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David Hall,
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Ofgem
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By email only: RetailFinancialResilience@ofgem.gov.uk

Dear David,

Statutory Consultation: Strengthening Financial Resilience

Thank you for the opportunity to comment on Ofgem's latest proposals about strengthening supplier financial resilience. In our response to Ofgem's July policy consultation, we were strongly in favour of the swift implementation of ringfencing customer credit balances (CCBs) and RO payments. At the same time, we agreed with Ofgem's overall shift to a more prudential-styled framework for energy regulation.

We are disappointed that Ofgem has decided to abandon its proposal to require compulsory ringfencing of CCBs and surprised Ofgem has moved so quickly to implementation of capital adequacy via a statutory consultation, given the limited discussion on it in the July consultation.

Notwithstanding our views outlined above, implementing something quickly to reduce the moral hazard is essential; for this reason, we support the ringfencing of RO and implementation of minimum capital adequacy requirements by March 2025 at the latest. The dates outlined by Ofgem must not slip and the proposals must not be diluted.

Appendix 1 provides our responses to Ofgem's consultation questions and appendix 2 provides feedback on the associated draft licence conditions.

Should you have any questions, please do not hesitate to contact us.

Yours sincerely,

Steve Davies
Head of Regulation

Appendix 1

Question 1: Do you agree with our package of proposals and overall approach?

As mentioned in our cover letter, we were strongly in favour of the swift implementation of ringfencing customer credit balances (CCBs) and RO payments to immediately change the behaviour of any supplier relying on customers' money to fund other parts of their business and significantly reduce the moral hazard. At the same time, we agreed with Ofgem's overall shift to a more prudential-styled framework for energy regulation but suggested that Ofgem should take time to assess the role of capital adequacy alongside other forms of prudential-style regulation to enable a coherent framework to be established.

Although we are disappointed that Ofgem has decided to abandon its proposal to require compulsory ringfencing of CCBs we are supportive of ringfencing RO and the implementation of minimum capital adequacy requirements by March 2025 at the latest.

We are concerned however, that Ofgem appears to have missed a number of steps in implementing its new prudential-style regulatory regime. It is being implemented from the bottom-up, with several specific and distinct regulatory tools with varying degrees of effectiveness. Ofgem needs to develop an overall vision for this new regulatory model and a framework to articulate how each component fits with the others, and how they work alongside existing regulation. We are already seeing evidence of disjointed and overlapping regulations, RFIs and other requirements which are a symptom of not having this in place.

As Ofgem highlights, the capital adequacy regime has a direct link to the design of the price cap. As we outline in our response to the EBIT consultation there are serious flaws in the design of the price cap that are leading the market down a path towards limited competition, where all suppliers look and act in the same way (based on the notional supplier), and with limited innovation. A capital adequacy requirement based on the current price cap design further embeds the consequences of this model. This is something Ofgem needs to actively and transparently choose rather than it emerging as an unintended consequence of multiple, detailed policy choices over a longer period.

The Pillar 2 elements of the enhanced FRP are likely to have limited impact. In the main this is because, in our view, they are largely unenforceable. By the time a supplier is struggling financially Ofgem will either be unable to use its powers for fear of creating further financial distress or distortion to competition or, where Ofgem does attempt to use its powers, the supplier will have nothing to lose by gambling in an attempt to survive. Ofgem can't impose financial penalties on an insolvent supplier.

Financial Responsibility Principle

Question 2: Do you agree with our proposal to enhance the FRP to require suppliers to ensure there is no significant risk that liabilities cannot be met as they fall due?

We agree with the principles of the enhanced FRP. E.ON has always had thorough risk management controls in place and has always ensured it is sufficiently capitalised. That some suppliers have not illustrates one of the unsustainable cost advantages for those suppliers that ultimately lead to their failure. It is crucial that all suppliers are held to sufficient standards.

We have reservations about the effectiveness of the EFRP in practise which we outline below. Ofgem's ability to monitor and enforce the EFRP before a supplier becomes distressed will be the key determinant of its success.

As described throughout this consultation, we support in principle what Ofgem is trying to do but it needs to develop a clearer framework for the role of prudential-style regulation alongside existing regulation. Ofgem has not shared the outputs of its reviews of regulation in other sectors, to show which elements of prudential style regulation it has adopted and why, and which aspects it has not. Currently, the framework is being built from the bottom up, with implementation of technical elements without the overall vision or framework to set out what Ofgem is trying to achieve and how each element of the framework contributes.

Question 3: Do you agree with our proposed approach to FRP reporting, including Trigger Points and annual self-assessment reporting?

Since the supplier failures of 2021, Ofgem has acknowledged that changes to its regulatory regime have been required to ensure suppliers operate sustainable and resilient business models. As a result, Ofgem outlined, in its December 2021 Action Plan on Retail Financial Resilience, proposals for an enhanced monitoring regime and its intent to follow up with suppliers on the results of the data provided. The Oxera report, commissioned by the GEMA Board, along with the findings from the BEIS Select Committee on Energy Pricing and The Energy Supplier Market Report published by the National Audit Office, all highlighted the weaknesses in Ofgem taking a reactive approach to monitoring in the past. A more proactive approach is welcomed by E.ON.

We are however, concerned that Ofgem's reliance on suppliers to notify them (self-report) when a Trigger Point is about to be or has been reached, is not in line with this proactive approach outlined in the Action Plan. Many suppliers experiencing financial stress may be reluctant to alert Ofgem to this. An unscrupulous supplier facing significant financial challenges could easily decide not to self-report issues to Ofgem in line with proposed requirements or be dishonest in reports they make (noting they may well have nothing to lose), we suspect this has happened in the past. Other suppliers may simply be overly optimistic about their situation and reflect this optimism in their reports to Ofgem. Although Ofgem would still be in receipt of monthly FRP and stress testing data, it will only be of use if it contains the data Ofgem requires to be identify when a supplier is experiencing financial challenges. At present it is very possible for a supplier to fail before Ofgem is able to take any action which will help reduce the costs of mutualisation.

Even where a supplier does comply with the EFRP and report information honestly and accurately, it is not clear what action Ofgem can take to improve the situation without causing further distress. For example, if a supplier is beginning to struggle, requiring ringfencing of credit balances is likely to be impossible or would push that supplier further into distress. We note that Ofgem's proposals on discretionary ringfencing would not be of an amount that has an adverse effect on the licensee's ability to finance its activities. As a consequence, we cannot see a situation where a supplier would be directed to ringfence a portion of its credit balances. Similarly, a supplier that is struggling to survive is unlikely to be concerned by the threat of enforcement action - if it's failing anyway, it has nothing to lose by gambling to survive.

A more beneficial and robust approach to Ofgem's reporting regime would be to make the most of the existing tools in place which monitor supplier financial resilience. As mentioned above, Ofgem already issues a monthly Financial Responsibility Principle and stress test RFIs will be issued quarterly from 2023. Ofgem should take a holistic view of the various financial resilience tools already in place and evaluate the changes required to incorporate the proposed Trigger Points into this suite of reporting. Ofgem would then be able to take action proactively should it identify potential issues with the data received.

Ofgem recently consulted on the stress test RFI with the aim of making enhancements in the New Year. Ofgem should take the responses to that consultation into account when reviewing the responses to this consultation. Now is the perfect opportunity to review all financial resilience reporting to ensure it is set up to provide Ofgem with the intelligence it needs to act swiftly should any concerns present themselves through the data. It is imperative that Ofgem makes full use of the data it receives and engages with suppliers where necessary at the earliest opportunity.

As part of this approach, Ofgem should engage regularly with suppliers through working groups and bilaterals to ensure future financial resilience reporting is set up for success. This should, in future, reduce the potential for changes to the data requested and the relatively short timescales to turnaround new requests. We note Ofgem's proposal to notify suppliers of any changes to the questions for regular reporting at least two weeks before the deadline. It is difficult to determine whether this timeline would be sufficient in all cases as it depends on the data requested. We would, however, advise that a more sensible approach would be to notify suppliers at the time of issuing a monthly RFI of any changes that will come into effect from the following month. This will give suppliers the opportunity to review the request and revert back to Ofgem if necessary.

We recognise Ofgem is attempting to streamline reporting requirements, we still have a confusing set of overlapping, regular RFIs that take an increasingly significant amount of resource to complete. Suppliers need a much clearer view of the framework so they can plan and prepare resource accordingly. We note that the reporting burden is now at a level that is likely to require dedicated resource, this needs to be reflected in operating cost allowances under the price cap. Ofgem stated in its December Action Plan on Retail Financial Resilience, *"To oversee the market efficiently, in the longer term we need a more sophisticated approach to collecting and managing data. Our vision is to consolidate and improve how we collect this data and digitalising collection and analysis to reduce burden on suppliers"*. So far, our experience has been the opposite.

Ofgem's proposals to introduce an annual self-assessment were not mentioned in its original policy consultation and are, at this stage, very high level. Ofgem has not yet indicated when these would be issued to suppliers or the timescales for responding. In principle we understand why Ofgem may be interested in the information it is proposing to request however, as mentioned above, Ofgem should first look at how existing tools can be used to gain the right level of understanding of a supplier's financial resilience. We recommend that Ofgem makes use of working groups and bilaterals already mentioned to help inform its early proposals in this space.

Question 4: Do you agree with our proposal regarding the notification and monitoring approach for reliance on CCBs – including the proposed 50% of total assets threshold –or would it be more beneficial to set a prescriptive maximum reliance on CCBs?

No, we do not agree. As outlined in previous consultation responses, our view is that ringfencing of credit balances should be implemented for all suppliers in the short term whilst proposals on capital adequacy measures were developed. As we describe throughout this consultation, we recognise that Ofgem has chosen to implement capital adequacy measures more quickly in place of ringfencing of CCBs. Notwithstanding this overall view we provide comments on Ofgem's proposals below.

The proposal requires suppliers to proactively notify Ofgem should they meet a certain threshold. Ofgem should instead, in line with its action plan, be taking proactive steps of its own to identify when a supplier has met a defined threshold through existing reporting as part of the FRP RFI and/or stress test RFIs. This will help avoid the situations of the past where suppliers have failed almost overnight leaving a significant amount of costs to be mutualised. An overreliance on CCBs to fund their business was a contributing factor to the supplier failures of 2021 and it's unlikely that this would have been self-reported to Ofgem.

If an overreliance on CCBs remains an issue, some suppliers are not meeting existing licence conditions and Ofgem should already be taking action as a result. Suppliers should not be relying on CCBs at all as customers can ask for this money to be returned to them at any time and, should a significant proportion of customers choose to do this, a supplier may become insolvent as a result.

Ofgem gives no evidence about why it has chosen a trigger of 50% of total assets so it is difficult to comment on whether this is appropriate. Ofgem should review the information it has about failed suppliers to understand at what point it would/could have required ringfencing and whether that supplier could have responded. We suspect Ofgem's proposed arbitrary trigger based on CCBs as a share of total assets is not sufficient to drive action quickly enough to prevent mutualisation of costs (either using total assets as the measurement or the % threshold).

Question 5: Do you agree with our approach requiring notification by suppliers ahead of non-essential payments when in breach of the FRP, and regarding the ability to direct hard ringfencing of CCBs?

We understand the intentions of these proposals, however, it will be challenging for Ofgem to enforce either of them.

In relation to requiring suppliers to notify Ofgem ahead of non-essential payments, our points raised in answer to some of the earlier questions remain. Should a supplier experience financial challenges, there is a real risk that it will seek to extract value from the business as swiftly as possible for their own gain. Actions like these were reported during the many supplier failures of 2021. Ofgem's proposals would not prevent a supplier from taking these actions in future (it might simply change the actions or timing of actions), leaving the related costs to be mutualised should it become insolvent. We urge Ofgem to make the most of the insight it can gain from regular, meaningful reporting as already referenced above.

E.ON has long been a strong advocate of ringfencing CCBs and we are disappointed that Ofgem has decided not to take its proposals forward as outlined in the related policy consultation. Given

Ofgem's shift in focus to implementing capital adequacy measures alongside other requirements, we do not understand how Ofgem would also be able to direct hard ringfencing of CCBs to an individual supplier. Where a supplier is unable to meet the capital adequacy requirements or other standards of financial resilience, a supplier may not be able to ringfence CCBs as directed without it causing significant detriment to them i.e. insolvency. In addition, once a supplier has ringfenced a proportion of its CCBs it will then become more difficult for that supplier to meet the other obligations under the financial resilience proposals. We note that Ofgem would require ringfencing of an amount which "*will not have an adverse effect on the licensee's ability to finance its activities such that the level of required ringfencing is likely to cause the licensee to exit the market due to insolvency*". In our view, the reality is this condition combined with the threshold means Ofgem would never direct hard ringfencing, so we are concerned that this approach does not reduce the risk of mutualisation of CCBs much, if at all. By the time Ofgem intervenes and requires ringfencing it is already likely to be too late.

Requiring ringfencing on a bespoke basis for an individual supplier risks interfering with the competitive market and will make it extremely challenging for Ofgem to implement. A supplier subject to the requirement will legitimately argue that Ofgem has limited its ability to compete and may well cite Ofgem's actions as a reason for further financial distress.

Minimum Capital Requirement

Question 6: Do you agree with our proposed approach to the minimum capital requirement, including our proposed longer-term trajectory as well as our transition minimum capital requirement for 2025? What is your view on our proposed range for the 2025 minimum capital requirement amount?

Ofgem's financial resilience policy consultation demonstrated that its thinking on capital adequacy was at an early stage and its proposals at the time were put forward to complement the proposed requirement to ringfence CCBs. In light of Ofgem's shift of focus from CCBs to capital adequacy, it is right that Ofgem explores this topic more thoroughly to understand the risks suppliers face and the implications for the levels of capital they should hold. Ofgem is also right to acknowledge the link between capital adequacy and supplier returns.

It may be appropriate to introduce minimum requirements on capital adequacy in 2025 however, at this stage, there are some key decisions that need to be made about the price cap and supplier returns before being able to comment on the proposed target of £110-220 of net assets per customer.

In addition, Ofgem should evaluate the impact of ringfencing RO payments before committing to how capital adequacy should be treated in 24 months' time. The regular reporting referenced throughout this response should go a long way to informing Ofgem about suppliers' financial resilience and help guide next steps.

We note the lack of engagement on this topic since the policy consultation closed and would welcome the opportunity to discuss these proposals as part of a working group and through bilaterals over the coming months to help Ofgem devise robust proposals on this topic. This should not impact the proposed 2025 implementation date in any way.

The target level of £110-220 is based around the capital employed implied by the price cap. Ofgem extends this requirement to all customers, not just those subject to the price cap. Ofgem presents no evidence to suggest the capital employed for an SVT customer is the same as a non-SVT customer. In our response to Ofgem's consultation on the EBIT allowance we highlighted that many of the risks suppliers face, for which they need to hold risk capital, are a direct result of a flawed price cap design. Therefore, Ofgem needs to consider the impact of price cap design on the capital adequacy requirement (i.e. note that price cap design itself is driving some of the capital adequacy requirement). The target level is something that can be determined longer-term following a more robust analysis at a later date.

Ofgem describes the minimum capital requirements as Pillar 1 elements, supplemented by Pillar 2 (the enhanced FRP set out in chapter 2). As we outline above, we are concerned that the Pillar 2 elements are largely ineffective and unenforceable. Ofgem also sets out a long-term view that the minimum capital requirement should be closely informed by what they are compensated for under the price cap. As we outline in our response to the EBIT consultation, this principle of price cap design, assuming all suppliers incur the same costs in the same way, removes diversity in the market and undermines competition and innovation. Suppliers will all need to act like Ofgem's notional supplier in order to survive (whether than be making a return under the price cap or being able to meet capital adequacy requirements). We note that in other markets, capital adequacy requirements have flexibility built in that reflect the risks a particular company incurs because of the way it runs its business but based on a common framework. For example, a supplier who decides not to hedge is by default taking more risk than a supplier that hedges and should face a higher capital adequacy requirement to account for this. Aligning a one-size-fits-all capital adequacy requirement to a one-size-fits-all price cap leads the market down a path toward limited, if any, competition in future. This is a fundamental question that Ofgem needs to draw out and review urgently as it is currently making detailed technical decisions without the overall view of where it is heading.

As outlined in our response to the EBIT consultation, and notwithstanding our overall concern with the use of the notional supplier modelling described above, Ofgem's assumptions about the notional supplier are flawed. In paragraph 3.21 Ofgem states an assumption that the notional supplier "*is sufficiently efficient to recover its costs under the cap over a projected two-year period.*" Ofgem recognises in the EBIT consultation that the vast majority of suppliers have been loss making over the last three years. This clearly shows that suppliers are not able to recover their costs under the cap so Ofgem should not assume that the notional supplier can do something that real suppliers can't.

In paragraph 3.25 Ofgem proposes to exclude capital requirements for collateral due to the range in collateral arrangements across the market. Ofgem should reconsider this approach and take account of the different ways suppliers run their businesses to help ensure they have the right level of capital to support collateral. It is not logical to simply exclude a potential driver of capital because other suppliers structure their businesses differently or the notional supplier behaves in a different way. Should a supplier become insolvent due to lack of capital to support collateral, it would be odd for Ofgem to explain this by comparing it to the way the notional supplier would operate its business and therefore wouldn't require collateral. Ofgem states this is best dealt with under Pillar 2 requirements, but it is not clear how the Pillar 2 requirements will help.

Question 7: Do you agree with our proposed approach of setting the minimum capital requirement on a per-customer basis, or do you have a preference for a volumetric approach? In the case you prefer volumetric approach, what calculation method is most appropriate?

We agree that any approach should be simple to apply and a per customer basis sounds sensible.

Question 8: We set out a range of issues that may need to be considered in the future as we ratchet up the minimum capital requirement, including differences between tariff types and payment types. Do you agree with our proposal to consider these in future consultation, and to treat all tariff and payment types the same in our first minimum capital requirement? Do you have suggestions on how best to reflect the different drivers in the range of competitive tariffs versus SVT tariffs? Are there other elements that you think would be a significant driver of differences in capital needs across tariff offerings that we should consider?

Yes, we agree. As mentioned above, any approach should be a simple as possible to apply and consultation on a change to this approach is sensible.

In paragraph 3.39 Ofgem states that the main driver of the difference between fixed term contracts (FTCs) and SVT is backwardation risk. Backwardation is certainly a difference but there are many more that need to be taken into account. Most notably, the price cap is a free option that suppliers are forced to provide; it creates risks when prices rise (customers on FTCs can switch to the cheaper SVT even though the supplier may not have hedged for them) and when prices fall (customers can switch away from SVT when cheaper FTCs are available leaving the supplier with an out of the money hedge). We provided detailed analysis on this effect and its costs alongside our response to Ofgem's original EBIT consultation[1].

Question 9: What is your view on our proposed approach to considering alternative sources of funding?

Whilst we understand Ofgem is trying to ensure there is a range of ways for suppliers to meet the 2025 capital adequacy arrangements, any alternative source of funding should be subject to rigorous evaluation and consultation in a similar way to the protection mechanisms outlined in the consultation.

Ofgem should have a defined list of alternative sources of funding, with associated qualifying criteria, which remains flexible enough to be amended should a new source of funding become available or if an existing source of funding is deemed to be no longer fit for purpose. Any alternative sources of funding put forward as part of a response to this consultation or at a later date should be subject to consultation to ensure the right level of scrutiny is applied and feedback on its suitability can be assessed prior to being added to the list of options.

With regard to licensees that supply both domestic and non-domestic consumers, Ofgem stated in paragraph 3.46 that, *"reporting on compliance with the minimum capital requirement required under*

[1] Oxera_Ofgem consultation on EBIT allowance

the enhanced FRP should also seek to explain any split of assets between the supply business for non-domestic supply versus domestic supply". Ofgem should be mindful that some suppliers will hold

certain assets centrally within the licensee and therefore will need to provide guidance as to how those assets should be split between Residential and SME for example.

Ringfencing RO receipts and CCBs

Question 9: Do you agree that suppliers should protect 100% of their RO (attributable to domestic supply) from the 2023/24 scheme year onwards on a backwards-facing basis? If not, what do you consider to be the optimal implementation period, and why?

We agree that suppliers should protect 100% of their RO (attributable to domestic supply) from the 2023/34 scheme year. In order for these proposals to be implemented successfully, it is essential that they are applied consistently across domestic suppliers without exception. Any approach other than market-wide application would defeat the object of introducing the requirement and undermine competition in the market.

We note however, reference in the draft licence conditions to the RO Timetable which suppliers will be required to adhere to. In the absence of the inclusion of a draft timetable as part of the consultation and given the proximity to the beginning of the next RO scheme year, Ofgem should issue suppliers with an indicative timetable as soon as possible to enable them to prepare for the upcoming changes.

Question 10: How, and to what extent, might our proposals for RO ringfencing impact the way in which your company interacts with other Government schemes?

Question 11: Would you envisage ringfencing your RO using a Protection Mechanism, protecting ROCs, or using a mixture of the two?

A mixture of the two.

Question 12: Do you agree that the proposed price cap allowance is appropriate to account for the costs that an efficient supplier might incur in ringfencing their RO receipts? (See appendix 1)

A recognition of any cost is important but, as set out in our response to the EBIT consultation, one price will not suit all business models and the flaws in the design of the price cap need to be rectified to account for the varying operating models in the market.

Protection Mechanisms

Question 13: What are your views on the minimum requirements that should be set for the Protection Mechanisms, including our proposals around minimum credit ratings?

The minimum requirements proposed seem, on the whole, sensible and should provide Ofgem with the confidence they need that supplier can meet its relevant financial obligations.

For First Demand Guarantees, we note the requirement for them to be provided (or confirmed) by a person established within the United Kingdom. As standard practice, counterparties usually accept a PCG from outside the UK as long as it's a guarantee governed by UK law. Some counterparties may require the provider of the PCG to purchase a legal opinion from an external law firm, to confirm that the counterparty will be able to confirm against the foreign entity under the guarantee. This option should also be available to suppliers as it will provide Ofgem with the same level of assurance as a UK PCG.

Additional topic not covered by consultation questions: Ringfencing of CCBs

We note Ofgem asks no questions about its decision not to require ringfencing of CCBs. As outlined above, our strong preference was to quickly implement ringfencing of CCBs to reduce the moral hazard in the UK supply market then take the time to review aspects of prudential-style regulation (including capital adequacy) that may have benefits for consumers in addition to ringfencing of CCBs (or instead of). Ofgem has instead decided to abandon the ringfencing of CCBs and rush through a minimum capital adequacy requirement. We remain of the view that it would be better to implement ringfencing of CCBs quickly to allow more time to consider the best way to implement capital adequacy and other forms of prudential-style regulation. We are concerned Ofgem is building a new regulatory framework from the bottom-up rather than from the top-down. However, there is an urgent need to implement some form of protection so, on that basis, we will work with Ofgem to implement capital adequacy requirements quickly. However, alongside this it is essential that Ofgem takes the time to consider and articulate the overarching vision and framework for this new regulatory regime.

Appendix 2

Comments on proposed Licence Conditions

Licence condition/ definition	Wording	Comments
"First Demand Guarantee"	An irrevocable, independent, primary, and autonomous (in all circumstances) guarantee	The primary obligation should sit with the contracting entity. This should be a guarantee in the event that the contracting entity doesn't fulfil its obligations, not a requirement to pay in the first case. Appropriate measures should be taken to obtain funding from the Company before calling on the Guarantee.
"First Demand Guarantee"	a) it does not contain any surety defence waivers	The Guarantor should be entitled to all defences to which the Guarantor or Obligor is entitled to under the Agreement or otherwise. Claims should not be able to be made against the Guarantor once any proceedings against the Company in respect of such claim would be statute barred.
"First Demand Guarantee"	b) it is issued in favour of the Authority as beneficiary, or in favour of any other beneficiary that the Authority shall nominate;	We are not comfortable with these rights for free assignment. Suggest revised wording which explains who the 'other beneficiaries' could be.
"First Demand Guarantee"	f) it provides for all demands to be full, final and conclusive proof for all purposes of the guarantee of their contents, including (without limitation) that the entity issuing such a guarantee may not dispute any demand on these matters;	This essentially says that the demand could be completely wrong / contain errors etc. and the Guarantor has no right to dispute it.