Friday 30 December 2022

Statutory Consultation on Strengthening Financial Resilience

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Summary

Utility Warehouse was one of the first ‘challenger’ brands when it entered the retail energy market over 20 years ago, and we have a unique perspective in that we operate across numerous regulated markets: energy, telecoms and insurance. Today we serve over 800,000 households.

We broadly welcome the package of policy interventions Ofgem has settled on for this Statutory Consultation. The spike in wholesale energy prices in late 2021 was the trigger for a run of supplier failures which have proven extremely costly for consumers and taxpayers. If the wholesale market was the trigger, the underlying cause is now widely accepted to have been a regulatory environment that allowed unsustainable business models to operate whilst accumulating excessive risks.

Building on numerous policy interventions implemented over the past year, this package of reforms can be understood as Ofgem completing the task of shutting out unsustainable business models for good. It is disappointing, however, that Ofgem is still not inclined towards adopting the far simpler option of banning advance payments, which would have targeted much of the exposure at its root.

For major market interventions of this scale, Ofgem should always aim for clear and universal rules where possible. Without this principle in mind, measures can quickly and easily become overly specified and bureaucratic.

One such example of this problem being played out concerns Ofgem’s decision <u>not</u> to mandate credit balance protection, the first component of this Financial Resilience package. A difficult decision has finally been made, so it makes no sense to then detract from that position by also overlaying a ‘halfway’ option, whereby suppliers would have to notify Ofgem if credit balances exceed 50% of total assets. This would create an optional intervention rather than a universal rule, with ambiguous outcomes, and is therefore an example of a solution having become over-engineered.

By contrast, the proposal to mandate Renewables Obligation protection, the second component of this package, does meet the ‘simple and universal’ principle. Suppliers’ obligations will be unambiguous and Ofgem has avoided the risk of over-engineering the solution by allowing suppliers choice from a range of market-based Protection Mechanisms. We would only add that Ofgem should allow itself room to consider any additional form of collateral that a supplier may bring to its attention.

Finally, we see the proposal to implement a capital adequacy requirement, the third component of this package, as the final piece of the framework needed to create a stable and sustainable retail energy market for the long-term. However, we note that the lead time Ofgem intends to provide is generous, meaning that the market will retain considerable exposure to the risk posed by any under-capitalised suppliers for some time yet. Whilst we acknowledge the need to phase the requirement in, it’s concerning that for the first year suppliers will be allowed to operate with a net

asset position below zero. Therefore we propose that negative net asset position suppliers are prevented from taking on new customers and offering new fixed tariffs to existing customers until they have reached a positive net asset position. This is a short-term solution that would be effective in preventing unhedged fixed tariffs being used to bolster a weak financial position.

Questions from the Statutory Consultation document

1	**Do you agree with our package of proposals and overall approach?**
	Overall, yes. This package of measures will create the long-term conditions for a stable and sustainable market. That said, Ofgem must be vigilant to the risk of over-engineering each solution. On credit balance protection, it's disappointing that Ofgem is still not inclined towards the far simpler option of banning advance payments, which would have targeted the market's exposure to lost credit balances at its root. In contrast, the option for Ofgem to intervene if a supplier's credit balance accumulation exceeds 50% of total assets is overly-complex. At this stage, with Ofgem having reached a clear position against mandating credit balance protection, the '50% rule' only looks indecisive and so should be dropped. On Renewables Obligation ring-fencing, Ofgem sets out clearly that this proportion of supplier revenues should be out-of-bounds as a form of capital, which is fundamentally true. Attention therefore turns to consideration of how implementation is to work, which is discussed below, in question 9(2). And on capital adequacy, Ofgem's approach is stringent and balanced overall, with a generous timescale being factored in for suppliers to meet an unambiguous target. However, we make two recommendations below in question 6: an adjustment to the metric; and the application of a safeguard to cover the short-term risk posed by suppliers operating with a negative net asset position.
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, this licence update makes sense. The new text to capture the enhanced principle will be: "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". Suppliers are in effect already operating to this requirement via the financial resilience data submissions that have become part of the regular reporting schedule over the past year, meaning that the licence is aligning to what has become the practice. This reporting exercise has become slicker over time - but with Ofgem expected to increase its resources, in order to systematically monitor the enhanced financial resilience requirements, it's imperative that additional reporting is designed to be streamlined and repeatable. It has been the case in the past that Ofgem's financial data requests, including the stress-testing exercises, have suffered from inefficient scope creep and become burdensome. Data of interest has been incrementally added to or marginally changed as subsequent rounds have progressed. The market remains challenging and suppliers' focus on customer delivery is paramount, meaning Ofgem should help by maintaining consistency.
3	**Do you agree with our proposed approach to FRP reporting, including Trigger Points and**

	annual self-assessment reporting?
	Yes, and we would again emphasise the risk of scope creep: for example if testing where to become more frequent. An annual self-assessment, as proposed, will be sufficient; particularly considering the view already provided to Ofgem via the monthly data submissions and the now quarterly stress-testing. We notice across the supplier community, via Energy UK, that a perception remains that Ofgem could still do more to consistently join up the insights it gathers from all of the discrete reporting exercises.
4	**Do you agree with our proposal regarding the notification and monitoring approach for reliance on CCBs – including the proposed 50% of total assets threshold – or would it be more beneficial to set a prescriptive maximum reliance on CCBs?**
	No, because this is a cumbersome 'halfway' solution. It has become over-engineered and should be dropped. We have long held the view that customer credit balance risk emerged primarily as a feature of taking advance payments, and so could be resolved to all reasonable extent by abolishing this discredited practice. Instead, Ofgem has finally settled on a proposal to give itself the option to enforce credit balance protection by exception, if a threshold is exceeded. Naturally this could become complex in practice, given that a supplier's position relative to the threshold will be continually moving. If Ofgem is satisfied that advance payment can remain a feature of the market, then it should logically tolerate that credit balance exposure will be higher than it needs to be, and would likely grow when new entrants return. Therefore it would be better just to move on from this long-running issue and focus attention on the other components of this financial resilience package: Renewables Obligation protection and capital adequacy. Ofgem notes that it still retains an effective tool to control credit balance risk through monitoring of the existing Direct Debit obligations.
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 ring-fencing of CCBs?**
	No, because by coming out against credit balance protection yet wanting to retain the option to intervene, Ofgem appears indecisive and risks introducing ambiguous regulatory outcomes. This proposal is impractical because the requirement will continually have to aim at a moving target. Furthermore, the market would not have a transparent view of the penalty for exceeding the credit balance threshold, as Ofgem may or may not direct hard ring-fencing. It would be better to drop this 'halfway' solution and focus on achieving clean outcomes for the other components of the financial resilience framework.
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?**
	We have two recommendations we think Ofgem should apply to achieve its aims. One adjustment to cover long-term risk and another to cover short-term risk. Long-term risk is to be covered within Ofgem's preferred definition for the capital adequacy metric: (Fixed Assets + Current Assets) – (Current Liabilities + Long-term

	Liabilities). This choice of metric is a reasonable baseline, to be calculated by each supplier at their group level. That said, an adjustment should be applied to better cover the exposure that an individual supplier's capital position creates for all. Specifically, Ofgem is proposing to exclude from this metric any long-term debt which has an associated fixed or floating charge. Given that such broad security arrangements apply to a number of energy suppliers, we would recommend that such an exclusion applies only to long-term debt where that debt is secured against a specific asset. In contrast, long-term debt secured via more general fixed or floating charge security arrangements should be in scope. Regarding short-term risk, Ofgem evidently still has significant concerns about the ongoing stability of the market, as indicated by the separate proposal to extend the Market Stabilisation Charge. In this context, suppliers who will first have to achieve a net asset position of zero, before they can ramp up to reach the 2025 target, remain a serious concern. It's not rational that negative net asset suppliers should simultaneously be seeking growth, which by definition is unaffordable. A simple overlay to protect the market, consumers and taxpayers in the short-term would be to prevent unhedged fixed tariffs being used to bolster a weak financial position: with a rule that negative net asset position suppliers are prevented from taking on new customers and offering new fixed tariffs to existing customers. The rule would be short-lived, given that there is to be only a one-year deadline for achieving a positive net asset position.
7	**Do you agree with our proposed approach of setting the minimum capital requirement on a per-customer basis, or do you have a preference for a volumetric approach? In the case you prefer volumetric approach, what calculation method is most appropriate?**
	Yes, as it has the benefit of being transparent and easily understood. It is also easily scalable, to accommodate growth and decline in suppliers' customer bases.
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?**
	Our message is that Ofgem should proceed cautiously when considering how granular the details within substantial policy interventions should be. Regulation should fundamentally be concerned with setting out the framework within which the market operates. The minimum capital requirement proposals must be set at the right level: there should be a clear framework, with a clear target and timescales, alongside appropriate supplier flexibility (e.g. setting the staging posts). We are therefore somewhat sceptical about the merits of incremental details to be consulted on at a later date. But it's appropriate for now that these details have not complicated the capital adequacy requirement to be introduced via this Statutory Consultation.
9(1)	**What is your view on our proposed approach to considering alternative sources of funding?**
	As with the menu of existing market Protection Mechanisms available to protect revenues

	attributable to the Renewables Obligation (and also as originally envisaged for credit balance protection), Ofgem is right to avoid over-prescribing requirements that may need to be bespoke depending on the supplier. Alternative sources of funding, such as Parent Company Guarantees, are applicable sources of capital.
9(2)	**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 think there is likely an industry consensus that the potentially very long lag for suppliers to settle their Renewables Obligation payments needs to be greatly reduced. We've long had a situation whereby revenues attributable to April, as the first month in the Regulatory Year, could remain unsettled until the expiry of the late payment window at the end of October in the following calendar year. Therefore the proposal for quarterly and backwards-facing protection introduces sensible milestones to ensure that these funds are protected for their proper use. However, we've not yet been able to ascertain how the process would work at the end of one Regulatory Year and into the start of the another: the period before the actual settlement obligation at the end of each August. For example, shortly after the end of March, backward-facing, that Regulatory Year's Renewables Obligation would be fully protected, yet the certificates and funds wouldn't clear until the end of August. In the meantime an full additional quarter of obligation, April - June, would also have been protected. Therefore it would seem that suppliers will have to protect five quarters rather than four, before the certificates and funding clear and the process can start from a zero position again. It may be that Ofgem has already foreseen this event and it's simply that we are yet to understand the scenario fully. It's the occasional implementation query like this that leads us to our only significant criticism of Ofgem's proposals. Issues such as this would normally have been thoroughly ironed-out by the time we'd reached the Statutory Consultation phase and clarified in the Statutory Consultation document. To the extent that potential ambiguities such as this are raised by others in this round of response, it may be that there is some further work to do before Ofgem can proceed with implementation.
10	**How, and to what extent, might our proposals for RO ring-fencing impact the way in which your company interacts with other Government schemes?**
	We do not foresee changes.
11	**Would you envisage ring-fencing your RO using a Protection Mechanism, protecting ROCs, or using a mixture of the two?**
	This may be a difficult question for suppliers to answer with confidence because it will depend on their choice of, and access to, an efficient form of Protection Mechanism. For this reason we offer some further advice on the proposed drafting of the new licence text. Back in the summer, when suppliers were workshopping Protection Mechanisms with Ofgem for the intended purpose of credit balance protection, some draft licence text was shared as follows: "[Credit Balance Support Arrangements] means one or more of the following: (a) Standby Letter of Credit; (b) First Demand Guarantee; (c) Cash deposited in a Credit Balance Trust Account; and (d) **Any other arrangement that meets the** **requirements of paragraph 27.22 and which has** **been approved by the Authority in writing for the**

	purposes of this condition." Now that this work has been converted to serve as the definition for 'RO Credit Cover Mechanism', the 'any other arrangement' option has been dropped. It would be prudent to reinstate it, so that Ofgem has a free option to consider any as-yet-unknown Protection Mechanisms that may be forthcoming from suppliers or their financial service providers. There is no risk to Ofgem in adding room for any necessary and/or efficient alternatives.
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?**
	Whilst it's accepted that the suppliers' role in the Renewable Obligation is solely as collection agents to pass through revenues, it's naturally the case that the cost of this collection service needs to be paid for fairly. In the early years of implementation it would not be reasonable to assume that the fair assessment of the cost of this service can be indexed to an 'efficient supplier' methodology. Some headroom above the costs associated with an efficient supplier should be built in for an implementation period, whilst more data on actual costs becomes available from suppliers' real-life compliance solutions.