Centrica plc

Millstream
Maidenhead Road
Windsor
SL4 5GD
www.centrica.com

David Hall
Financial resilience and controls team
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

3 January 2023

Sent by email to: RetailFinancialResilience@ofgem.gov.uk

Dear David,

Statutory consultation: Strengthening Financial Resilience[1]

Centrica welcomes the opportunity to respond to this consultation.

In its review setting out the facts of the recent exit of energy suppliers; the National Audit Office highlighted that:

- 29 energy suppliers have failed since July 2021
- This meant 2.4 million customers moving to a new supplier
- Ofgem's best estimate of the cost of transferring these customers was £2.7bn or around £94 for every energy customer – not just those customers whose supplier had failed.
- This meant that a typical customer on the price cap paid had an annualised bill of £1,971 in the Summer of 2022, of which £66 were due to approved claims from transferring customers of failed suppliers.[2]

Of the £2.7bn cost, £217m relates to the cost of honouring customers' credit balances; nearly 10% of the total.[3] Given this, Centrica has a number of concerns not only with the substance of the majority of the proposals set out in the consultation, but also the apparent lack of rationale or clear analysis behind many of the positions Ofgem has adopted in this Statutory Consultation document. In particular, by not addressing the risks consumers face when suppliers use their credit balances as working capital, Ofgem is leaving the door open for future supplier failures leading to these costs being mutualised.

[1] Statutory Consultation - Strengthening Financial Resilience | Ofgem.
[2] Report by the Comptroller and Auditor General, The energy supplier market: The Department for Business, Energy & Industrial Strategy and Ofgem, 22 JUNE 2022, Key facts, and Figure 8.
[3] Ibid, Paragraph 2.8.

We outline our main concerns and corresponding proposals in this cover letter. We answer each question posed in the Statutory Consultation the Appendix. Our main concerns and proposals are:

- **Ofgem's own Impact Assessment shows it should bring back ringfencing of CCBs:** Ofgem's impact assessment has failed to assess the benefits and risks of a combination of all three policy interventions. We attach a report by Frontier Economics which shows that once errors are removed, Ofgem's own Impact Assessment model demonstrates that a package of all three policies – i.e. ringfencing CCBs, ringfencing RO, and capital adequacy - has the highest long-term value to customers. Indeed, this result is obtained even if the only change is to remove the impact of ringfencing proposals on the Default Tariff Cap (DTC).

- **Ofgem has unjustifiably reversed its position on the ringfencing of customer credit balances** (CCBs) since its June 2022 policy consultation. This reversal is not justifiable with respect to Ofgem achieving its statutory objectives. To best protect current and future consumers, Ofgem should require suppliers to ringfence 100% of gross CCBs net of unbilled consumption. <u>If Ofgem does not proceed with CCB ringfencing, it should require suppliers to disclose whether their credit balances would be fully protected prominently in all communications - particularly at point of sale and tariff renewal.</u>

- **Bespoke ringfencing will at best be ineffective:** Rather than require suppliers to ringfence CCBs, Ofgem has proposed that it has the power to require suppliers to ringfence CCBs once a supplier exceeds a threshold for reliance on CCBs. This proposal for bespoke ringfencing is unjustified and will be ineffective. Ofgem has not justified why an efficient notional supplier would use CCBs as working capital, and if so for what. The threshold is arbitrary, and once a supplier is relying on CCBs to an arbitrarily unacceptable level, bespoke ringfencing may already be too late.

- **The transition to capital adequacy should not be delayed:** CCBs should be ringfenced straightaway. Capital adequacy requirements – which serve a different purpose – should be brought forward from 2025 and made genuinely effective. The purpose of ringfencing CCBs is to protect customer credit balances in the event of supplier failure, whereas the purpose of capital adequacy is to mitigate the risk of failure in the first place. To the extent that suppliers are able to use customer credit balances to fund their business, less responsible suppliers will continue to do so, maintaining the risk of a "race to the bottom" that led to around 30 supplier failures over the past two years.

- **Delaying capital adequacy requirements to prevent these suppliers from exiting is not promoting sustainable competition.** Furthermore, if Ofgem were to bring forward proposals it would not need to cause suppliers to exit. Any supplier that cannot demonstrate appropriate financial resilience without recourse to customer credit balances and RO payments could be prohibited from acquiring new customers.

We elaborate on these, and further points, in the rest of this cover letter and the Appendix.

Ofgem's own Impact Assessment shows it should bring back ringfencing of CCBs

The attached Frontier report[4] ('the Frontier report') shows that once errors are removed, Ofgem's own Impact Assessment model demonstrates that a package of all three policies – i.e. ringfencing CCBs, ringfencing RO, and capital adequacy - has the highest long-term value to customers.

An important error in Ofgem's IA is that contrary to Ofgem's statement, the Default Tariff Cap already incorporates the costs of ringfencing CCBs. The Frontier report explains why.

It should explain why it has failed to assess all the policy measures together. Ofgem should also explain over what period it considers these interventions should be addressed and why, with reference to the guidelines set out in the HMT Green book.

Ofgem has unjustifiably reversed its position on the ringfencing of CCBs

We consider Ofgem's U-turn on the issue of the protection of credit balances to be an appalling missed opportunity; if adopted, we consider the regulator to be guilty of gross negligence in the discharge of its duties and obligations to consumers. Ofgem's established and very public position has long been – quite rightly – that the use of customers' monies to fund working capital by energy suppliers is akin to using "interest free company credit cards"[5]. Yet Ofgem is now suggesting that using customers' credit balances is acceptable behaviour up to a certain point, beyond which such behaviour becomes unacceptable once more. This is a position that strains the bounds of credibility.

Ofgem has set out no clear rationale for its position that the use of customers' monies to fund working capital is an acceptable practice, aside from an oblique, unexplained and highly specious references to practices in the "travel and durable consumer goods" markets.[6]

Our own customer research – previously shared with Ofgem – is clear that customers (including those of suppliers who have resisted the protection of credit balances) overwhelmingly expect their credit balances to be properly protected by their supplier[7]; they would be shocked to learn that their energy payments are being used for anything other than to settle their accounts. We are equally disturbed that the regulator, which is charged with protecting their interests, endorses such a position. In effect, the inescapable conclusion is that Ofgem considers that the credit balances of customers can be used to fund the types of commercial behaviour on the part of energy suppliers that resulted in the implosion of the energy supply market in 2021-2022.

In its Impact Assessment Ofgem rightly points out that 'Any capital that is at risk of being mutualised if a supplier fails is effectively insured by consumers because they will bear the cost in the long-term'.[8] Consumers have a right to know when their deposits are being used

---

[4] Frontier Economics, Review of Ofgem's revised impact assessment of Strengthening Financial Resilience proposals, Prepared for Centrica, 30th December 2022.
[5] Ofgem announces tough new financial measures to ensure energy suppliers can withstand future shocks - including protection for customers' credit balances, 20th June 2022.
[6] Statutory Consultation - Strengthening Financial Resilience | Ofgem, Page 78.
[7] Research conducted by YouGov in March 2022 showed that the vast majority (86%) of consumers want their energy supplier to protect their credit balances.
[8] Ofgem, Revised impact assessment of Strengthening Financial Resilience proposals, November 2022, Page 30.

to fund business operations. If Ofgem pursues its proposal to allow suppliers to use CCBs as working capital, it needs to make sure that consumers understand the risks that they are bearing when contracting with those suppliers, even if those risks are indirect[9].

To that end we propose that if Ofgem does not proceed with CCB ringfencing, it should require suppliers to disclose whether their credit balances would be fully protected prominently in all communications - particularly at point of sale and tariff renewal. This disclosure should be accompanied by a notice supplied by Ofgem that explains what ringfencing means and how failure to ringfence CCBs will affect all consumers bills.

Why did Ofgem reduce ringfencing proposals to 30% of gross CCBs?

We are extremely concerned that Ofgem has limited its Impact Assessment to the protection of 30% of customer credit balances, given the diluted impact on moral hazard and incentives on suppliers to behave responsibly. Such limited action belies Ofgem's public statements regarding the need to take urgent action to protect consumer interests and falls short of what is required to deliver the consumer benefits outlined in NERA's cost benefit analysis, namely 100% protection. There is no assessment to suggest that the 30% requirement is more appropriate for consumers than an immediate requirement for 100% protection.

The Frontier report sets out arguments for assessing a higher level of coverage including a point previously made by Centrica that Ofgem should not delay action to protect suppliers who cannot comply[10]. Instead, a sensible implementation of the policy that is effective, whilst mitigating the risk of supplier insolvency, could bring about the assessed benefits with minimal transition costs. Implementation coupled with measures that allow suppliers to keep trading, but not acquire new customers until they have fully protected the relevant liabilities, should prevent transitional disruption to the market.

Bespoke ringfencing will at best be ineffective

Ofgem's proposals for bespoke ringfencing of CCBs based on notification and monitoring do not go far enough to prevent future mutualisation of these costs. The fact that Ofgem does consider ringfencing of Renewables Obligation payments to be appropriate shows that there are benefits to consumers of ringfencing costs that can be mutualised in the event of supplier failure. Failing to act on CCBs will leave these payments at risk.

In setting a monitoring threshold of 50% of total assets, Ofgem appears to suggest that the use of customers' credit balances up to that point is acceptable. Aside from being an apparently unsubstantiated and arbitrary threshold, the signal this statement sends to suppliers ahead of what is likely to be a period of volatile and unpredictable market conditions over the winter, and in which supplier finances will be put under extreme strain is nothing short of reckless.

Capital Adequacy does not substitute CCB ringfencing: it is necessary in and of itself

We have long been advocates of the introduction of minimum capital requirements, recognising that these play a very different role to ringfencing of credit balances. Ringfenced funds protect consumers' interests when a supplier is entering administration, whereas

[9] The risks are indirect because a consumer's credit balances are at risk of being mutualised and spread across all consumers bills; with no direct effect on the consumer who contracted with a failed supplier.
[10] Centrica, Response to Policy consultation: Strengthening Financial Resilience, 19th July 2022, Page 13.

minimum capital requirements seek to prevent suppliers entering financial difficulty in the first place.

Ofgem's proposals on capital adequacy as part of a broader move towards prudential regulation are an essential step in the right direction but will not kick in until March 2025. Ofgem has deliberately delayed implementation to support suppliers who cannot raise enough capital to finance the risks to their business. Ofgem hopes that the end of the energy crisis along with implementation of the government's new retail strategy will help these suppliers raise capital at lower costs. Even if this turn out to be true – which is by no means guaranteed, there is a material gap in the regulatory framework, during which, consumers will continue to bear the risks of supplier failures.

Delaying capital adequacy requirements is not promoting sustainable competition.

To justify the delay to 2025 Ofgem points to the balance between increasing resilience while still maintaining a competitive market[11]. It indicates that the risks to competition are short term and that the transition period addresses this issue[12]. Centrica's view is that Ofgem have failed to appreciate that the competition provided from firms that are not able to move more quickly to deliver the Capital Adequacy requirements will act as an entirely illusory and short-term source of competition.

The Frontier report highlights the fact that the short-term costs that Ofgem have identified won't be uniform across all suppliers:

> *'Suppliers which are fundamentally sound should find it substantially easier and cheaper to raise capital than suppliers which may ultimately be unsustainable once the regulations come in to full force. Such suppliers may face an extremely high cost of capital.*[13]

In mitigating the impact on competition from these suppliers, Ofgem must consider the impact this has on sustainable competition and consider any impact of distorting competition on lower risk business models in making its decision. Delaying implementation might perpetuate unsustainable suppliers and distort competition. Furthermore, Ofgem has not set out how delaying the implementation of capital adequacy will allow suppliers, who are currently unable to raise capital without a significant cost uplift, to become sustainable.

Furthermore, if Ofgem were to bring forward proposals it would not need to cause suppliers to exit. Any supplier that cannot demonstrate appropriate financial resilience without recourse to customer credit balances and RO payments could be prohibited from acquiring new customers until such time as the supplier in question has (to Ofgem's satisfaction) hedged its commodity risk effectively or demonstrated that it has unfettered access to the requisite level of capital to mitigate the risk appropriately. To the extent that such action were not taken within a designated period, then Ofgem would need to assess whether that supplier's participation in the market presents a risk to the stability of the market and energy consumers, consider enforcement against individual directors of energy suppliers and/or initiate the process for licence revocation.

---

[11] Statutory Consultation - Strengthening Financial Resilience | Ofgem, Forward.
[12] Ibid, Paragraph 1.26.
[13] Frontier Economics, Review of Ofgem's revised impact assessment of Strengthening Financial Resilience proposals, Prepared for Centrica, 30th December 2022, Paragraph 27.

On capital adequacy; Ofgem should set out the process

It appears that Ofgem may review the approach to the Minimum Capital Requirement (MCR) following its initial implementation through further consultation which will take into account the outcome of the open consultation on the EBIT margin. Given this, we do not comment in detail on the proposed range of between £110 - £220 per customer and we reserve the right to comment further on the detail as it emerges.

However, Ofgem should consult on the longer-term trajectory as soon as practicable and it should set out the timeline for this consultation immediately.

Ofgem must also consider how the MCR must be held

Ofgem also needs to consider how the MCR must be held, specifically whether net assets are an appropriate basis. This might include considering alternatives and assessing how well they meet Ofgem's objective of financial resilience, which Ofgem does not appear to have done to date.

Alongside capital requirements, liquidity is a critical element at the heart of prudential regulation, given its importance to financial resilience at times of market stress. By liquidity, we mean the resources that the supplier has available to pay amounts when they fall due. If a firm's capital resources are invested in illiquid assets – assets that cannot be readily realised in cash – then it risks not being able to pay its debts (including customer credit balances) when required.

As a point of reference, some of the bank failures that took place in the financial crisis of 2007-9 were driven by insufficient liquidity rather than inadequate capital. Ofgem should consider whether using net assets as a requirement for the MCR achieves its financial resilience objectives, including any objectives for liquidity.

The process of consultation

Centrica is concerned, not only with the substance of the majority of the proposals set out in the consultation, but also the apparent lack of rationale or clear analysis behind many of the positions Ofgem has adopted in its consultation document.

There are a number of new proposals in the Statutory Consultation where Ofgem has either not described the proposed process for implementation and/or not provided any supporting analysis. In addition to these omissions, Ofgem has not explained why its Impact Assessment does not assess the option of ringfencing CCBs in addition to ringfencing Renewables Obligations and the minimum capital requirement. It is especially odd that Ofgem does not consider this option, given that it consulted on implementing a combination of the three in June 2022.

Finally, Ofgem's publication of the Guidelines for the Financial Responsibility Principle, part way through the Consultation gives stakeholders insufficient time to review these and these guidelines are heavily referenced in the proposed licence conditions. We comment further on these Guidelines in Appendix 2.

Our responses to Ofgem's specific consultation questions are set out in the Appendix below. As noted above, we also append the Frontier report which reviews the Impact Assessment published alongside the Statutory Consultation.

Yours sincerely,
Tim Dewhurst
Director of Regulation and Policy

Appendix 1 – Response to Consultation Questions

1. **Do you agree with our package of measures and overall approach?**

We strongly disagree with Ofgem's proposed package of interventions and its overall approach. Ofgem should be making proposals that are far-reaching and rapid to correct the clear market failures that it has identified, and which were responsible for the crisis in the energy retail market.

Compared to the Policy Consultation (which envisaged the implementation of both Renewables Obligation (RO) and CCB ringfencing (RF) *in addition* to the development of Capital Adequacy (CA) requirements), what is being proposed represents a substantially watered-down package. It is deeply concerning that packages that would provide the most protection for consumers are not even assessed.

As we described in our Policy Consultation response, a combination of CA (implemented as soon as possible), RO RF and 100% CCB RF would offer the best protection for consumers. There is a strong principled case for adding CCB RF to the package of policies: there is no justification for suppliers to risk consumers' money in this way (rather than raising funds from investors). Our own customer research is clear that customers overwhelmingly expect their credit balances to be properly protected.[14]

The Frontier report submitted alongside this response describes how Ofgem's existing Impact Assessment can be used to validate this more comprehensive package of proposals despite not including them in the published analysis.

Consumers have a right to know when their deposits are being used to fund business operations. If Ofgem pursues its proposal to allow suppliers to use CCBs as working capital, it needs to make sure that consumers understand the risks that they are bearing when contracting with those suppliers.

To that end we propose that if Ofgem does not proceed with CCB ringfencing, it should require suppliers to disclose whether their credit balances would be fully protected prominently in all communications - particularly at point of sale and tariff renewal. This disclosure should be accompanied by a notice supplied by Ofgem that explains what ringfencing means and how failure to ringfence CCBs will affect all consumers bills.

Ofgem's own Impact Assessment shows it should bring back ringfencing of CCBs

As we described in our response to the Policy Consultation, CA is not a substitute for ringfencing of ROs and CCBs. While CA can help to reduce the risk of supplier failure, RO and CCB ringfencing are also required to ensure that – should a supplier fail – the costs that are mutualised onto the wider base of consumers are minimised.

The addition of CCB RF will also mitigate the substantial risks that will come from the way that Ofgem is proposing to introduce the CA requirements. For example:

- The CA requirements would not come into full effect until 2025.

[14] Research conducted by YouGov in March 2022 showed that the vast majority (86%) of consumers want their energy supplier to protect their credit balances.

centrica

- Suppliers with a substantial non-domestic business may be able to use assets from this part of the business to count towards their domestic requirements, despite being undercapitalised as a whole or having poor liquidity.

These are not reasons to avoid implementing CA. Indeed, they suggest that the rules should be tighter and brought in sooner, as discussed below. However, there is a real risk that the CA will not lead to a meaningful reduction in the moral hazard problem seen in the market. Ringfencing of CCBs enforces a specific action which will directly reduce suppliers' risks, and the resulting risks to consumers.

It is therefore perplexing why Ofgem's IA does not even *consider* a policy package consisting of all three interventions. This is a major U-turn compared to the Policy Consultation, with no coherent rationale. The three potential justifications made by Ofgem are invalid.

- Ofgem has stated that it has shortlisted options to "*find the optimal components of the proposals*". But in order to determine the optimal level of protection, Ofgem would logically need to consider options with the highest levels of protection to determine whether or not they go too far.
- In response to questions from Centrica, Ofgem indicated its choice of options was informed by stakeholder feedback. However, we (and others in the industry) have long argued for a comprehensive set of policies, and supported Ofgem's previous position during the Policy Consultation. Ofgem itself acknowledges that some suppliers welcomed the proposals on CCBs and urged it to go further and faster. And while stakeholder feedback should feed into an Impact Assessment, it is incorrect for the feedback from one group of stakeholders to entirely limit the scope of the Impact Assessment in this way.
- Ofgem has indicated that it is considering these options alongside its proposal for an enhanced Financial Responsibility Principle, which would require suppliers to notify Ofgem if their gross domestic CCBs exceed 50% or more of their Total Assets. However this is a far weaker threshold which will be ineffective at best, and at worst gives a green light to suppliers to utilise credit balances for up to 50% of their total assets.

As described in the Frontier report, Ofgem's IA has a number of issues which will tend to reduce the apparent benefits associated with ringfencing CCBs. These are:

- Assessing the NPV of the options over a short period (6 years);
- A distortion where ringfencing proposals but not CA are assumed to lead to an increase in the DTC; and
- Assuming that the 500bps WACC uplift will apply to all capital raised by small and challenger suppliers: The act of attempting to raise capital should itself allow the markets to distinguish between those suppliers that are sustainable and those which are not, and it should ultimately be the sustainable suppliers that are able to raise money (at a lower rate) and attract customers.

The report shows that once errors are removed, Ofgem's own Impact Assessment model demonstrates that a package of all three policies – i.e. ringfencing CCBs, ringfencing RO, and capital adequacy - has the highest long-term value to customers. Indeed, this result is obtained even if the only change is to remove the impact of ringfencing proposals on the DTC.

CCB ringfencing should cover 100% of gross CCBs net unbilled consumption

Where Ofgem does assess CCB ringfencing, it has continued to assume that only 30% of gross CCBs would be protected. Nowhere in the Statutory Consultation or IA is it justified why Ofgem is not considering a policy that protects all CCBs.

The 30% figure has apparently been taken from the Policy Consultation. As we stated in our response to that consultation, Ofgem gave no evidence why a 30% requirement would be more appropriate for consumers than an immediate requirement for 100% protection. No such evidence has been provided.

The Frontier report describes some of the arguments for assessing a higher level of coverage:

- The Policy Consultation envisaged the implementation of CCB ringfencing by the end of 2022. The Statutory Consultation assumes implementation by April 2023, which has allowed suppliers a further four months to prepare. Supplier working capital requirements also tend to be less in the summer than winter. We would expect that suppliers would therefore be able to withstand a higher rate of protection.
- Even if this were not the case, Ofgem has tools at its disposal to ensure that a supplier unable to meet the requirement does not become insolvent. For example, such suppliers could be required to halt customer acquisition until they are able to meet the requirement.
- Finally, if some suppliers are in such a weak position that they would be unable to withstand such regulations, they are also likely to experience particularly high costs of raising capital. It would be to the benefit of consumers if the regulations led to customers of these suppliers moving to those that are on a sounder financial footing.

The transition to CA should be faster

Ofgem is proposing a long transition period for the CA requirements: these will not fully come into force until 2025, and even then may be based on price cap allowances set during a time when wholesale energy prices (and therefore overall levels of capital held) are much lower than today.

Such a lengthy transition period will simply prolong the amount of time during which suppliers with unsustainable business models can engage in the market.

Links between the Market Stabilisation Charge (MSC) and supplier financial resilience

It is imperative that Ofgem appreciates that there is a link between the MSC and supplier financial resilience. The MSC incentivises suppliers to hedge expected SVT demand in line with the price cap methodology. In the absence of any minimum capital requirements, the MSC is absolutely essential in that it prevents unhedged, undercapitalised and financially irresponsible suppliers from engaging in reckless commercial practices in the event of a drop in commodity prices. If the MSC is removed before all suppliers are financially resilient, suppliers have less comfort to hedge in line with the price cap methodology and will be more likely to fail if there is an adverse wholesale market outcome compared to their position.

The process of consultation

Centrica is concerned not only with the substance of the majority of the proposals set out in the consultation, but also the apparent lack of rationale or clear analysis behind many of the positions Ofgem has adopted in its consultation document.

There are a number of new proposals in the Statutory Consultation where Ofgem has either not described the proposed process for implementation and/or not provided any supporting analysis. These are:

- Ofgem's assertion that the use of Customer Credit Balances as working capital is now justified is not substantiated or explained with reference to market failures.
- The 50% of total assets thresholds proposed to monitor Consumer Credit Balances is not justified by any published analysis.
- The process by which Ofgem will calculate the 'adjustment percentage' is opaque at best.

In addition to these omissions the following points of process are concerning:

- Ofgem has not explained why its IA does not assess the option proposed in its policy consultation, on which stakeholders' previous comments were based.
- Ofgem's publication of the Guidelines for the SFRP part way through the Consultation gives stakeholders insufficient time to review these and these guidelines are heavily referenced in the proposed licence conditions.

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?**

Ofgem has set out that the enhanced FRP condition SLC 4B will 'complement the Pillar 1 minimum capital requirement set out in chapter 3 – by building on this market-wide minimum standard to require that a supplier is able to manage its business-specific risks.'

We support Ofgem's proposals for a capital adequacy framework. Capital adequacy requirements are needed to ensure that suppliers can meet their commitments to their customers in a variety of scenarios, thereby mitigating the risks and costs of failure, including protecting consumers against costs of hedging the customers of failed suppliers. However, as we noted in our response to the Policy Consultation[15], Ofgem should not pursue capital adequacy instead of CCB protection as it has now proposed in it's the Statutory Consultation. Protection of CCBs and RO payments is an essential and urgent step in the right direction. It is imperative that Ofgem addresses the moral hazard that leads to excessive risk taking with customers' money.

Ofgem is proposing that the capital adequacy framework will commence in 2025 and take some years to 'ratchet up'. In our response to the Policy Consultation we said that Ofgem needs to bring forward it's proposed capital adequacy framework as soon as possible (and certainly no later than Q2 2023 given the obvious customer benefits that such a framework would deliver). It is therefore disappointing that Ofgem is proposing a long transition period. This transition period means that the capital adequacy framework offers no near-term protections to address the moral hazard identified by Ofgem and still present in the energy supply market. Combined with a lack of protection for CCBs this means that Ofgem has not delivered for consumers who remain exposed to the risks and costs of supplier failure.

[15] Ofgem, Policy Consultation: Strengthening Financial Resilience, 20th June 2022.

Whilst we do not think the reliance on capital adequacy combined with the long transition meet Ofgem's stated objectives, we support Ofgem in developing this framework. We agree that Ofgem should work towards a framework that specifically targets capital requirements as part of a wider strategy to manage financial resilience risks. As Ofgem notes, this is particularly important given the clear role that insufficient capital and financial resilience played in supplier failures during the recent price volatility as set out in Oxera's report for GEMA.

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

To be effective, Ofgem would need to be able to monitor and enforce the new requirements that are proposed. To do this Ofgem needs to strike the right balance between accurate and timely reporting and the burden on itself and suppliers. Accurate reporting needs an appropriate approval process to ensure that suppliers are properly considering the information that they submit. Information also needs to be timely, ensuring that Ofgem is able to react to changes in a suppliers' financial resilience quickly. In order to process information in a timely manner Ofgem will need the proper level of resources to process this information. A proper level of resources will also allow Ofgem to focus on streamlining requests to suppliers and minimise costs of compliance with these new requirements.

Approval process for reporting

Ofgem sets out clearly the approval process it proposes for the annual self-assessment report which includes the capitalisation plan. Ofgem does not set out an approval process for the reporting of trigger points in the Statutory Consultation of the accompanying guidance. This discrepancy will lead to inconsistent approaches to approval processes across suppliers. Ofgem should clarify the proposed approach to trigger point reporting so that suppliers implement these requirements consistently.

Frequency of reporting

Effective monitoring needs to consider both what will be reported and the appropriate frequency. In new SLC4B Ofgem has set out the requirement to report triggers 'as soon as reasonably practicable'. Ofgem should set out clearly in the guidance how this requirement should be interpreted in order to ensure that the information that they receive is consistent across all suppliers.

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?**

We have long called for appropriate protection to prevent misuse of customer money by under-capitalised suppliers treating customer credit balances (CCBs) and renewables obligation (RO) payments as interest free, risk-free working capital. The consequences of a regulatory regime that fails to adequately protect all consumers from the systemic risk of failure caused by financially irresponsible energy suppliers are now plain for all to see. Since September 2021, we have seen 29 supplier failures. These consequences have been well documented in Oxera's recent report for GEMA and the subsequent report by the Public

Accounts Committed which found that four million household have been affected and costs of £2.7bn are likely to increase.[16]

Bespoke ringfencing does not go far enough

Ofgem's proposals for bespoke ringfencing of CCBs based on notification and monitoring do not go far enough to prevent future mutualisation of these costs. The fact that Ofgem does consider ringfencing of RO payments to be appropriate shows that there are benefits to consumers of ringfencing costs that can be mutualised in the event of supplier failure. Failing to act on CCBs will leave these payments at risk.

Ofgem has not evidenced its proposed threshold

Ofgem's proposed threshold of 50% of total assets has been set so that it can be 'more proactive with suppliers to avoid over-reliance on CCBs'. Ofgem does not provide evidence that the 50% of total thresholds is a good indicator of 'over-reliance' on CCBs. Ofgem merely states that this level is based on 'suppliers' current balance sheets'.[17]

For ringfencing to be effective it needs to avoid any reliance on CCBs. Proactive ringfencing must deter suppliers from engaging in under-capitalised and risky business models including those with low levels of liquidity. It must also reduce costs at risk of mutualisation by ensuring that suppliers do not rely on these funds for day-to-day operations from the start. Ofgems' proposals are a reactive control rather than a proactive one and may not be effective in preventing mutualisation of credit balances.

In particular, Ofgem is constrained in issuing a direction to protect CCBs by the requirement to set an adjustment percentage (AP) which is set out in proposed SLC 4B.9. The AP determines the proportion of CCBs a supplier must protect and can vary between 0-100%. The proposed licence condition sets out that the AP 'will not have an adverse effect on the licensee's ability to finance its activities to the extent that the level of the Adjustment Percentage is likely to cause the licensee to exit the market due to insolvency'[18]. Given this, if a supplier is already in financial difficulty, the proportion of CCBs protected under a Direction seems likely to be lower than necessary.

It is therefore important that the threshold that triggers a possible direction is set at the right level to ensure it meets Ofgem's objective of avoiding 'over reliance' on CCBs. Ofgem has not presented any analysis that 50% is that right level but refers to it being based on suppliers' current balance sheets.

Centrica asks that Ofgem share this analysis with consultees in order to gather stakeholders view on the efficacy of its proposed threshold. In addition, Ofgem should not base this threshold on a snapshot of current balance sheets as the level is very likely to fluctuate over time.

[16] PAC: Ofgem failures "come at considerable cost to energy billpayers" - Committees - UK Parliament
[17] Statutory Consultation - Strengthening Financial Resilience | Ofgem, Paragraph 1.13.
[18] Ofgem, Guidance – Financial Responsibility Principle, 5th December 2022, Page 31.

centrica

Ofgem has not provided a theoretical basis for the threshold

Ofgem has stated an aim of avoiding over reliance on CCBs through the monitoring threshold. In order for stakeholders to understand and comment on this proposal, Ofgem should explain what it considers 'over reliance' to be. It is clear that Ofgem now considers that some level of reliance is efficient[19]: but why and for what?

In the Statutory Consultation Ofgem state:

> 'We recognise the view that it is generally in consumers interests for suppliers to appropriately use some CCBs as working capital, noting the analogies in some other industries (e.g., travel, durable consumer goods) that suggest consumers should expect credit balances to be part of an efficient business.'[20]

In, 'noting the analogies' Ofgem does not provide any detail as to whether it has considered the degree to which these analogies are relevant, and specifically whether consumers of energy would have the same expectations as those in the travel and durable consumer goods sectors. These sectors are different to energy supply in a number of ways. In the travel and durable goods sectors, purchases are typically large "one-off" spending well in advance of receiving any good at all, where it would be more obvious to consumers that they are making an advance payment. Furthermore as travel and durable consumer goods markets have not experienced a similar failure event to that seen in the energy supply sector the issue of moral hazard may be less relevant. Finally, energy supply is a unique sector with the Default Tariff Cap regulating consumer prices and where costs of failure are mutualised reactively across all consumers, including vulnerable ones.

At the same time Ofgem set out its objectives as removing 'incentives for excessive risk-taking with consumer money (the moral hazard) whilst enabling an environment for investment and sustainable competition.'[21]

We would therefore expect 'over reliance' to be grounded in the concept of moral hazard which is the market failure that Ofgem identified as the basis for policy development.[22] Ofgem should explain how the moral hazard is reduced under its proposed threshold approach. We note that Ofgem has already assessed that protecting net credit balances would not fully resolve the moral hazard in discarding this option.[23]

Ofgem's threshold isn't based on working capital

Finally, Ofgem should consider the use of total assets in its proposed ratio. Ofgem has often recognised that suppliers have a variety of business models. A ratio based on total assets means that suppliers with significant long terms assets may be able to hold high levels of CCBs relative to their working capital whilst remaining below the threshold.

---

[19] Statutory Consultation - Strengthening Financial Resilience | Ofgem, Paragraph 4.63.
[20] Ibid, Paragraph 1.13.
[21] Ibid, Paragraph 2.31-2.33.
[22] For example; Ofgem, Policy consultation: Strengthening Financial Resilience, 20th June 2022, Paragraph 7.8.
[23] Ofgem, Revised impact assessment of Strengthening Financial Resilience proposals, Nov 2022, Page 21.

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?**

On notification of non-essential payments, we agree that this licence condition is an important step to ensure that any licensee in breach of the FRP cannot extract capital from its business which might lead to higher costs to consumers in the event of failure. To ensure that this licence condition is effective, we would suggest that Ofgem define the meaning of 'essential' in the proposed licence condition.

On the ability to direct hard ringfencing, Centrica has long called for appropriate protection to prevent misuse of customer money by under-capitalised suppliers treating customer credit balances (CCBs) as interest free, risk-free working capital. However, Ofgem's proposal that it should have the ability to direct hard ringfencing of CCBs does not go far enough.

Ofgem would need to be swift in directing hard ringfencing should a supplier breach the FRP. It is important that any licensee in breach of this licence condition cannot quickly accumulate debts that it isn't able to honour should it fail. Suppliers should be expected to report any breach of this licence condition to Ofgem, in line with Ofgem's enforcement guidelines[9]. We note that Extra Energy was under investigation for over two years before it failed and yet no actions were taken by Ofgem. Ofgem will need to be able to identify a licence breach quickly and act upon it to limit the impact on the wider market.

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?**

Ofgem's proposals on capital adequacy as part of a broader move towards prudential regulation are an essential step in the right direction but will not kick in until March 2025. Ofgem has deliberately delayed implementation to support suppliers who cannot raise enough capital to finance the risks to their business. Ofgem hopes that the end of the energy crisis along with implementation of the government's new retail strategy will help these suppliers raise capital at lower costs. Even if this turns out to be true – which is by no means guaranteed - consumers will continue to bear the risks of supplier failures in the meantime.

During the recent spate of energy supplier failures, no less than 29 suppliers exited the market in a single year (2021). Over a period of two years (the time that Ofgem suggest is required to transition to Capital Adequacy requirements) from 2020 - 2021, a total of 37 suppliers failed representing more than half of the 58 suppliers active at the start of 2020.

This recent example of a stress event in the energy supply market should have led to urgent action by Ofgem to mitigate the risks of future events. It has not. As a result there is a material gap in the regulatory framework for two years, for which there is no apparent mitigation advanced by Ofgem, leaving the energy supply market vulnerable to another stress event.

The chart below illustrates historic gas prices for forward delivery contracts since 2021. The chart shows a peak at just under 600p/therm in August 2022, a level far higher than those recorded in the winter of 2021/22 during which multiple suppliers exited the market.

Source: Ofgem, Wholesale market indicators, 29/12/2022.

A recent publication by Cornwall Insight looks ahead to gas prices over winter 2022/23 and 2023/24. It notes that:

> 'wholesale gas prices are expected to remain elevated for the rest of this winter, compared to last, and that this is not a single winter problem.'[24]

They go on to note that gas futures contract prices for winter '24 'are substantially elevated compared to their value throughout 2021, even if they are reduced from the August 2022 peak'.[25]

Given this outlook Centrica would welcome Ofgem providing an assessment of the risks to the energy supply market during the proposed transition period.

The transition to the longer-term trajectory should not be delayed

In the short-term suppliers will need to submit a 'Capitalisation plan'. Ofgem states that 'To credibly be en-route to meet this 2025 requirement, we would expect suppliers to illustrate how they will be above zero net assets within about a year.'[26] This will be followed by a requirement to meet the minimum capital requirement by the end of March 2025.

[24] Cornwall Insight, Another winter of discontent? December 2022.
[25] Ibid.
[26] Statutory Consultation - Strengthening Financial Resilience | Ofgem, page 39.

To justify this delay Ofgem points to the balance between increasing resilience while still maintaining a competitive market[27]. Ofgem also indicates that the risks to competition are short term and that the transition period addresses this issue[28].

Centrica would welcome a full assessment of the impact on competition of delaying the implementation of the Capital Adequacy requirements. Such an assessment should be in line with the recommendation made by Oxera in its report for Ofgem[29] to:

- ‘Develop a framework for how effective competition is defined and measured, and revise the current existing dashboard supplied to the board on market indicators.’

In making their recommendation, Oxera note that ‘Ofgem already monitors relevant metrics such as the degree of market concentration, switching, and price dispersion in the form of deviations from the SVT over time. Further to this, analysis of effective competition should consider whether the market can sustain the same number of market players in the longer term, e.g. by examining ongoing profitability.’[30]

In assessing the impact of the proposals on effective competition Ofgem should consider whether the short-term cost of capital uplift, which it assumes some suppliers will face (in its impact assessment), is an indication of levels of profitability that are too low to be sustainable. An assessment should also recognise that switching is no longer the critical indicator of an effectively competitive market. As Ofgem notes in its Competition Impact Assessment the savings that customers of failed new entrants made were not genuine savings. Specifically in making an estimate of the annual savings being delivered to consumers prior to the recent energy crisis.

> ‘the largest benefit came from the price reductions offered by the former incumbents in response to competitive pressures, given that they still had most customer accounts. *After this, the next largest category was from the failed new entrants, but as these proved to be unsustainable, they are not counted as genuine savings to consumers.*’[31] (emphasis added)

Given this Ofgem must consider what is the contribution to competition delivered by suppliers who cannot transition to a sustainable business model. This should include an articulation of what business model adopted by these suppliers would in Ofgem’s view be able to deliver sustainable competition.

The Frontier report highlights the fact that the short-term costs that Ofgem have identified won’t be uniform across all suppliers:

> *‘Suppliers which are fundamentally sound should find it substantially easier and cheaper to raise capital than suppliers which may ultimately be unsustainable once the regulations come in to full force. Such suppliers may face an extremely high cost of capital.*[32]

27 Ibid, Forward.
28 Ibid, Paragraph 1.26.
29 Oxera, Review of Ofgem’s regulation of the energy supply market, Prepared for Ofgem 3 May 2022.
30 Ibid, Page 82-83.
31 Revised impact assessment of Strengthening Financial Resilience proposals, Nov 2022, Paragraph 5.38.
32 Frontier Economics, Review of Ofgem’s revised impact assessment of Strengthening Financial Resilience proposals, Prepared for Centrica, 30th December 2022, Paragraph 27.

In mitigating the impact on competition from these suppliers, Ofgem must consider the impact this has on sustainable competition and consider the impact of distorting competition on lower risk business models in making its decision.

Indeed, Ofgem's own impact assessment for the policy consultation identified that current market arrangements effectively subsidise market participants with high-risk business models and distort competition by disadvantaging lower risk business models[33]. These impacts must be considered by Ofgem in relation to its proposed delay to capital adequacy requirements.

Finally, as an absolute minimum, Ofgem must prohibit those suppliers who cannot implement the Capital Adequacy requirements from being allowed to acquire customers.

Ofgem should set out the timeline to reach the 'longer-term trajectory' now

It appears that Ofgem may review the approach to the MCR following its initial implementation through further consultation which will take into account the outcome of the open consultation on the EBIT margin. Given this we do not comment in detail on the proposed range of between £110 - £220 per customer and we reserve the right to comment further on the detail as it emerges.

However, Ofgem should consult on the longer-term trajectory as soon as practicable and that they should set out the timeline for this consultation now.

In this consultation Ofgem should set out its assessment of the impact that the proposed balance between Pillar 1 and Pillar 2 will have on financial resilience considering the unique characteristics of the energy market and the risks that energy suppliers face. This review should also consider the wider regulatory context which is complex and unique to the energy sector.

The proposed range for the MCR is based on an estimate of capital employed produced by the CMA as part of its profitability analysis in the Energy Market Investigation. A profitability analysis looks at the question of 'whether prices are above competitive levels' by considering the profitability of the business activity being investigated. The CMA's guidance notes that 'In many cases, the CC's focus will be on the largest incumbent firms in the market or market sector'.[34] In this case the CMA focused on the six largest energy suppliers to estimate capital employed.

In setting the longer-term trajectory Ofgem will need to consider whether this approach provides the best framework to drive long term financial resilience. The price cap does not currently require suppliers to hold a certain volume of capital although it does provide an allowance for doing so. As such, the cap level is independent of whether Ofgem requires suppliers to hold a minimum capital requirement and at what level. Put another way, whilst the cap does provide an estimate of the amount of capital a notional efficient supplier holds the Minimum Capital Requirement should be determined independently of the cap based on the objective of financial resilience. This point seems to be recognised by Ofgem in its current EBIT consultation:

---

[33] NERA, Proposed Reforms on Protecting Credit Balances and Renewables Obligations – Evaluating Cost and Benefits, June 2022, Section 2.2.

[34] CMA, Guidelines for market investigations: Their role, procedures, assessment and remedies April 2013.

'Our view is that while work on proposals on financial resilience will be coordinated with our work on setting the EBIT allowance and the final capital adequacy requirements will be informed by the capital employed level, these amounts are unlikely to be exactly identical. This is because when the capital employed number is translated into a capital adequacy number, we are likely to use slightly different approaches to achieve specific FRC policy objectives.'[35]

Ofgem will also need to consider the issues around trading collateral in setting the longer-term trajectory. Ofgem's proposed transition requirement includes trading collateral which was explicitly part of the capital employed calculated by the CMA.[36] However, Ofgem note in the Statutory Consultation that trading collateral will not be included in the longer-term trajectory for the MCR because of the range in collateral arrangements across the market.[37]

Ofgem must also consider how the MCR must be held

Ofgem also needs to consider how the MCR must be held, specifically whether net assets are an appropriate basis. This might include considering alternatives and assessing how well they meet Ofgem's objective of financial resilience which Ofgem does not appear to have done to date. Net assets do not necessarily equal the implied capital employed which Ofgem has used to calculate the transition requirement. This is because implied capital employed was calculated following a series of adjustments to accounting values. As a result a notional efficient supplier may not be expected to hold a net asset position equal to their implied capital employed.

Ofgem should also consider the degree to which net assets are loss absorbing. Capital absorbs losses only if it does not diminish in value or has to be repaid to a provider of funding before those losses are incurred. So, capital of this kind includes share capital without mandatory dividends, and distributable reserves, but would not, for example, include senior or secured debt. The 'quality' of capital describes how likely it is to be available to absorb losses when they arise.

Alongside capital requirements, liquidity is a critical element at the heart of prudential regulation, given its importance to financial resilience at times of market stress. By liquidity, we mean the resources that the supplier has available to pay amounts when they fall due. If a firm's capital resources are invested in illiquid assets – assets that cannot be readily realised in cash – then it risks not being able to pay its debts (including customer credit balances) when required.

As a point of reference, some of the bank failures that took place in the financial crisis of 2007-9 were driven by insufficient liquidity rather than inadequate capital.

Liquidity requirements are necessary to ensure suppliers' capital is not tied-up in assets that are difficult to realise in times of stress. Ofgem should therefore consider whether using net assets as a requirement for the MCR achieves its financial resilience objectives, including any objectives for liquidity.

[35] Further consultation on amending the methodology for setting the EBIT allowance, November 2022, Page 24.
[36] CMA, Energy Market Investigation, Appendix 9.10: Analysis of retail supply profitability – ROCE, Paragraph 159.
[37] Statutory Consultation, Strengthening Financial Resilience, November 2022, Paragraph 3.25.

Any system of prudential regulation must allow firms to use minimum capital requirements if a severe stress materialises, and they must then be given time to build up their capital and liquidity again afterwards. If this isn't the case then firms would have to raise capital and liquidity in or shortly after an actual stress scenario, which might prove difficult and exacerbate the stress. In any event, a prudential regime in energy should define absolute minimum levels of capital and liquidity below which Ofgem would intervene.

Ofgem must consider how frequently the MCR should be updated

Ofgem has proposed a per customer MCR that will apply from the end of March 2025. After 2025, Ofgem propose to 'set higher targets' and note that building up to this 'full requirement' will take place 'over a period of years'.[38]

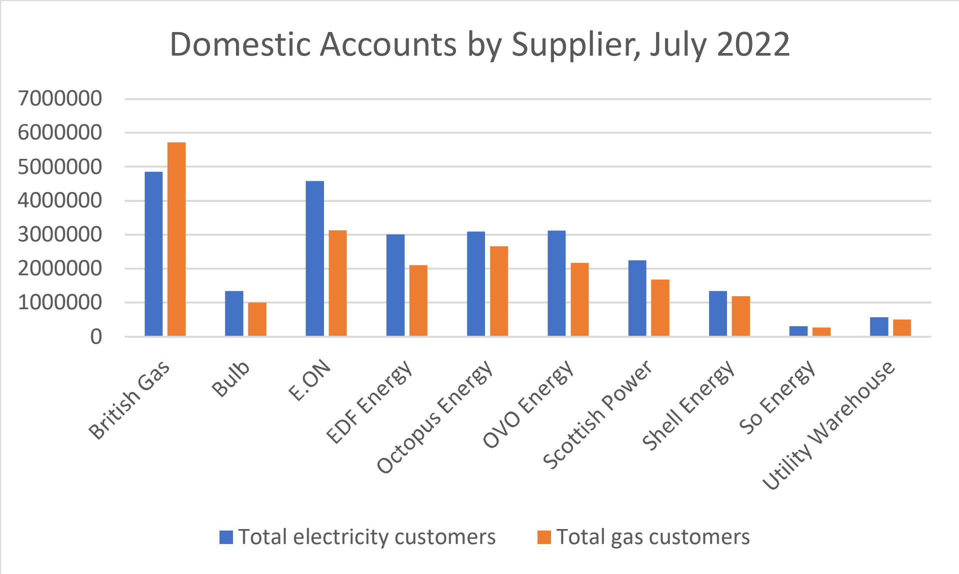
Ofgem should give suppliers an indication of the likely frequency of updates to the MCR including the route to the longer-term trajectory. This could include a timetable over which it will review these issues as noted in our response to later questions. Understanding the update frequency will give suppliers more information to plan capital requirements over a number of years. If, as noted in Paragraph 3.38, Ofgem considers a more sensitive measure for the MCR, including one that fluctuates with the price cap, Ofgem should consult suppliers on the impact of this change.

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?**

We agree with Ofgem that setting the Minimum Capital Requirement (MCR) on a per customer basis has the advantage of being clearer to comply with and could reduce the administrative burden on energy suppliers. In particular, as customer numbers are less volatile than volumes of energy consumed it would be easier for suppliers to monitor. Basing the MCR on energy consumption would be extremely challenging to implement and therefore disproportionate.

However, an average MCR for a single customer type fails to take into account different customer populations across licensees. Ofgem's retail market indicators show that there were 24 active suppliers in the domestic gas and electricity retail markets as of June 2022. This consisted of 21 suppliers active in both gas and electricity, 2 in gas and 1 in electricity only.[39] Whilst there are currently only 3 single fuel suppliers active there will, in addition, be differences across the population of customers for dual fuel suppliers. For example, using the same data source we can see how the customer population varies by supplier:

[38] The Statutory Consultation, November 2022, Page 8.
[39] Retail market indicators | Ofgem



Source: Retail market indicators | Ofgem, Number of domestic accounts by supplier, by fuel, all tariffs, July 2022.

Given these different customer populations, Ofgem should consider calculating the MCR on a single fuel basis. Ofgem should consider the approach in the longer-term trajectory as part of future consultations.

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 with Ofgems' proposal. However, Ofgem should set out a timetable over which it will review these issues so that suppliers can have certainty on the longer-term trajectory of the MCR. We believe that any outstanding backwardation costs should be recovered via the Market Stabilisation Charge (MSC). Doing so may impact the capital requirements for fixed tariffs compared to the SVT.

In our response to the policy consultation, we made some comments about the holding period of different types of tariffs with reference to the importance of holding period for potential losses. Holding period refers to the holding period on an investment - in this case tariffs. In relation to Ofgem's estimated holding period for an SVT tariff under the price cap (4.5 months) we stated:

> *'We note, however, that this would only reflect the average holding period across a supplier's portfolio if all its tariffs mirrored the quarterly cap – which has not been the case historically. It seems unlikely that the exposure of suppliers pursuing the 'timing model' discussed in Oxera's report for GEMA was limited to 4.5 months. The*

prevalence of fixed term contracts of 12 months or more suggests a longer time horizon may be appropriate.'[40]

Whilst Ofgem is temporarily setting the MCR based on a notional efficient supplier the level of capital employed will be, implicitly, based on the tariffs that the Six Large Energy Firms were offering at the time the allowance was set. Ofgem needs to consider this point in carrying out its Pillar 2 monitoring ensuring that it is aware of any supplier that is offering tariffs with relatively high capital requirements. In addition, Ofgem should consider in more detail the tariff basis of the MCR in the longer term trajectory, as it proposes in the Statutory Consultation. Additionally, Ofgem should set out a timetable for this review without delay.

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

In our previous response we noted that we see regulatory capital as the financial resources a supplier has available to absorb losses. Capital absorbs losses only if it does not diminish in value or has to be repaid to a provider of funding before those losses are incurred. So, capital of this kind includes share capital without mandatory dividends, and distributable reserves, but would not, for example, include senior or secured debt. We also noted that the 'quality' of capital describes how likely it is to be available to absorb losses when they arise and that Ofgem should make clear in the license condition what kind of capital suppliers may use.

We agree that the proposed license condition sets out the type and quality of capital that suppliers may use and that the types of debt that are allowed (those that 'must not be secured on licensee assets by a fixed or floating charge or other security arrangements'[41]) would be of the type that can absorb losses.

Where the alternative source is held by a third party Ofgem notes that:

- 'the licensee must have robust, legally enforceable, and clearly defined arrangements in place to ensure that it can draw on that funding at all times, including in times of financial stress.
- said arrangements should not be capable of termination without good cause and without sufficient notice to enable the licensee to put in place arrangements to meet the Minimum Capital Requirement in another way.' [42]

These types of capital appear able to absorb losses when they arise and if a severe stress materialises.

Any system of prudential regulation must allow firms to use minimum capital and liquidity reserves if a severe stress materialises, and they must then be given time to build up their capital and liquidity again afterwards. If this isn't the case then firms would have to raise capital and liquidity in or shortly after an actual stress scenario, which might prove difficult and exacerbate the stress. In any event, a prudential regime in energy should define absolute minimum levels of capital and liquidity below which Ofgem would intervene.

---

[40] Centrica's response, Policy consultation: Strengthening Financial Resilience, 19 July 2022.
[41] Proposed new Licence condition 4B, Definitions, Alternative Sources of Funding.
[42] Proposed new Licence condition 4B, Definitions, Alternative Sources of Funding.

Ofgem does not state the absolute minimum levels of capital and liquidity below which Ofgem would intervene. Centrica's view is that Ofgem should do this in order that suppliers understand the process in a severe stress event.

> **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 have long called for appropriate protection to prevent misuse of customer money by under-capitalised suppliers treating customer credit balances and RO payments as interest free, risk-free working capital which is effectively insured by other suppliers' customers. The consequences of a regulatory regime that fails to adequately protect consumers from financially irresponsible energy suppliers are now plain for all to see and are well documented in Oxera's recent report for GEMA.

Until recently, Ofgem's approach has been to prioritise low barriers to market entry, but this has been at the expense of requiring an appropriate level of financial resilience to systemic risks. We welcome this Statutory Consultation as Ofgem is clearly committing to reallocating the risk of supplier failure away from all consumers, and onto the businesses that are responsible for creating this risk. However, all customers remain exposed to systemic risks so long as effective action is not taken to ensure energy suppliers are appropriately capitalised, sufficiently resilient to market shocks and bear their own risks rather than passing them off to all customers in the UK. We urge Ofgem not to delay these proposals from the proposed implementation date of April 2023.

We agree that suppliers should protect 100% of their RO obligation given that ROCs count towards this protection to maintain incentives and avoid double counting. This would be consistent with the obligations which would be mutualised across all UK customers on supplier failure, and therefore needs to be protected.

We agree the proposal should be fully effective from April 2023. A quarterly reporting mechanism would fit with the proposed quarterly protection period. It would be accurate for the reporting to be backward looking (as proposed for quarterly) rather than forward looking (as proposed for annual).

Ofgem has not yet published the RO timetable which is referred to the in the new licence condition SLC30. We assume that the first date on which suppliers will be required to protect Renewables Obligation will be 30 June 2023 in lieu of the period 1 April 2023 – 30 June 2023. Ofgem would not normally have registered ROCs for electricity generated over that period by 30 June 2023. The same would apply in all subsequent quarters as the number of ROCs registered will lag the relevant electricity supplied by approximately four months.

We welcome further information from Ofcom on how suppliers can manage the RO timetable given the lag in the registration of ROCs.

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

We do not currently foresee material impacts on our engagement with the ROC scheme, providing ROCs themselves count towards the required protection and assuming the availability of parent company guarantee (PCG) as sufficient protection mechanism given our investment grade credit rating.

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

We expect to use both protection of ROCs and a Protection Mechanism to ringfence Renewables Obligations payments.

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. Please see Frontier report for further information.

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

Ofgem sets out protection mechanism in the proposed new licence conditions SLC4D and 30. Our comments apply to both conditions.

As we said in our response to Ofgem's Policy Consultation, we agree in principle with suppliers being able to select from a menu of approved protection mechanisms reflecting that different business models have inherently different levels of risk.

However, we noted that the economic effect or outcome must be the same in all cases and in particular that parent company guarantees should be dependent on public commitment and an investment grade credit rating and in a form prescribed by the regulator.

The proposed licence conditions set out a number of requirements for a 'First Order Guarantee'. We have the following comments on these requirements:

- The First Demand Guarantee must be 'An irrevocable, independent, primary, and autonomous (in all circumstances) guarantee'[43]. We ask that Ofgem clarify what is meant by 'independent' and whether that includes, for example, a parent company guarantee. If it does Ofgem should include in the definition, 'including a Parent Company Guarantee if the Parent Company is rated at least investment grade.'
- The definition of 'First Demand Guarantee' which appears in SLC 4D and SLC 30 states that 'it is expressly governed by UCP 600 (excluding article 32) or ISP 98..'. This clause should only be applicable if the guarantee is issued by a bank, in all other circumstances, it should be governed by English law, with an exclusive jurisdiction clause in favour of the English courts. The guarantee can be issued by any person with the correct rating, if it is not a bank, UCP 600 and ISP 98 are not appropriate.

[43] Proposed SLC 30.

- Ofgem does not make any proposals on the need for a public commitment to be included in a parent company guarantee. Ofgem should add this requirement which ensures that, alongside our proposals on transparency of CCB protection, consumers understand what their supplier is using their money for and what will happen if the supplier enters financial difficulty.

centrica

Appendix 2 – Response to Consultation on Guidance on the Financial Responsibility Principle

Guidance on the Financial Responsibility Principle

Centrica welcomes the opportunity to respond to this consultation on the guidance on the Financial Responsibility Principle ('the FRP Guidance'). As there are no specific questions for consultation we set out our general comments below.

On the status of the Guidance

Guidance is usually voluntary in the sense that a supplier may or may not choose to follow it, however, it is indicative of how to demonstrate compliance with obligations/legal requirements. Therefore, a supplier can point to having followed guidance as evidence of adhering to obligations/legal requirements.

Centrica would welcome further explanation from Ofgem as to why the mandatory obligations are not contained directly in the licence but instead through guidance. In doing so, Ofgem should demonstrate that mandatory guidance is necessary and that the mandatory obligations cannot be met through amended licence conditions, as we expect would be the best regulatory practice.

In addition, Ofgem should explain to stakeholders how it is using its legislative powers to require mandatory guidance, and in what case a rule change may be implemented through changes to the guidance and not through a licence change, giving clear examples. In setting this out Ofgem should explain why this process is being followed and how this differs from the current process whereby each change to a licence condition may be appealable to the CMA.

On the content of the guidance

Given the status of the FRP guidance as mandatory, any obligations in the FRP Guidance must be necessary, reasonable and proportionate. Ofgem should seek stakeholders view as to whether this is the case and to the extent that the FRP Guidance contains a mix of mandatory or discretionary requirements, this must be very clear in all cases. Centrica notes some examples, which are not exhaustive, below where it is not clear whether provisions in the FRP Guidance is mandatory or discretionary:

- Paragraph 3.24 says 'Where a licensee supplies both domestic and non-domestic customers, we would expect the supplier to explain in its Annual Adequacy Self-Assessment any split of assets between the supply business for non-domestic supply versus domestic supply..'. It is not clear whether this is a mandatory or discretionary requirement.
- Paragraph 3.37 states that 'How a supplier completes its Annual Adequacy Self-Assessment, including the evidence it provides, will vary, as we recognise there is no one-size-fits-all approach to running a supply business.' It is not clear whether the factors listed in the same paragraph are mandatory or discretionary requirements.
- Ofgem sets out a number of things that suppliers should do in the section 'Business-specific arrangements and risks'. For example, Paragraph 3.41 states that 'A non-exhaustive list of what this should consider includes:..'. Ofgem should clarify whether this list is mandatory.

- Paragraph 3.45 states that 'For that plan to be credible, we consider that the supplier should illustrate how they will achieve at least an above-zero net asset position about a year ahead of the minimum requirement going live.' It is not clear whether this is a mandatory or discretionary requirement.[44]

On the process for consultation

Proposed SLC 4B.13 makes it mandatory for a licensee to comply with the FRP Guidance and not doing so would therefore be a breach of that licence condition. Ofgem has stated that it will issue the FRP Guidance document through a direction power under the licence, and amending the Guidance is subject to consultation.

Ofgem published the FRP Guidance on 5 December 2023 and has asked for responses by 3 January 2023.

Proposed SLC 4B.18 states that representations may be made on the content of the guidance for a period of not less than 10 working days. Likewise, proposed SLC 4B.19 states that for amendments to the guidance, representations may be made on the content of the guidance for a period of not less than 10 working days.

Given the mandatory nature of the FRP Guidance it is Centrica's view that a 28-day minimum consultation period should be required.

A breach of the FRP Guidance will be a breach of the licence and therefore subject to potential compliance/enforcement action, the issuance of and changes to the guidance must be subject to consultation requirements equal to what is required to amend a licence condition under the Electricity Act 1989 and Gas Act 1986, i.e. 28 day minimum consultation period. These statutory procedural protections should be adhered to. Suppliers particularly need adequate time to understand, consider and respond. Ofgem have not demonstrated that deviating from a 28 day minimum consultation procedure is necessary here or would be procedurally fair.

On the drafting or the relevant licence conditions:

- Ofgem has referred to "Guidance" in Condition 4B, this is a defined term but does not seem to be adequately defined anywhere. This also applies to SLC 4D and SLC 30.
- SLC 4B.16 is incomplete as is 4B.17.

On the proposed guidance on SLC 4D and SLC 30

Ofgem has not yet published guidance on SLC 4D and SLC 30 and so Centrica is not able to comment. However, we are taking this opportunity to comment on the relevant licence conditions which refer to future guidance which will be published by Ofgem, because the process and content of the guidance underlying all three proposed licence conditions are interlinked.

- SLC 4D.9 refers to the "Consumer Credit Balance Guidance" which is yet to be published and SLC30.4 refers to "Guidance" that may be issued 'from time to time'. Given the links between the FRP Guidance and any future guidance on SLC 4D Ofgem should publish these sets of guidance together to allow stakeholders to understand the full package of requirements before commenting.

[44] Ofgem, Guidance – Financial Responsibility Principle, 5th December 2022.

- Furthermore, SLC4D.9 requires the licensee to comply with any guidance in addition to the Customer Credit Balance Guidance as does SLC30.4. This is an obligation to comply with prospective, unseen guidance and Ofgem should justify why this is necessary (i) in addition to the licence conditions and (ii) in addition to the Customer Credit Balance Guidance in relation to SLC4D. Ofgem should also explain why the procedure for issuing and amending the prospective guidance differs from that for the FRP Guidance. For example, there is no specified minimum consultation period, and it appears any guidance can be issued without requiring a power of direction. Therefore, can Ofgem also explain how it intends this guidance to be mandatory under its legislative framework.
- In addition, the points above on the process to consultation, the status of the guidance and the content of the guidance apply equally to the, yet to be published, proposed Guidance on SLC 4D and SLC30.