not Ofgem’s preferred option. We agree with Ofgem’s assessment of the risks inherent in this option, namely that for suppliers who choose to ‘report’ under this option, Ofgem’s ability to see issues and require the supplier to take necessary action is delayed leaving some potential for mutualisation remaining. Therefore it may not be effective at addressing the risk this policy proposal is intended to address .
- Ofgem has discounted Option 2 which would require suppliers to ‘protect’ their RO obligation via an insolvency remote mechanism regardless of whether the supplier has purchased any ROCs. We agree with Ofgem’s decision not to proceed with this option.

Scope of Suppliers Covered by the Requirements

Ofgem notes within the consultation document that the proposals would be limited to domestic suppliers only. However, we see no reason why the RO protections would not apply to non-domestic suppliers in the same manner as domestic suppliers. While historically those non-domestic suppliers who have failed and contributed to RO mutualisation costs have been small, we do not consider this to be a strong justification for not considering requiring current non-domestic suppliers to protect their RO obligations in the same manner as domestic suppliers.

If it is Ofgem’s intention that the policy would apply to only domestic suppliers then it will be important, to avoid market distortion, that Ofgem considers how the protections will be applied to those suppliers who supply both domestic and non-domestic customers, and thus have an RO obligation based on both customer groups. There is no detail within the consultation document as to how this would work.

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 are supportive of Ofgem's proposed approach to require suppliers to protect their RO obligations. Option 3 aligns closely with the approach we proposed in our response to Ofgem's open letter on this topic. Depending on the details, we do not consider that there would be significant impact to us (ScottishPower) and how we interact with the RO scheme.

Ofgem notes that one potential risk of Option 3 is that if a supplier becomes insolvent, and that supplier had chosen to use ROCs to discharge some or all of their accruing RO obligation, the value of the ROCs may not automatically act to reduce the costs at risk of mutualisation. We agree that this risk may arise with certain suppliers especially those assessed to be at higher financial risk.

We are however concerned that Ofgem's proposal to address this risk as part of Option 3 (ie to require a supplier to create a trust fund for the proceeds from the sale of any ROCs), has not been fully assessed within this consultation. This proposal appears similar to the proposals in subsequent sections relating to the liquidation of "in-the-money" hedges. We note that Ofgem has not presented the same level of analysis of risks and issues relating to this similar proposal for the sale of ROCs. Ofgem must fully consider any such requirement to ensure no unintended consequences or undue administrative burden, including creating additional costs with no benefit to consumers.

We do however understand the risk Ofgem is aiming to address, and propose an alternative approach should act to mitigate the risk without placing undue administrative burden on either Ofgem or responsible suppliers. Where, within a quarter, a supplier sells ROCs that it has used to discharge its RO obligation under Option 3, the licence conditions should require the supplier to:

1. Put in place alternative protections via one of the approved insolvency remote protection mechanisms (Ofgem should not limit this to only trust funds as this would only act to increase the costs of the policy); and
2. Notify Ofgem of the sale of ROCs and confirm that it has put in place alternative protections for its RO obligation.

Where, through its financial monitoring, Ofgem considers a supplier to present a higher risk, Ofgem could then take further action to engage with suppliers and request further information, for example, evidence of the mechanism used to protect the RO obligation previously covered by ROCs. We do not consider that suppliers will be selling ROCs used to discharge their obligation under Option 3 regularly, therefore do not consider the above approach to place a particular administrative burden on either Ofgem or the supplier.

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

Assuming Ofgem proceeds with an approach in line with that described under Option 3 (a 'protect or discharge via ROCs' obligation), we consider there would be little adverse impact on the ROC market. As with CCB protections, we note that it is likely to be appropriate to allow a transitional period to allow suppliers to prepare and implement the new measures, but the timing of this should be balanced against the desirability of protecting consumers earlier from mutualised costs.

As Ofgem itself recognises within the consultation document, it will need to ensure that any licence obligations are consistent with the Renewables Obligation Scotland (ROS) and we welcome the intention by Ofgem to work closely with the Scottish Government in this regard.

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 with Ofgem's proposals to have the full policy in place from April 2023 which represents the start of a new obligation period. We consider this should allow suppliers sufficient time to put in place the necessary protections and implement any changes to internal processes needed to support the new policy.

Ofgem is also proposing a phased transitional approach prior to this to mitigate RO mutualisation costs ahead of full implementation. This would take the form of a two phased approach covering:

- *"Immediately to 31 October 2022"*: suppliers would have to report to Ofgem via requests for information how they plan to comply with their RO obligations for 2021/22
- *"31 October 2022 to 31 March 2023"*: suppliers would have to report to Ofgem via requests for information how they plan to comply with their RO obligations for 2022/23

In each case, Ofgem would consider compliance or enforcement action where it identifies a risk that a supplier does not have sufficient financial arrangements in place to meet its RO obligation.

We see no risks or issues with Ofgem's transitional approach. While we consider it important that the full policy is in place as quickly as possible, we understand the need for a transitional period to ensure suppliers have time to make any necessary changes to comply with the enduring protection measures. However, we consider that responsible suppliers will have robust plans in place regarding how they intend to meet their RO obligations for 2021/22 and 2022/23 and therefore this additional reporting obligation should not place any undue burden on suppliers. We would of course ask Ofgem to ensure that it allows suppliers sufficient time to respond to the requests for information, and suggest that it issues drafts for comment ahead of formally issuing the requests to allow suppliers to comment ahead of the formal issue.

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

Ofgem is proposing requiring suppliers to protect their RO on a quarterly basis using a backward-facing approach.

We agree with Ofgem that a quarterly frequency feels like the right option in terms of balancing the need to protect RO obligations against the administrative burden on suppliers and Ofgem of doing so. We also agree with Ofgem's preference for a backward facing approach to protections. This aligns to other similar schemes and with the accruing of the RO obligation itself, therefore suppliers should be well placed to administer the scheme. While it will create a risk of some costs being mutualised on supplier failure, we consider on balance it should still deliver significant improvements to the market in relation to incentivising responsible supplier behaviour with respect to treatment of RO obligations and mitigate mutualisation of RO costs.

Ofgem is proposing aligning the timescales for this scheme with the quarterly Feed In Tariff levelisation schedule. This would require suppliers to have protections in place by the middle of the month immediately after the end of each quarter, ie for the first quarter of each scheme year (April to June), suppliers would have to present their protection to Ofgem by the middle of July, then by mid October, suppliers would have to present their protection for the first two quarters of the scheme year, and so on.

While we are supportive of this approach as it seeks to protect the previous quarter's accruing obligation as quickly as possible, we would note that Ofgem only issues ROCs around two and a half to three months after the month of generation. For example, for April, May and June 2022, suppliers will only receive ROCs from generators after 21 July, 22 August and 21 September 2022 respectively when Ofgem issues the generator with ROCs for each period. If Ofgem aligns the RO protection requirements with the FIT levelisation schedule, then suppliers hold additional ROCs from previous obligation periods, they will need to use one of the approved forms of protection to demonstrate compliance with this obligation prior to receiving ROCs. This could increase the cost of implementation of the scheme for suppliers and ultimately consumers and potentially create double counting of protection where suppliers submit ROCs to the Register during the period but also have protection in place via one of the approved protection mechanisms.

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?

Yes, we agree that suppliers should be able to choose from a menu of "approved" protection mechanisms to protect CCB and RO payments. We think this is the right approach to ensure different suppliers can use different protection options that allow them to implement the policy in the most efficient manner for their own business models.

Ofgem is currently proposing that its approved mechanisms would be:

- Trust Account;
- Escrow Account;
- Third Party guarantee (financial institution);
- Parent Company Guarantee; and
- Standby Letter of credit.

We are in general agreement with Ofgem regarding the current list of approved options, though would note that we would normally categorise a Standby Letter of credit as a subset of a Third Party Guarantee from a financial institution. We think these offer a reasonable range of options for different suppliers and should ensure that across the market, the policy can be implemented as efficiently as possible reducing the costs of implementation that are required to be passed to consumers.

We note that Ofgem intends continuing to assess potential additional options and will add these as "approved" mechanisms if they deem they meet the criteria required. We think this is a sensible approach. We would expect that Ofgem would consult on any changes to the "approved" list to ensure suppliers are able to comment on each ahead of any changes being made. Ofgem also notes its intention that the licence drafting will include how a supplier will be able to change the mechanisms it uses as protection over time, however no detail of how it proposes this would work is included in the current consultation.

In this regard, we welcome the early sight of the draft licence conditions (for both the CCB and RO policy proposals) which Ofgem has just issued to allow suppliers to provide comment ahead of statutory consultation. It is unusual for significant changes to be made at statutory consultation stage, and therefore having earlier sight of the licence drafting allows any potential unintended consequences from licence drafting to be identified as early as possible and in advance of the statutory consultation itself.

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?

Yes, we generally agree with the minimum requirements set out in the consultation document for each of the proposed “approved” protection mechanisms.

Again, Ofgem notes that the specifics of the minimum requirements will be included within the licence modifications and/or accompanying guidance. As we note above, we would welcome early sight of any proposed licence conditions and guidance to ensure stakeholders can provide comment in advance of the statutory consultation stage.

With respect to Third Party guarantees (and as such Standby Letter of credit) and Parent Company Guarantees, Ofgem notes a requirement that each organisation offering the guarantee have a “minimum credit rating” which we agree should be the case. Ofgem however does not include within this consultation document what this minimum credit rating should be. The drafting suggests that a similar approach could be adopted for each of these options, however from our experience we consider the risks of each are different and therefore that Ofgem should adopt a different minimum standard for each. Our view is that for third party guarantees from financial institutions, Ofgem should be requiring a minimum rating of A- by Standard & Poor’s or A3 by Moody’s, the lower of which should apply, while for Parent Company Guarantees a minimum rating of BBB- from Standard & Poors or Baa3 from Moody’s, the lower of which should apply, should be appropriate. The rating requirements for financial institutions should be of a higher standard and this is consistent with other industry requirements.

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 agree with Ofgem’s assessment regarding the potential for insurance to be available to suppliers on reasonable commercial terms (particularly at times of supplier stress) and consider Ofgem’s current approach to not include this within its range of “approved” options seems sensible.

For Chapters 5 and 6, Ofgem has helpfully agreed to a two week extension for our substantive response. At this point therefore we are providing only some high level thinking rather than responding to the specific questions and will follow up by the agreed 2 August deadline with a more detailed response.

Chapter 5: Hedging

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

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

As we have noted above, we do not intend providing responses to individual questions at this point and have provided only some high level thinking at this point which may change following further consideration of these questions.

Ofgem’s proposals in this area are seeking to address perceived risks of treatment of “in-the-money” hedges at the point of supplier failure. It notes concern from recent SoLR events which

have contributed to consumer detriment and note the time limited tax introduced by Government earlier this year in relation to the situation where hedges are not held by the supplier but by another company in the same group.

Ofgem considers that the most effective solution to the concern it has identified would need to be delivered via legislative change, however this would take significant time and therefore it considers a need to assess alternative options that would enable appointed Suppliers of Last Resort (SoLRs) to access the financial benefit of hedges positions of insolvent suppliers at this point.

Ofgem's options are:

- *Option 1: Licence change*
 - Require that the proceeds of "in-the-money" 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 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 also considered whether it would be possible to mandate a transfer of hedging arrangements from failing supplier to SoLR, but consider challenges undermine this as an option.

Our initial review of the policy proposals being assessed by Ofgem suggests real challenges in implementation, as well as risk of unintended consequences. Ofgem's assessment within the consultation document has highlighted a number of challenges with each option alongside the identified benefits. While we are still reviewing this in detail, we agree with the challenges with each option already highlighted by Ofgem, however consider there are others not considered by Ofgem at this point.

This proposal would represent a significant policy change and as such needs proper scrutiny to ensure any intervention is proportionate and does not create unintended consequences for the market and consumers. We will follow up by 2 August with substantive comments, however at this point if Ofgem is to move forward with intervention in this area, we would make the following observations:

- We think there will be significant risk to the investment perception of the market with any intervention in this space which must be considered within Ofgem's assessment of risks and benefits
- We think any intervention must be "two-sided". Ofgem has already highlighted a risk of a one-sided approach where the SoLR on behalf of the customers has the right to the benefit of in the money hedges, but does not have to contribute to the cost of liquidating out of the money hedges.
- Ofgem should consider the potential for any intervention altering the balance of risk and reward around hedging, thus distorting hedging behaviour by suppliers

- An alternative option could be to consider an adjustment to Option 2 which would see the obligation limited to only any excess funds that would otherwise be returned to shareholders as part of any liquidation process

As we have noted, this represents very early thinking and we will continue to discuss the proposals and evolve our thinking over the coming weeks. Our position set out above may change once our review of these questions has concluded.

Chapter 6: Capital Adequacy

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

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

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

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

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

As we have noted above, we do not intend providing responses to individual questions at this point and have provided only some high level thinking at this point which may change following further consideration of these questions.

In advance of providing more detail comments in our follow up response on 2 August, at this point our feedback is limited to the following.

- We are supportive of Ofgem giving further consideration to requiring suppliers to hold minimum levels of risk capital in their businesses.
- We agree that this will be inter-linked with other policy proposals on financial resilience, including the protections of CCB and RO payments, and agree that Ofgem must assess this to ensure no double counting of protections that add cost to suppliers and consumers with no benefits.
- We consider that a minimum capital requirement could potentially have a twin benefit.
 - First, the holding of risk capital will be set off against and reduce any costs that are mutualised on failure. So, for example, if the risk capital is sufficient to cover customer credit balances, there will be less need for prescriptive rules around ringfencing and the current rules could be reviewed in the future.
 - Second, whoever is providing the risk capital, be it the parent company or capital markets, will have a strong incentive to monitor the supplier risk

management practices – and may be able to do so more effectively than Ofgem.

- We agree with Ofgem that policy proposals in this area must be reviewed in the wider context of policy development and supplier monitoring, including stress testing, price cap methodology and supplier return, and the future retail market design activity.

Chapter 7: Impact Assessment

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

Ofgem's impact assessment is limited to only the CCB and RO protection policy proposals at this point. Ofgem notes that it is not publishing a detailed IA on hedging and capital adequacy proposals at this point however notes that the *"current IA indicates the general consumer benefits from a more resilient supply sector and further protection measures."* We consider it important that Ofgem completes a full IA on the hedging and capital adequacy proposals at an appropriate time. Each of the proposals represents a significant policy intervention and it is important that any intervention of this scale has been appropriately assessed as required by Ofgem's own consultation policy.

With respect the IA on CCB and RO protection proposals, we have no substantive comments to make on the detail within Ofgem's consultation or the NERA report at this point.

ScottishPower
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