Energy UK

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22 December 2022

Dear David

Statutory Consultation – Strengthening Financial Resilience

I am writing in response to Ofgem's policy consultation on Strengthening Financial Resilience, and in particular, the proposals to introduce a capital adequacy regime and ringfencing of Renewables Obligation (RO) receipts in domestic supply.

This is a high-level industry view - Energy UK's members hold different views on aspects of the consultation. We particularly focus on processes relating to the proposals in this response.

Energy UK supports Ofgem's objectives of strengthening financial resilience in the energy retail market to create protection and benefits for current and future customers. We welcome Ofgem's recognition that regulatory interventions should strike the right balance between competition and customer protection. Ofgem has a duty to ensure that existing suppliers are resilient and can finance their activities and that new entrants have sustainable business models. A resilient market is necessary to attract investment and ensure that consumers do not pay a high cost for failed suppliers.

We note that Ofgem's proposals require significant, deep and ongoing monitoring of the financial position of energy suppliers. We expect Ofgem will need additional resources to conduct this monitoring. We strongly encourage Ofgem to seek an approach to sourcing data which limits the resource burden on suppliers. This is at a time when suppliers have a lot of pressure on them, with larger volumes of inbound consumer contact given the challenging market conditions.

Energy UK is disappointed that the response time for this important consultation is limited. Suppliers are delivering many schemes, including the Energy Price Guarantee, Energy Bill Relief Scheme and Energy Bill Support Scheme, as well as the Energy Company Obligation and the Warm Home Discount. They are also engaging with many other changes from the government and Ofgem. Ofgem needs to give recognition of the extensive package of changes they are consulting on, the impacts they will bring and the time of year that has been chosen to open these consultations.

Enabling a Competitive Market

Ofgem must ensure the right balance between competition and customer protection, ensuring that new resilient entrants have sustainable business models. A resilient market is necessary to attract investment. Many factors need to be considered along this journey to ensure a balance is struck in this currently loss-making industry for retail suppliers. We must consider the drivers of competition in the current market and prevent the depletion of diversity among suppliers. We recommend that Ofgem's approach to capital adequacy and financial resilience is responsive to other work strands on market reform, such as the Review of Electricity Market Arrangements (REMA), and that it is flexible and able to reflect variations in business models.

Due Process for Change

We recommend that strengthening financial resilience is done through processes and timings that recognise recent and future market conditions. For instance, we note that Ofgem's proposed 10 days to make changes in response to SLC 4B in relation to the Guidance on the Financial Responsibility Principle (FRP) is shorter than usual. We recommend that Ofgem extends the implementation time so that the Guidance comes into effect 56 days after the decision on changes to SLC 4B. Extending this would allow for thorough alterations and ultimately, for better customer outcomes. The gas crisis has seen 30 supplier failures, which has passed on unacceptable costs to customers and turmoil to the sector.

We recommend that Ofgem communicates any intervention to protect credit balances and explains the level of protection transparently. This is particularly important as Ofgem is proposing to give itself significant discretion on the level of protection that is required. We recommend that Ofgem provides more information about the process they would use to determine an appropriate level of credit balance protection.

Implementation

We expect Ofgem to ensure that the transition periods for the capital adequacy regime are implemented speedily and proportionately to protect consumers and the resilience of the energy market. Market conditions have altered significantly over the past 15 months and we expect them to continue to evolve. Energy UK urges Ofgem to reflect the challenging environment retail suppliers are working in, as outlined in the First Economics[1] report when implementing transition periods for RO ringfencing in particular. Ofgem is consulting on a wide range of factors currently which creates uncertainty in the market. We encourage Ofgem to consider both the need to ensure existing and potential new entrants have the equity capital to be able to operate sustainably in this market.

Liability for Additional Costs

Energy UK suggests that Ofgem ensures the anticipated costs to suppliers of using a more expensive form of capital are allowed costs under the price cap. Whilst we understand that price risk is impacted by hedging behaviours, we recommend that Ofgem considers the additional costs to be balanced as a result of its proposals.

[1] First Economics, GB Energy Retail Businesses: Risk Profile and Cost of Capital, December 2022

We provide answers to the consultation questions in the appendix below, as well as seeking clarification and amendments to the proposed licence conditions.

We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party.

Best wishes,

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Appendix 1: Response to consultation questions.

Introduction

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

Energy UK supports Ofgem's objectives of strengthening financial resilience in the energy retail market to create protection and benefits for customers and ensure efficient supplier operations.

Enhancing Financial Responsibility Principles: (SLC 4b)

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?

Yes, we agree with the proposal set out in SLC 4B.1:

"The licensee must ensure that it maintains Capital and Liquidity of sufficient amount and Quality so that it can meet its reasonably anticipated financial liabilities as they fall due on an ongoing basis"

We welcome further clarity from Ofgem on their power to amend the direction, as set out in the guidance.

We note that Ofgem's proposals require significant, deep and ongoing monitoring of the financial position of energy suppliers. We expect Ofgem will need additional resources to conduct this monitoring. We strongly encourage Ofgem to seek an approach to sourcing data which limits the resource burden on suppliers.

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

Overall, Energy UK is supportive of reporting Trigger Points to Ofgem should they find themselves at risk of not meeting the FRP, and on annual self-assessment reporting. However, we would welcome Ofgem providing more detail on what they define as "reasonably practicable". We encourage Ofgem to look at how other regulators, such as the Bank of England conduct self-assessments and ensure the reporting is proportionate to the risk and does not compromise the quality of the exercise not to increase this level of testing to more than once a year as this may compromise the quality of the exercise. We suggest that Ofgem considers the monthly data that is sent by suppliers and the existing quarterly stress testing.

We encourage Ofgem to be clearer on how the reporting tools work together. Energy UK has stressed for a number of years that Ofgem's RFI process could improve by being more joined up, avoiding duplication. In implementing the annual self-assessment stress testing, we recommend that Ofgem learns from the experience of implementing the Operational Capability principle and Financial Responsibility principle in 2020/21.

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?

Energy UK does not have a view on the specific thresholds in relation to customer credit balances.

Energy UK recommends that Ofgem improves its monitoring approach for the proposals to work effectively. Data requests need to be proportionate. With such an increase in Ofgem's monitoring of suppliers' financials, Energy UK recommends that Ofgem's respective teams are well-resourced. This will ensure that processes are carried out in a timely manner and that sufficient support is provided.

We would welcome further clarity from Ofgem on the notice that suppliers will receive before they submit their Annual Adequacy Self Assessment.

We would also welcome more information on how the Annual Adequacy Self Assessment might work for new entrants to the market.

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?

Yes, Energy UK agrees with Ofgem's approach requiring notification by suppliers ahead of non-essential payments when they are in breach of the FRP. We expect this approach to be supported by Ofgem's enhanced financial monitoring of suppliers.

<u>Minimum capital requirement:</u>

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?

Energy UK recognises that Ofgem is seeking to balance various issues in setting both the level and the implementation period for new minimum capital requirements. Members may have different views and evidence of the appropriateness on both fronts.

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 a volumetric approach, what calculation method is most appropriate?

We have no strong view on this question.

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?

Ofgem's proposed approach seems reasonable.

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

No response.

Ringfencing RO receipts:

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?

Yes. We encourage Ofgem to engage bilaterally with suppliers to understand how this change will affect them and to ensure that the transition occurs smoothly.

We agree with Ofgem that BEIS should also amend the Renewable Obligation legislation to ensure more frequent payment of the RO and to extend this to the non-domestic market.

We suggest that Ofgem considers an appropriate allowance for ringfencing RO receipts.

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?

Ministers have reserved the right to make changes to the methodology of Government schemes. This means that we do not know the full potential impacts of RO ringfencing and how this will interact with Government schemes. To prevent negative impacts, we encourage a clear process and timeline for both Ofgem and government reforms to the RO and government schemes.

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

No response.

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)

No response.

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?

We recommend that Ofgem ensures that this measure allows for diverse sustainable business models to compete in the market.

Appendix 2: Table seeking clarification on the drafting of Ofgem's proposed licence condition changes to implement financial resilience proposals.

Below is a table that outlines points that Energy UK requires further clarity on from Ofgem regarding supply licence conditions or definitions from the Guidance document.

Licence condition/ definition	**Proposal**	**Clarity needed**
SLC 4B.4	"If the licensee supplies to Domestic Premises, with effect from 31 March 2025, the licensee must, at all times, maintain the 2025 Minimum Capital Requirement."	We welcome clarity on Ofgem's steps after this period. E.g. refer to 31 March 2026 and the 2026 Minimum Captial Requirement. We also suggest that Ofgem clarifies this definition by referring to the existing definition of "Domestic Premises" in SLC 1 and SLC 6.1.
Definition of "2025 Minimum Capital Requirement"	"means licensee Net Assets of XX per Domestic Customer or access to an alternative source of funding with equivalent effect such as but not limited to, long term unsecured debt or similar financial instruments, access to undrawn credit facilities, a guarantee from a third party provided that alternative source is notified to the Authority in writing no later than 12 weeks before the date provided for in standard condition [4B.6] and in respect of new market entrants within 28 days of the grant of the [gas/electricity] supply licence and meets the Alternative Source Conditions"	This refers to SLC 4B.6, but the licence condition where this definition is required is SLC 4B.4, therefore, Energy UK welcomes clarity as to whether this is a typing error.
SLC 4B.7	"If the licensee does not, at any point in time after the effective dates at 4B.4, hold the 2025 Minimum Capital Requirement as required by standard condition 4B.4 or if any of the Trigger Points have occurred, it must notify the Authority 28 days before making any payment, providing any loan or transferring any asset to any third party unless that payment, loan or transfer is one that it is essential to the licensee's operation as a supplier of gas and electricity to consumers"	Ofgem should provide a description of what they define as an essential payment, loan or transfer to the licensee's operation as a supplier.
"Adjustment Percentage"	"Prior to directing a licensee to ringfence CCBs Ofgem will issue a notice of intent to direct. The licensee will have a period of no less than 7 days from the date of the notice during which the licensee can make a representation to Ofgem. The time permitted for representation will be stated in the notice along with details on how to make the representation. Ofgem will review the	Energy UK suggests providing more detail and transparency on the end-to-end process regarding the adjustment percentage.

	representation, contacting the licensee if additional information if required. Following a review of the representation Ofgem will decide whether to issue a direction”	
“Low-Cost Transition to Net Zero”	“means the ability of gas/electricity supply licence holders to take the appropriate steps, at lowest cost to consumers, toward an energy system which relies on renewable, zero-emission sources and [to] facilitate the use of zero-emission technologies that are connected to the energy network”	This refers to “zero emission technologies” which do not exist. We welcome clarity on whether Ofgem means “zero emission at point-of-use technologies” or something similar. We presume Ofgem intends to incorporate low-carbon technologies such as heat pumps and electric vehicles into the definition
SLC 4D: “Domestic Customer Credit Balance”	“The licensee will calculate the Protected Amount in accordance with SLC 4D.4 based on Gross Credit Balances in relation to fixed Direct Debit domestic customers minus the Unbilled Consumption of all fixed Direct Debit domestic customers, multiplied by the Adjustment Percentage. The balances of other customer groups including pre-payment customers, those paying on demand, by variable Direct Debit, or by other methods are not required to be included in the calculation.”	This only refers to fixed direct debit customers. We welcome further detail from Ofgem as to why customers who pay in forms other than fixed direct debit are not included.
SLC 30 Protecting the Renewables Obligation		The RO will eventually disappear from the market so Energy UK suggests that Ofgem include a sunset clause in SLC 30. If the government introduced a requirement to pay the RO quarterly, we welcome clarity on whether SLC 30 would continue to be relevant.
ROC(s)	“Renewables Obligation Certificates as defined in the RO Order, Scottish ROCs as defined in the RO(S) Order and Northern Irish ROCs as defined in the Northern Ireland Renewables Obligation Order 2009. “	Energy UK would welcome clarification on whether “Northern Irish ROCs” are relevant to GB suppliers and therefore should be included in this definition of ROC(s).