

Cathryn Scott
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Dear Cathryn.

POLICY CONSULTATION – STRENGTHENING RETAIL FINANCIAL RESILIENCE

We submitted an initial response to your policy consultation on 19 July in which we commented on the proposals for protecting customer credit balances (CCB) and Renewable Obligation (RO) payments, and offered some initial high level thoughts on proposals relating to hedging and capital adequacy.

I am now writing to supplement that response with further comments on hedging and capital adequacy. Our responses to Questions 13 to 19 are in Annex 1. Our main points are as follows:

- We support Ofgem's intention to close the loophole whereby shareholders of an insolvent supplier can benefit from the proceeds of liquidating in-the-money hedges whilst the SoLR's hedging costs are mutualised. However, we think Ofgem's Option 1 is likely to be impracticable and Ofgem should focus on variants of Option 2. If Ofgem proceeds with Option 2, we believe it should make the supplier-SoLR obligation in reciprocal rather than one-way. We also think it should cap the obligation at the amount left over after creditors' claims have been satisfied.
- We support in principle Ofgem's proposals to introduce a capital adequacy regime, which we believe should run alongside the existing financial resilience measures and the more direct protections proposed for customer credit balances and RO payments. We would caution Ofgem against going too far in the direction of a risk-based approach. For the majority of suppliers with a reasonably standard business model we think capital requirements should scale broadly with turnover, with exceptions only where suppliers have objectively higher levels of risk.
- We urge Ofgem to prioritise its consideration of levels of capital currently employed by suppliers and hence the appropriate EBIT allowance in the price cap. Ofgem should not wait until it has settled on final capital adequacy requirements before updating the EBIT allowance but should urgently assess

levels of capital employed today (including risk capital and the substantial levels of working capital created by retrospective price cap allowances), and the typical weighted average cost of capital for suppliers, reflecting current market perceptions of risk.

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive, flowing style.

Richard Sweet
Director of Regulatory Policy

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

Ofgem makes reference to incidents in 2021, where it suspects that shareholders of failed suppliers were able to benefit from the proceeds of liquidating in-the-money hedges, at the same time as consumers were exposed to the significant hedging costs faced by the SoLR. We agree that this is an inappropriate outcome and support Ofgem in giving consideration ways of addressing it.

Ofgem has proposed two options to ensure that, in the event of insolvency, the proceeds of in-the-money hedges can be used to mitigate any additional hedging costs faced by the SoLR and hence reduce the extent of cost mutualisation:

- **Option 1: Licence change** - Require that the proceeds of “in-the-money” hedges, once liquidated, are paid directly into a trust established by the supplier when the hedges are taken out for the benefit of customers; in the event of insolvency, the funds in the trust would be made available to the SoLR.
- **Option 2: Contractual change** - Require a 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.

We largely agree with the risks and challenges identified by Ofgem for the two options, as set out below.

Challenges with Option 1

In the time available to respond to this consultation we have not been able to explore in detail the practicability of creating a trust from ScottishPower’s perspective, but we would note that:

- This option would drastically curtail the ability of existing creditors to recover their debts in the event of insolvency, with the risk of wider repercussions in the market. Any intervention such as this which shifts the balance of risk between creditors (who are not licensed by Ofgem) and customers should properly be introduced by Parliament via a change in insolvency law, not by Ofgem.
- Creation of the trust (or other form of security) arrangement could disrupt suppliers’ normal financing arrangements, including the example cited by Ofgem where the trust is inconsistent with a supplier’s (and its group’s) negative covenants in its existing debt arrangements, and therefore requires debt refinancing. Anything which adversely affects the perceived risk profile of the supplier will have a negative impact on credit ratings and cost of debt.

- Operation of the trust account structure is likely to be extremely burdensome operationally, particularly with regard to defining and applying any controls to limit withdrawals from the trust to “business as usual” purposes. (Trusts are not well suited to frequent withdrawal of money.) As well as adding significant administration costs, this could constrain or distort suppliers’ normal hedging activities leading to higher trading and transaction costs.
- The impact on suppliers’ hedging activities could be particularly complicated where energy trading is carried out for domestic and non-domestic customers or for a wider range of activities within a group. Any requirement to ring-fence and redesign hedging arrangements will add to setup and ongoing costs.
- Ofgem will need to consider how this intervention might distort the incentives around supplier hedging or indeed supplier decisions around timing of market exit. For example, would this have the effect of shifting the balance of risks in favour of not hedging so far forward? Would it make suppliers more risk averse, leading to earlier exit from market?
- The design of the scheme would need to recognise that there are two distinct ‘methods’ of hedging, bilateral/OTC market trades which are typically, but not always, uncollateralised (ie forward contracts) and exchange-based hedges which are collateralised (ie futures contracts). For exchange-based contracts, trades are represented not just by Variation Margin but also by Initial Margin, so it would be expensive to cash out on such trades (these costs also mean that such trades are not as in the money as it might first appear).
- Even if adequate controls can be imposed through licence conditions to ensure that proceeds are paid into the segregated account and not withdrawn inappropriately, there is still a risk that in the approach to insolvency company officers may not adhere to the rules .

We disagree with Ofgem that it would be necessary to ensure that Option 1 provides a ‘one way’ protection so that the SoLR (or transferred customers) are not responsible for hedging contracts that are ‘out-of-the-money’. As explained in response to Question 14, we think it would be fairer for the obligation to be two-way or reciprocal.

Challenges with Option 2

In the time available to respond to this consultation we have not been able to explore in detail the practicability of creating a trust from ScottishPower’s perspective, but we would note that:

- As with Option 1, this option would curtail the ability of existing creditors to recover their debts and would be better achieved by a change in insolvency law, not by Ofgem. If creditors face additional credit risk, this is likely to be reflected in the prices they charge to suppliers.
- It is unclear how the new debt obligation would be recognised for accounting purposes in terms of measurement and timing. If it alters the perceived risk profile of the supplier it may have a negative impact on credit ratings and cost of debt.
- The option will only work if the insolvency practitioner is willing to accept the debt claim from the SoLR, which will mean there is uncertainty over the effectiveness until

it can be tested in practice. As Ofgem notes, if the new contractual terms creating the debt to consumers are put in place after a supplier has started experiencing financial difficulties, this may be grounds for the insolvency practitioner to refuse the claim.

- In the event of a claim by the SoLR, the insolvency practitioner would need to assess the validity of a claim, including whether hedging costs had been reasonably, efficiently and necessarily incurred. While a specialist energy regulator such as Ofgem may be able to assess LRSP claims, this could be a significant challenge for an insolvency practitioner.
- As explained in response to Question 14, we think it would be fairer for the obligation to be two-way or reciprocal, so that the SoLR (on behalf of customers) owes a debt to the insolvent supplier in a situation where hedges are out of the money.

Overall, we consider that Option 1 is too extreme and presents too many legal, operational and financial challenges. We do not think it merits further consideration by Ofgem. Option 2 also presents significant challenges, but we consider Option 2 (or at least variants thereof – see response to Question 14) should be considered further.

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

As explained above, we believe Option 1 is impracticable and Ofgem should focus its consideration on variants of Option 2, pending an opportunity for legislative reform. We have identified two variations on Option 2 which we believe would strike a better balance between the interests of the various parties and reduce the risk of unintended consequences:

- Transferring only the residue of hedging proceeds after creditors' claims have been made good.
- Making the obligation in Option 2 two-way or reciprocal, so that where hedges are out of the money, there is an obligation from customers to the insolvent supplier.

Transferring only the residue of hedging proceeds

In this variant, only the residue of hedging proceeds, after all creditors' claims have been made good, would be transferred to the SoLR to help mitigate the SoLR's hedging costs. Although this approach would reduce the extent of the mitigation, it would have the advantage that it would not curtail creditors' existing rights, since only the surplus, which would otherwise have been returned to shareholders, would be transferred to the SoLR. In favour of this approach we would note that:

- Any intervention which has the effect of curtailing creditors' rights should properly be implemented by changes to insolvency legislation rather than supply licence conditions, as Ofgem acknowledges.¹ Parliament, rather than Ofgem is best placed to balance the competing interests of customers, creditors and other parties.

¹ Condoc para 5.9

- Transferring only the residue of hedging proceeds would still prevent the types of incident highlighted by Ofgem, where Ofgem suspects that certain insolvencies in 2021 may have resulted funds being returned to shareholders²
- Transferring only the residue of hedging proceeds would have a similar effect to the time-limited tax introduced by the Government in 2021 to address related risks, such as when the hedges are held separately by another company in the same group.³

We believe Ofgem should pursue this more limited option as an interim measure, pending changes to insolvency legislation.

Making the obligation in Option 2 two-way

Ofgem suggests that the obligation in Option 2 should be one-way (asymmetric), in the sense that suppliers would be obliged to pay customers (or the SoLR as a proxy for customers) the proceeds of in-the-money hedges that are liquidated upon insolvency, but there would be no reciprocal obligation on customers (or the SoLR on their behalf) to offset losses arising from out-of-the money hedges that are that are liquidated upon insolvency. We disagree with this position and believe that any obligation should be two-way (reciprocal).

Ofgem's thinking appears to have been influenced by recent market conditions, where markets have been rising sharply and SoLRs face significant hedging 'catch-up' costs. The situation is very different in a sharply falling market, where the SoLR can purchase energy much cheaper than assumed in the cap and has an opportunity to offer transferring customers a significant discount (or make a super-normal profit if they stay on SVT) as summarised in Table 1.

Table 1: Consequences for hedging positions in the event of supplier failure

	Insolvent supplier	SoLR
Rising market	Hedges will be in the money. (Insolvency potentially precipitated by supplier not being fully hedged and unable to match costs assumed in cap)	Significant cost to catch up with hedging profile assumed in price cap
Falling market	Hedges will be out of the money. (Insolvency potentially precipitated by supplier's inability to compete against acquisition tariffs on offer in the market)	Opportunity to offer transferring customers significant discount on price cap (or generate super-normal profits from customers remaining on cap)

Ofgem has recognised the circumstances of a falling market in its design of the market stabilisation charge, where the losing supplier receives compensation from the gaining supplier related to the out-of-the money hedge. In our view it would be anomalous if a supplier was able to acquire customers through the SoLR process without paying any compensation when it would have had to pay compensation to acquire the customers through normal market switching. This would discriminate unduly in favour of the failed supplier's customers and discriminate against the failed supplier's creditors and shareholders. The MSC is currently only a temporary measure, but we believe the considerations which led to the MSC's introduction are also relevant here.

² Condoc, para 5.6

³ Technical_Note_-_Public_Interest_Business_Protection_Tax.pdf (publishing.service.gov.uk)

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?

The case for minimum capital requirements

We broadly agree with Ofgem's proposed high level approach to a capital adequacy framework. As Ofgem notes, it has introduced a range of new measures to improve financial resilience (Financial Responsibility Principle, requirements on new entrants regarding funding, 'fit and proper' assessments, milestone assessments) but these are complementary to and not substitutes for a capital adequacy framework. The more targeted protections Ofgem is proposing for CCBs and RO obligations may to some extent substitute for wider capital adequacy requirements (and double counting should be avoided), but they do not remove the need for suppliers to hold additional capital to make them more resilient against potential shocks.

We agree with Ofgem that requiring suppliers to maintain sufficient minimum levels of capital will make them better able to survive market shocks and incentivise robust risk management (eg around hedging behaviour). Indeed, we see two key additional benefits:

- 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.

Risk-based requirement

As explained in response to Question 16, we agree that the capital adequacy regime should be broadly reflective of the different levels of risk faced by different categories of supplier, but we would caution against Ofgem getting drawn into detailed supplier-by-supplier risk assessments for the purpose of setting capital requirements. For the majority of suppliers with more or less standard business models, we suggest Ofgem should set overall capital requirements by reference to a measure of scale such as turnover. Only where there is evidence that a supplier's business model is distinctly riskier than the norm should Ofgem impose additional capital requirements.

Implications for EBIT margin in price cap

We welcome Ofgem's intention to address the allowed EBIT margin in the price cap as part of this workstream, but we are concerned that Ofgem is not treating this aspect with sufficient urgency. The inability of suppliers to earn a return on the capital they have tied up in the retail market is in itself a key threat to resilience and investor confidence. It is vital that this weakness in the price cap methodology is addressed urgently alongside other price cap issues, to provide reassurance to investors over Ofgem's direction of travel. This is a complex area which will require careful consideration, and we believe Ofgem should prioritise early working papers or consultations on key issues such as:

- The amount of risk capital (or equivalent) that suppliers currently hold or may be required to hold in future. We presented arguments to the CMA Energy Market Investigation (based on historical patterns of supplier losses) that suppliers such as ScottishPower were effectively committing hundreds of millions of pounds of risk capital – arguments which the CMA disregarded for the purpose of its EBIT allowance but which have been vindicated by recent market developments. Although the EBIT allowance may ultimately be driven by the minimum capital requirements set by Ofgem, Ofgem should consider transitional adjustments to the EBIT allowance to reflect the levels of risk capital currently held by larger suppliers.
- Working capital requirements and how these have changed since introduction of the price cap. Ofgem has repeatedly rejected requests for financing costs to be included in price cap allowances where there is a lengthy delay between costs being incurred and recovered, on the grounds that suppliers should be able to finance the working capital through existing arrangements.⁴ In our view a typical supplier's working capital requirements have increased materially as a result of these price cap delays, and Ofgem is wrong to disregard the associated costs.
- The appropriate weighted average cost of capital for suppliers. This is a complex question since the cost of capital will depend on the perceived risk, which in turn will depend on the level of risk capital held by suppliers and the market's perception of regulatory risk (such as created by flaws in the price cap methodology).

Ofgem says (para 6.20) that it will want to consider whether an EBIT margin that scales fully with the bill level remains appropriate in light of the impact of recent high price volatility on consumer bills. In our view, the level of risk capital (and indeed working capital) required by a supplier is likely to scale with turnover, so it seems appropriate that the EBIT margin should scale with bill level.

Design of capital adequacy framework

It is too early to comment in detail on Ofgem's proposals but we generally support Ofgem's intention to learn from the tried and tested principles employed in the banking sector. The detail would need to be refined to suit the energy sector then appropriately calibrated.

We are less persuaded that the insurance-based approach in the aviation sector would offer a useful model for the energy sector but agree that it is worth considering.

Given the timescales to raise additional equity finance, a key consideration will be the extent to which the capital adequacy requirements should vary dynamically, eg in response to changes in market or individual company circumstances, or set on a longer term basis reflecting, eg changes in supplier turnover.

⁴ Recent examples include: the delay between incurring COVID bad debt costs and receiving the associated allowance (May 2022 consultation on the true-up process for COVID-19 costs); and the financing costs of the backwardation allowance (August 2022 decision on changes to the wholesale methodology).

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?

Ofgem says its minded to position is that an enduring capital framework would need to have some element of risk sensitivity and supplier segmentation, and the majority of suppliers it has engaged with also have supported a risk-based framework despite some added complexity, compared to more blunt 'one-size-fits-all' approaches.⁵

As noted above, we agree that the capital adequacy regime should be broadly reflective of the different levels of risk faced by different categories of supplier, but we would caution against Ofgem getting drawn into detailed and intrusive supplier-by-supplier risk assessments. It would make sense for any segmentation to take account of high level characteristics of the supplier such as:

- Domestic versus non-domestic;
- Relative proportion of licensed versus non-licensed activities.

For the majority of suppliers with more or less standard business models, our initial view is that Ofgem should set overall capital requirements by reference to a simple measure of scale such as turnover. Only where there is evidence that a supplier's business model is distinctly riskier than the norm should Ofgem impose additional capital requirements. As a general rule, we disagree with the stakeholders who told Ofgem they favoured a risk-based approach to a capital adequacy framework, including Ofgem evaluating suppliers' competence, governance, and maturity. We also disagree with stakeholders who thought that requirements should apply only to new entrants.

This is based in part on our view that capital markets are likely to be better placed to assess risk than Ofgem - and better able to impose constraints (as a condition of loan) on suppliers' approach to risk management. Although we understand Ofgem intends to conduct its supplier stress testing exercises on a regular basis, we think Ofgem should be very cautious in using the results of these exercises to derive tailored supplier-specific capitalisation requirements. This could create perverse incentives on suppliers to game the process or under-state risk (particularly given the asymmetry of information between suppliers and Ofgem) and thus reduce the value of stress testing for Ofgem. It would also raise the stakes and make the whole process significantly more onerous.

In terms of the trade-offs illustrated in Table 5, we believe Ofgem should lean towards 'High restrictions, lower ongoing monitoring'.

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?

Ofgem lists the following eight generic risks.⁶ This seems reasonably comprehensive, although we would note that one of the most significant, political and regulatory risk, is absent.

- Price risk

⁵ Condoc, para 6.31

⁶ Condoc, para 6.35

- Churn/ volume/ demand risk
- Counterparty credit risk
- Liquidity risk
- Other market risks
- Credit risk
- Operational risk
- Systemic risk.

These risks will vary in significance through the economic cycle and we are not convinced that it will be appropriate to link capital adequacy requirements too closely to specific risks. Indeed, any risk modelling undertaken at present is likely to be heavily influenced by the price cap regime, which is unlikely to be in place on an enduring basis. Rather, we think it may be better to set the overall capital requirement on a more holistic basis, taking into account the statistics of supplier profits and losses over a reasonable period of time (to form a view on the likely range of losses that might need to be absorbed) together with the output of stress test modelling across a range of suppliers.

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?

As Ofgem notes, there are a number of trade-offs to be considered in determining the appropriate level of resilience that should be targeted, notably the costs and benefits to consumers, and we think it is currently too early to give a view on the best approach.

As part of this consideration, we would note that Ofgem will need to consider the appropriate metric for resilience, which could for example be expressed as:

- The risk that a supplier will become insolvent in any given year;
- The maximum loss (eg '1 in n years') that a supplier should be able to withstand
- A standardised 'shock' that the supplier should be able to withstand.

We do not at this stage have a firm view on the appropriate time horizon.

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?

We broadly agree with the high level categorisation of capital presented in the consultation document.⁷ We think Ofgem is right to focus on 'going concern' rather than 'gone concern' resources and in the case of going concern resources to distinguish between:

- **Going Concern capital** (on balance sheet): equity, retained earnings, reserves, and any other perpetual capital instruments that are sufficiently subordinated;
- **Contingent capital** (off balance sheet): credit facilities, letters of credit, overdraft facilities, parent company guarantees.

⁷ Condoc, paras 6.44 to 6.52

We agree that it will be necessary to consider the extent to which any regulatory capital measure is set at a subsidiary versus group level

In ScottishPower's case, we largely make use of contingent capital in the form of parent company guarantees.

ScottishPower
August 2022