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Dear David,

Statutory Consultation – Strengthening Retail Financial Resilience

EDF is the UK's largest producer of low carbon electricity. EDF operates low carbon nuclear power stations and is building the first of a new generation of nuclear plants. EDF also has a large and growing portfolio of renewable generation, including onshore, offshore wind and solar generation, and energy storage. We have around six million electricity and gas customer accounts, including residential and business users. EDF aims to help Britain achieve net zero by building a smarter energy future that will support delivery of net zero carbon emissions, including through digital innovations and new customer offerings that encourage the transition to low carbon electric transport and heating.

EDF remains supportive of Ofgem taking measures to improve the financial resilience of the retail market, which will lead to more sustainable competition in the long-term, to the benefit of consumers. We, therefore, support the direction of travel reflected in this statutory consultation. Overall, it represents a sensible balance between minimising additional costs on consumers and suppliers whilst ensuring Ofgem has powers to act where it has concerns around individual suppliers' activities.

In particular, we support Ofgem's proposals to:

- Not implement ringfencing proposals for Customer Credit Balances (CCB) on a market-wide basis, but rather take the powers to do so where there are concerns around an individual supplier's actions or financial resilience;
- Enhance the Financial Responsibility Principle. To support this, we would urge Ofgem to prioritise the digitisation and easing of data transfer from suppliers to reduce the resource burden suppliers face when providing data to Ofgem to enable this to function more effectively; and

- Ring-fence domestic RO receipts. RO receipts are a ‘pass through’ cost for suppliers and such monies should not be used to support other commercial or operational activities. Ofgem should also work with BEIS to consider how it can ensure suppliers are also adequately resourcing their ECO obligations and that such monies are not being used to support other activities.

Key to the utility of the above proposals will be that both RO and CCB ringfencing are insolvency remote. Ofgem must assure itself and consumers that it can act promptly to ringfence monies so that they will not be available to be claimed by administrators for other purposes in the event of a supplier failure, such as recompensing shareholders.

However, the current proposal for setting minimum capital requirements on all domestic suppliers will entail considerable costs for consumers and suppliers with minimal benefits in many cases. It is also surprising that this has not been subject to a more detailed policy consultation before being advanced to a Statutory Consultation. This will have prevented suppliers and other interested stakeholders from having the opportunity to consider more broadly the most proportionate approach to meeting Ofgem’s objectives.

In the current market where the current price cap methodology prevents efficient suppliers from making a fair margin it is not clear why any investor would provide additional funding or other financial instruments for a retail supplier to meet the capital adequacy requirements as currently proposed. Unless investors can see a route to making a fair margin then there is no clear business case for the provision of such additional financial support. With this in mind, it is important Ofgem also carefully considers the interlinkages with its concurrent consultation on changes to the EBIT allowance in the Default Tariff Cap (DTC), which could further reduce a supplier’s ability to achieve a fair margin, only serving to further reduce suppliers’ investability.

We have proposed a more detailed alternative approach as to how Ofgem should implement capital adequacy arrangements in the energy retail market in the Annex to this letter, which would better achieve Ofgem’s stated aims. In addition, we have identified several weaknesses with the approach currently outlined by Ofgem. In summary, however, we would like to see Ofgem adopt an approach based around share capital where:

- A new “minimum financial resources” requirement is introduced for all suppliers to demonstrate that suppliers are a going concern;
- A Minimum Capital Adequacy arrangement is set for all suppliers, based on share capital (and not net assets) or alternate financial approaches. For established and stable suppliers this should be no more than £100 per domestic customer; and
- Ofgem should take powers, as it has for CCBs, to be able to increase this level of Minimum Capital Adequacy where financial reporting data (e.g. rapid growth) raises material concerns around individual supplier’s financial resilience.

It should be recognised that all retail suppliers still operating in the market have proven their financial robustness over an extremely challenging period and so placing disproportionately high costs on existing suppliers will only add to costs with little market benefit. However, this will not be true of any new entrants once the market moves to a more competitive environment.

As part of its work implementing proposals to strengthening financial resilience, we would, therefore, encourage Ofgem to also have a particular focus on ensuring that new entrants are robustly financed and adequately hedged. To this end, in line with a risk-based approach to CCBs and capital adequacy, we would support Ofgem requiring new entrants to ringfence CCBs and have higher minimum capital adequacy requirements until such time as they have proven their financial robustness and stability. Ofgem should also closely review the hedging approach very regularly, as in the past this is what has led to rapid deterioration in financial stability. Such additional controls should be for a period of no less than three years (when they can be gradually decreased, in line with risk).

We would also encourage Ofgem to consider how their proposals would have impacted on previous insolvency events and prevented them having a negative impact on the market e.g. Bulb and Avro. This should determine whether the proposals are fit for purpose and sufficient and provide learnings to inform these areas as they are finalised.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre or myself.

Yours sincerely

John Mason
Senior Manager (Price Regulation & Market Dynamics)

Appendix
Policy Consultation – Strengthening Retail Financial Resilience

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

EDF supports the direction of travel reflected in this statutory consultation. Overall, it represents a sensible balance between minimising additional costs on suppliers whilst ensuring Ofgem has powers to act where they have concerns around individual suppliers' activities. However, we strongly disagree with the poorly defined minimum capital requirement as currently proposed in the consultation document. As proposed, the requirements will not achieve Ofgem's stated aims. Instead we propose, as part of our response to Question 6, an alternative approach, which would better protect consumers consisting of:

- A new "minimum financial resources" requirement to demonstrate that all suppliers are a going concern;
- Minimum Capital Adequacy arrangements for all suppliers based on share capital (and not net assets) or alternate financial approaches; and;
- Ofgem taking powers, as it has for CCBs, to be able to increase this level of Minimum Capital Adequacy where a supplier is new to the market or financial reporting data (e.g. rapid growth) raises material concerns around individual supplier's financial resilience.

With regards to Credit Balances, we agree it is necessary to bring in principles and regulations for suppliers to improve their financial resilience, and that this should be effectively monitored. EDF supports a risk-based approach whereby suppliers that do not reach an adequate threshold for financial resilience are subject to further investigation and restrictions (for example protecting a percentage of CCBs), as this will ensure robust suppliers are not subject to unnecessary costs which would ultimately be passed on to consumers. This is a prudent approach and acknowledges that for most suppliers their credit balance position is far outweighed by the debt that customers owe. Therefore, to further constrain the working capital management of prudent existing energy suppliers is unnecessary and disproportionate to the risks imposed by robust suppliers.

Ofgem should, as part of a risk-based approach to CCBs, have a particular focus on ensuring that new entrants are robustly financed and not misusing CCBs. To this end, we would support Ofgem requiring new entrants to ringfence CCBs until such time as they have proven their financial robustness and stability. We would suggest that this be for a period of no less than three years (when such additional controls can be gradually decreased in line with risk).

In addition, EDF supports action that ensures that where energy suppliers exit the market, they do so in an orderly fashion with mutualisation costs minimised. Consequently, we accept the rationale for ring-fencing RO receipts as this is a 'pass through' cost for suppliers and such monies should not be used to support other commercial or operational activities. Ofgem should also work with BEIS to consider how it can ensure suppliers are also adequately resourcing their ECO obligations and that such monies are not being used to support other activities.

Key to the utility of the RO and CCB ringfencing requirements, however, is that ringfenced funds are insolvency remote. Ofgem must provide confidence that any ringfenced monies will not be available to be used by administrators in the event of a supplier failure for other purposes, such as recompensing shareholders.

Finally, enhancing the Financial Responsibility Principle appears to be a sensible approach. Ofgem must now prioritise the digitisation and easing of data transfer from suppliers to reduce the resource burden suppliers face to enable this to function more effectively. It is essential that Ofgem is monitoring suppliers' financial resilience on an ongoing basis to ensure any areas of concern are quickly identified. Where issues are identified Ofgem must then be prepared to act in a timely and impactful manner, to ensure that risks to the wider market, via mutualisation and other pressures, are mitigated. An area of weakness with Ofgem's proposals in relation to improving financial resilience is the potential for a time lag from the point that Ofgem identify concerns and action being taken to improve an individual supplier's financial resilience (e.g. protecting a greater proportion of CCBs). We, therefore, continue to support Ofgem making full use of the various tools at its disposal, including, but not limited to, immediate bans on customer acquisitions, to help minimise any market risk and incentivise speedy resolution to issues.

In the responses to the questions below we have also detailed further specific elements of Ofgem's proposals in relation to CCBs, RO receipts and the Financial Responsibility principle that could be improved. For each, there are elements which may not meet their stated objectives or are onerous, leading to consumer cost for little gain.

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

Yes, EDF agrees with the proposal to enhance the FRP to require suppliers to ensure there is no significant risk that liabilities cannot be met as they fall due.

All stable and robust suppliers should be a Going Concern and able to meet their liabilities as they fall due. Any entities which cannot meet this threshold should not be allowed to operate in a market as fundamentally important to consumers as energy supply. A key focus for Ofgem should be to ensure robust monitoring of suppliers is in place so that it has early insight where there is any risk that a supplier cannot meet their liabilities. It is essential that this happens regularly and on an ongoing basis, not just an annual one-off, to ensure any areas of concern are quickly identified. Ofgem must also be ready to act quickly to ensure that CCB and further capital adequacy arrangements are put in place to limit the negative impact any such supplier failure can have on the wider energy market through mutualisation arrangements.

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

Overall, yes, we agree with the proposed approach to FRP reporting.

However, as a matter of principle Ofgem should ensure that it is making maximum use of existing information to inform evaluations before additional information is requested.

We note that the proposed Annual Adequacy Assessment will likely be very similar to the Going Concern assessment that Directors are required to make every year for audit purposes. EDF would encourage Ofgem to explore how these two requirements could complement each other to avoid unnecessary duplication of work and minimise costs.

Recognising, however, that many of the suppliers that have failed had filed accounts asserting that they were a Going Concern and this was not adequately challenged by their Auditors, Ofgem should also look to monitor the hedge positions of suppliers. This should ensure that suppliers are responsible in hedging their energy costs, to avoid a situation repeating whereby suppliers were allowed to assume massive exposure in the market whilst claiming they were a Going Concern. Hedging is a key decision that is made by suppliers, especially in a volatile and illiquid market and where they are making decision which could carry risk, and therefore must be a key area of focus when Ofgem is considering suppliers financial responsibility. Considering the risks of funding sources and their renewal is also pertinent in this regard.

Ofgem should consider how their proposals would have impacted on previous insolvency events and prevented them having a negative impact on the market e.g. Bulb and Avro. This should determine whether the proposals are fit for purpose and sufficient.

Requiring scenario analysis based on future events and commodity price movements would also allow suppliers to demonstrate that they could meet liabilities as they fell due in stress scenarios and EDF welcome this element of the Annual Adequacy Assessment. Ideally, Ofgem would allow suppliers to use the results as one of their quarterly stress tests to prevent duplication.

Finally trigger points are vital events whereby Ofgem can intervene when the stability of a supplier comes into question. Ofgem must not just monitor, as a regulator Ofgem must act quickly where necessary. Due to the particular financial risks unsustainable growth can bring to the market, we consider that a significant period of fast growth for a supplier should also act as a trigger point for Ofgem to consider whether further action is needed with regards to CCBs or Minimum Capital Adequacy requirements.

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

No, we do not agree with the proposal regarding the notification and monitoring approach for reliance on CCBs.

A reasonable level of CCBs depends on the seasonality of the direct debit cycle, tariff prices and customer numbers. It does make sense to use a percentage threshold of *certain* assets. We also do not agree with a definition of "*gross CCBs net of all unbilled debt for all fixed DD customers*".

Rather, the CCB amount should be calculated on an account level and include prepayment (both legacy and smart) customers in order to reflect the amount of costs at risk of mutualisation. EDF would prefer a threshold expressed as a percentage of gross consumer trade debtors (excluding bad debt provision), as this reflects the balance between money owed by customers and money owed to customers, so is more readily understood by consumers and less likely to be gamed by suppliers looking to maximise capitalisation of costs in order to maximise the CCBs they can reasonably hold.

Where Ofgem become aware of an insolvency risk then Ofgem must act quickly to ensure that further CCBs are mitigated from suppliers continuing to collect Direct Debits, and other payments, once they are no longer solvent. Action must be taken immediately where there is any risk of insolvency to ring-fence all future bill collections monies. Otherwise there is a high moral hazard where suppliers about to go/recently insolvent will collect DD receipts and other advance payments, but use the monies for other purposes, such as paying creditors or shareholders. This means that CCBs are not adequately protected from the insolvency process. This is a key area of mutualisation cost risk and Ofgem must ensure it is able to act quickly to mitigate this.

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

Yes, EDF agrees with the approach outlined.

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

No, we do not agree with Ofgem's proposed approach to the minimum capital requirement.

In particular, EDF does not recognise a link between a "minimum capital requirement" to ensure financial resilience and a net assets measure. We have outlined examples of our reasoning below (although this is not an exhaustive list):

- A Fair Value derivative asset related to a hedge book of purchase commodity trades gives a false impression of financial resilience, as it implies that a supplier could meet liabilities by unwinding its hedge position – which would in fact reduce its financial resilience.
- Many fixed assets (investments in subsidiaries, IT systems, capitalised acquisition costs) are not liquid and cannot be monetised quickly (or even at all) to meet liabilities that require payment.
- Fixed assets are normally recorded using historical cost; therefore, this may misrepresent their fair value.
- Some long-term borrowings may not fall due for a significant period, and therefore may not impact financial resilience at all within the assessment period.
- A net asset approach would allow Director loans to be counted as assets that can be used to fund the liquidity of the entity, when these may be of low likelihood of repayment.
- A net asset test could lead to an incentive to adopt accounting policies which may lead to inappropriate capitalisation of assets or accelerated revenue recognition.
- A net asset test does not consider available credit facilities or intragroup funding/support.

Ofgem's proposed range for the Pillar 1 minimum capital requirement, is too high when compared to the publicly available £75/account price paid per account by OVO for the SSE customer base. Where an account is only considered to be worth £75, asking suppliers to have financial resilience equivalent an amount much higher than that level is likely to be a significant barrier to future investment in the retail market. Given investors' expectations of returns in the current market (as evidenced by the rather low £75/customer valuation), it is not clear why any investor would provide additional funding or other financial instruments for a retail supplier to meet the proposed capital requirements.

Unfortunately, Ofgem concurrent consultation on the EBIT allowance under the Default Tariff Cap also potentially stands to further diminish investors' views of potential returns should the allowance be reduced. As an industry we need motivated investors who are ready to support innovative suppliers if we are to support customers in achieving net zero. However, the combination of high (and increasing) minimum capital requirements and the potential for a reduced EBIT allowance, together raise the serious risk of making this market un-investable. Ofgem must accept that one impact of introducing minimum capital requirements is that investors will require additional confidence in future levels of returns, otherwise requirements risk driving further market exits to the detriment of customers and net zero.

The current proposals for setting both the structure and level of minimum capital requirements for domestic suppliers will entail considerable costs for consumers and suppliers with minimal benefits in many cases.

Nonetheless, we agree that suppliers cannot be allowed to operate by Ofgem with minimal capital, as has often been the case in the past, to ensure that investors share any risk of liquidation with consumers and the wider industry. The current arrangements have led to significant risk of 'moral hazard' where any profits are owed to the directors/investors, but with any losses ultimately paid for by consumers through the mutualisation processes. There is, however, disparity between making investors share such risks to incentivise responsible behaviour and deciding that a high level of equity (net assets) is a good measure of financial resilience for the future. Ofgem should recognise that these are two separate issues that both require addressing in a robust manner individually. Ofgem's current Pillar 1 minimum net assets measure requirement is insufficient to cover either issue, let alone both.

EDF would instead welcome Ofgem adopting a minimum share capital requirement to ensure that investors hold risk capital in the form of a residual interest in the net assets of the business. This would mean they share the costs of a business failure, thus removing the moral hazard seen repeatedly during the recent rash of supplier failures.

We see such an approach as consisting of three stages:

1. A "minimum financial resources" requirement to demonstrate that suppliers are a going concern. This would be based on a cash flow forecast, determining the forecast maximum cash deficit over a two or three year timeframe, and then requiring firms to evidence to Ofgem that they had robust financial resources (cash, undrawn loan facilities etc.) that would meet this requirement across a range of scenarios. This should be based on a supplier by supplier assessment at a balance sheet date allowing the incorporation by each supplier of its own operating model, rather than a notional supplier approach solely focused on domestic SVT customers. This aligns somewhat to the Pillar 2 requirement.

2. A requirement for all suppliers to hold a minimum amount of share capital (not net assets) or alternate financial approaches, based on a judgement stemming from assessing current levels of share capital for existing suppliers, versus suppliers that failed. To ensure competition is allowed, this amount should be fair so as to reduce the moral hazard but simultaneously not act as an unreasonable long-term barrier to entry/growth. For an established and stable supplier, we see no reason why this would need to be any higher than a maximum of £100 per domestic customer.

3. Ofgem taking powers, as it has for CCBs, to be able to increase the target level of minimum financial resources requirement where financial reporting data raises material concerns around individual supplier's financial resilience.

In relation to the proposed risk-based powers to set higher minimum capital requirements, we have identified two specific circumstances where, due to the wider market risks of supplier behaviour, we would like to see Ofgem have a particular focus:

- New Entry – As evidenced by the market exists seen over the past year, there is a particular risk of new entrants not being robustly financed. We would, therefore, support Ofgem having higher capital adequacy requirements (in excess of £100 per customer) for such suppliers, until such time as they have proven their financial robustness and stability. We would suggest that this should be for a period of no less than three years (when such additional controls can be gradually decreased in line with risk).

- Rapid Supplier Growth - A significant period of fast growth for a supplier should act as a trigger point for Ofgem to consider whether further action is needed with regards to increasing a supplier's capital adequacy requirements exponentially in line with growth in order to mitigate any potential risk to the wider market and consumers should such growth prove to be unsustainable.

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

The proposed approach seems sensible, subject to our response to Question 6. EDF has not been given enough time to conclude definitively on whether a volumetric approach would lead to a materially different outcome, however it would not be expected to.

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

We do not agree with the proposal to treat all tariff and payment types the same in the first minimum capital requirement. Therefore, we do not agree with the proposal to consider these in a future consultation.

At a high level, in order to assess financial resilience, different tariffs, and the working capital terms of them, must be considered within any cashflow model that would be used for assessing financial resilience. We would welcome further discussion on how this could be achieved.

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

Alternative sources of funding in the current methodology are essential, as the base case "net assets" approach is wholly inappropriate for assessing financial resilience (see response to Question 6). With regards alternative sources of funding any investment grade parent should be able to provide support (BBB- rating), the BBB rating appears arbitrary (see response to Question 14).

It is also true that on balance sheet long term liabilities should not alone be sufficient to meet the financial resilience minimum requirement, as the pertinent fact is how much the entity has in cash and available facilities (*off* balance sheet).

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

EDF is not aware of any impact on how we will interact with other Government schemes.

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

(REDACTED)

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

The proposed price cap allowance of £8 per year for the typical customer does not seem inappropriate. However, with the limited data that Ofgem has provided it has not been possible to fully consider whether this allowance is appropriate.

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

Having a minimum rating set as high as BBB / Baa2 means that entities rated BBB- / Baa3, which are still investment grade, would not qualify. The minimum credit rating for any parent company guarantor should be BBB- (S&P or Fitch) or Baa3 (Moody's) (if the rules around providing an alternative form of protection if a rating downgrade below BBB- / Baa3 happens are clear). For any bank or other financial institution issuing a letter of credit or bank guarantee it should be a minimum A- (S&P or Fitch) or A3 (Moody's).

These are common minimum credit ratings utilised in the energy sector in the UK when negotiating bilaterally, and the minimum bank / financial institution ratings also aligns with several existing industry codes. We are aware that certain industry codes allow credit ratings down to BB- / Ba3 to qualify for some form of free credit line, therefore BBB- / Baa3 would be a more suitable threshold as that is investment grade, and introducing a tiered level (as they have with CUSC Use of System, DCUSA, and UNC Transportation & Distribution) would add operational and administrative complexity for these new arrangements.

Whilst it is less common for minimum short-term credit ratings to be used, a minimum of A-1 (S&P), P-1 (Moody's) or F1 (Fitch) are suitable for bank / financial institutions issuing letters of credit / bank guarantees of up to 1 year, but the A- / A3 ratings should qualify on an equal basis i.e. a bank / financial institution should be required to hold either a long-term rating that meets the test or a short-term rating that meets the test, not both.

Entities should also not have to be rated by all three main agencies (S&P, Moody's, Fitch) to meet the test, a rating from one agency, provided it meets the minimum, should qualify (otherwise it increases the costs associated with meeting the test).

EDF January 2023