Consultation

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Further Statutory Consultation: Strengthening Financial Resilience– introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction

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Response deadline:	5 May 2023
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We are consulting on introducing a common minimum capital requirement (as part of a wider capital adequacy regime) and powers to direct suppliers to ringfence customer credit balances to strengthen the financial resilience of the energy supply market. We have refined these proposals following our November consultation, and we are publishing this document alongside our decision to introduce ringfencing of Renewables Obligation receipts and enhancements to the Financial Responsibility Principle. We would like views from a range of organisations, including suppliers, investors, consumer groups, charities, government bodies, and trade associations. We also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose, and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive summary

In November 2022 we consulted on our proposals to introduce a minimum capital requirement and powers to ringfence customer credit balances by direction (CCBs), as well as ringfence Renewables Obligation (RO) receipts attributable to domestic supply and introduce an Enhanced Financial Responsibility Principle.

There was broad support for the principles of strengthening financial resilience of the sector and support for introducing an Enhanced Financial Responsibility Principle and Ringfencing RO. We have published a decision on those proposals.

There were a wider range of views on our proposals to introduce a minimum capital requirement and the power to direct ringfencing of CCBs. Following feedback from the statutory consultation and bilateral meetings, we have decided to seek further input through a supplemental statutory consultation to clarify our proposals and refine the policy design and the licence drafting. We believe that setting minimum capital requirements for all domestic suppliers and introducing powers to ringfence CCBs remain important solutions to address the systemic challenges the retail energy market has faced in recent years of high levels of supplier failure resulting from poorly capitalised companies reliant on customer credit balances, leading to high costs to consumers through mutualisation.

On the minimum capital requirement, we have further refined our policy and are proposing that suppliers maintain a Capital Floor of £0 Adjusted Net Assets per customer from 31 March 2025 and meet a Capital Target equivalent to £130 Adjusted Net Assets per dual fuel customer from 31 March 2025. We propose that suppliers not meeting the Capital Floor would be in breach of the licence condition. Suppliers not meeting the Capital Target would be required to submit a Capitalisation Plan showing how they intend to do so and would be subject to Transition Controls until they have an acceptable plan in place. We believe this approach strikes the best balance for consumers in providing strong incentives for suppliers in a stronger starting position to achieve and maintain the target, but also enabling those currently less well capitalised to take longer if needed to avoid exit, while facing more scrutiny and controls to mitigate the risks for consumers. We are seeking views on the compliance framework, the level of the Capital Floor and Capital Target and the definition of Capital.

The intention would be to retain flexibility to adjust the regime in consumers' interests, reflecting the risks facing suppliers. With that in mind, if there are reforms to the sector that change the common risks facing suppliers, we would consult to amend the capital requirements. For example, further price cap reform could reduce the capital target. We also recognise that these capital requirements will require a profitable and investable sector, and we will be taking that into account with our forthcoming decision on the EBIT allowance in the price cap.

We are also seeking views on our revised approach to introduce powers to ringfence CCBs by direction. This includes revisions to the data triggers that would prompt us to consider whether a specific direction to ringfence CCBs is needed, proposing that the Capital Target, and the requirement to hold cash balances at a level equal to or greater than 20% of gross CCBs net of unbilled consumption held by domestic Fixed Direct Debit customers, will be used as a trigger threshold for CCBs.

In addition to the Enhanced Financial Responsibility Principle and ringfencing of RO receipts being implemented through a separate decision, this package of measures will help deliver a retail energy market that is secure, sustainable, and therefore able to deliver the innovation and positive consumer outcomes needed in the future.

Introduction

Section summary

This section explains the context behind the broader proposals to strengthen the resilience of the energy supply market, why we have sought additional stakeholder feedback to further refine our proposals and the areas in which feedback has informed change in the proposals compared to the November 2022 Statutory Consultation.

Context

The energy sector has faced extreme volatility in recent years, with rising wholesale prices contributing to market exit of 30 suppliers since August 2021. This has led to significant impacts for consumers, with nearly 4 million experiencing the disruption of a supplier failure and all consumers facing higher prices due to costs being mutualised.

While some level of failure in a competitive market is inevitable, we have recognised the need to act to prevent these harms to consumers. Since December 2021 a wide range of measures have been put in place to help deliver a more resilient supply market including robust stress-testing, seeking assurance on suppliers' management control frameworks, and using compliance and enforcement powers to address concerns arising from these assessments.

However, we recognise the need to go further and address the underlying issues of suppliers being able to enter the market and operate in a way too reliant on customer funds rather than investor capital. This has meant – as identified by the independent Oxera review of Ofgem's regulation of the energy sector – that shareholders have been able to pursue a "free bet", pursuing growth fuelled by revenue from customers, which in the event of failure was costless from a shareholder perspective. These business models also faced high exposure to external shocks such as wholesale price volatility, creating the situation that led to high levels of market failure.

To address this, following the November 2022 Statutory Consultation we have decided to implement ringfencing of Renewables Obligation (RO) receipts and introduce an Enhanced Financial Responsibility Principle (FRP) to create the framework to allow us to better identify risk and intervene to mitigate it. These decisions are published alongside[1] this consultation and form important pillars of our enduring approach to ensuring supplier financial resilience.

[1] [Review of Ofgem's regulation of the energy supply market | Oxera]

We continue to intend to take forward the remaining elements of the proposed package – introducing common minimum capital requirements for domestic suppliers and taking powers to ringfence CCBs. However, following stakeholder input at Statutory Consultation stage we are taking the opportunity to seek further feedback to ensure the definitions and design of the measures offer the right balance of ensuring the key outcome of a more resilient retail energy sector are achieved, but also that the proposals are flexible in their implementation to recognise the circumstances of suppliers and the challenging broader market context.

What are we consulting on?

The need for capital

Events in the energy market have exposed that retail businesses have too often had insufficient capital to manage the risks involved in retail energy supply and pursued unsustainable growth strategies with low downside risk to investors.

The Oxera report found that all failed suppliers had negative and deteriorating equity balances before they failed. In particular, all failed companies had negative and deteriorating equity balances in the years leading up to their failure. These negative equity balances reduced the suppliers' abilities to absorb external shocks such as the demand uncertainties related to the COVID-19 pandemic and subsequent rapid and sustained increases in wholesale energy prices. They also implied low opportunity costs of exit, where the investors can walk away from negative equity balances and the potential losses of customer credit balances, due to mutualisation of costs as part of the Supplier of Last Resort (SoLR) process. Most of the failed suppliers also:

- had poor liquidity and low levels of capital;
- were over-reliant on customer credit balances to finance their operations; and
- were either unhedged, or not substantively (i.e. more than 50% over nine months or more) hedged

Taking the lessons from the Oxera report, we want suppliers to be sufficiently resilient to withstand severe but plausible financial shocks. As part of this and our wider reforms, we believe that it is essential that suppliers are sufficiently capitalised, and we are therefore proposing to introduce a capital adequacy regime to achieve this.

Suppliers face opportunity and risk, and therefore do not have certainty of outcome. This risk of outcomes worse than planned for or expected means suppliers must have financial reserves to ensure they survive these outcomes; this is the fundamental concept of capital adequacy. While a wide range of other indicators of financial resilience exist, following the level of previous supplier exits, we want suppliers who operate in the retail energy market to be prudent and act in the consumer interest and for that reason believe we must introduce minimum capital requirements.

There is no mechanism of implementing a minimum capital requirement that does not come with trade-offs in the interest of existing and future consumers. As we describe in this consultation and the accompanying impact assessment, a range of factors need to be considered and the approach will need to be flexible and adaptive. However, we believe that setting a minimum level of "skin in the game" is important and that although capitalisation does not guarantee resilience, in the absence of capitalisation it's difficult to adequately build long-term resilience.

Setting a minimum capital requirement on its own also does not guarantee a level of capital adequacy, or an organisation's ability to withstand shocks. For example, a company may appear to be well-capitalised but the capital may be largely invested in highly illiquid fixed assets and operate with a very low level or negative liquidity. In such a scenario, even a modest shock may force the organisation out of business. Similarly, an asset-light organisation with access to substantial off balance sheet liquidity, such as a guaranteed overdraft facility, may appear poorly capitalised but may in some cases be more resilient to short term shocks than a better capitalised, fixed asset heavy organisation. Our enhanced Financial Responsibility Principle implemented by the accompanying decision creates a set of standards that takes full account of the business-specific risks faced by each supplier. However, reflecting the incentives firms have to run their business in a less prudent manner than the consumer interest would indicate, there is also a clear role for us as regulator to specify a minimum amount of capital in the consumer interest.

Ultimately, we are seeking to transition the market to one of sustainable competition in which all suppliers have the capital base that makes them more resilient to severe but plausible shocks. The potential for shocks has been highlighted in recent years with both the COVID-19 pandemic and the invasion of Ukraine affecting demand and wholesale prices. However, we recognise that these events have had an impact on balance sheets in recent years and suppliers may face challenges in raising capital to repair them. Recognising this, we plan to take a pragmatic approach to the pace of introducing the common minimum capital requirement and are proposing a compliance framework that seeks to provide flexibility for suppliers while maintaining robust controls for consumer protection.

Our intention is to retain flexibility to adjust the regime in consumers' interests, reflecting the risks facing suppliers. With that in mind, if there are reforms to the sector that change the common risks facing suppliers, we would consult to amend the common minimum capital requirement. For example, further price cap reform could reduce the Capital Target.

In our November statutory consultation, we took the view that suppliers should be required to hold an amount of capital closely informed by the level compensated under the price cap return, as this is consistent with our view of the risks faced by a notionally efficient supplier. These risks are similar in relation to most competitive tariffs so, similarly, suppliers should be holding sufficient capital to ensure they are robust to the risks associated with these tariffs, as they are required to do by the Financial Responsibility Principle. As set out in our previous policy consultation, we expect suppliers to be able to recover associated costs through pricing. We recognise that these capital requirements will require a profitable and investable sector, and we will be taking that into account with our forthcoming decision on the EBIT allowance in the price cap.

Through this additional consultation, we are proposing to introduce the full package of measures we consulted on in November, but we are consulting again on a modified approach to the capital requirement given proposed changes to its implementation, level and definition. We are consulting on:

- Introducing a licence requirement for all domestic suppliers to be above a Capital Floor of at least zero Adjusted Net Assets per customer from 31 March 2025.
- Introducing a Capital Target initially set at the equivalent of £130 of Adjusted Net Assets per dual fuel customer from 31 March 2025 (i.e., £65 per domestic gas customer and £65 per domestic electric customer). The target is based on the minimum level of capital we expect suppliers to need to withstand severe but plausible shocks. This target level would be reviewed subsequently and could rise or fall depending on market-wide risks and related policy changes such as ensuring consistency with changes in EBIT allowed under the price cap.
- Using a Capitalisation Plan to manage compliance for suppliers who fall below the Capital Target but are above the Capital Floor. This also recognises that some suppliers may need to draw on their capital reserves and so fall below the target temporarily in certain circumstances.
- Calculating the target based on the number of accounts for each fuel (i.e. £65 per account) in recognition of the risk of over-insurance where some customers contract for a single fuel only with a supplier.
- Clarifying our definition of Capital, including our criteria for off-balance sheet arrangements to count as ‘adjustments’ towards the capital requirement, by reaffirming that they must be long-term, unsecured, unconditional and committed, and providing further detail on our expectations.

The power to direct individual suppliers to ringfence CCBs

In June 2022 we consulted on a policy that proposed industry-wide ringfencing of CCBs to reduce the costs directly incurred by consumers when a supplier fails, and to remove access to free working capital that could encourage strategies towards customer growth that involved high levels of risk.

This proposal would have seen CCBs ringfenced at a single Adjustment Percentage across the sector regardless of supplier efficiency and resilience. Following consultation feedback, and with consideration to the wider package of measures developed as part of our Strengthening Financial Resilience programme, we refined our proposals with the aim of supporting supplier resilience in a more focussed way, taking account of individual supplier risk positions, and taking appropriate action by way of issuing a direction to instruct ringfencing where certain triggers are breached. We have also separately strengthened the rules around setting direct debits which will help limit how CCBs are accrued[2].

Whilst the approach to direct ringfencing on a case-by-case basis was largely welcomed, some concerns were raised by stakeholders on the breadth and clarity of the threshold triggers that might lead to a ringfencing direction, as well as the circumstances around which a direction may be issued and the scope of the Adjustment Percentage.

We have listened to the feedback from the November consultation, held bilateral meetings and further refined our proposals on the ringfencing of CCBs. In this additional statutory consultation, we have outlined these refined proposals and set out the further specific detail that underpins them. Licence drafting published alongside this consultation also clarifies the circumstances in which we may use the direction.

Related publications

Policy Consultation - Strengthening Financial Resilience

Statutory Consultation - Strengthening Financial Resilience

Decision – Strengthening Financial Resilience

[2] Decision on statutory consultation on strengthening fixed direct debit rules | Ofgem

Structure of this Decision Document

This document is split into five chapters:

- The introduction provides the context for this consultation
- Chapter 1 sets out stakeholder responses, our subsequent proposals and questions on the minimum capital requirement Compliance Framework
- Chapter 2 sets out stakeholder responses, our subsequent proposals and questions on the minimum capital requirement definition of capital
- Chapter 3 sets out stakeholder responses, our subsequent proposals and questions on the minimum capital requirement level of capital
- Chapter 4 sets out stakeholder responses, our subsequent proposals and questions on ringfencing of CCBs
- Appendix gives links to additional documents and consultation responses

Consultation stages

Stage 1	**Stage 2**	**Stage 3**	**Stage 4**
Consultation open	Consultation closes (awaiting decision). Deadline for responses	Responses reviewed and published	Consultation decision
05/04/2023	03/05/2023	May 2023	Summer 2023

How to respond

We want to hear from anyone interested in this consultation including suppliers, trade associations, wider industry bodies and consumer groups. Please send your response to the person or team named on this document's front page.

We've asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the

Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

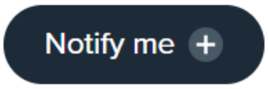
We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

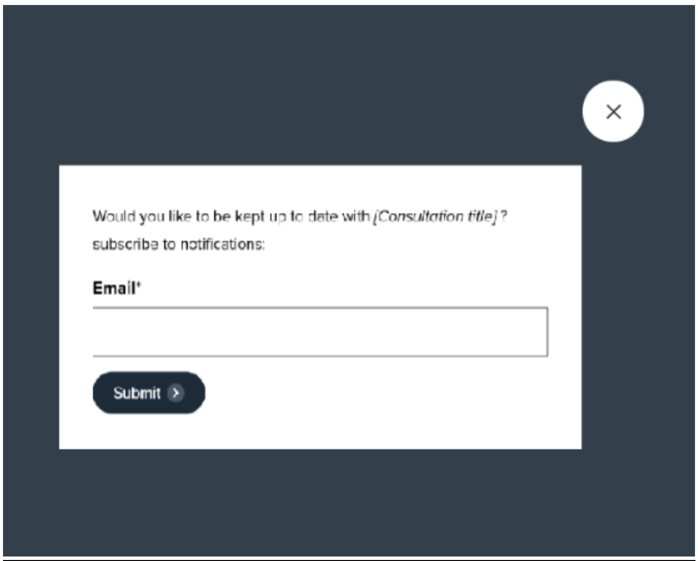
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations





Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming > **Open** > **Closed** (awaiting decision) > **Closed** (with decision)

1. Minimum capital requirement - Compliance Framework

Section summary

This section sets out our proposals to introduce a Capital Floor and Capital Target, and our approach to compliance and enforcement of these. It sets out that firms that are below the Capital Target will be subject to Transition Controls and required to adhere to Capitalisation Plans.

Questions

Q1. Do you agree with our proposed approach of the Capital Target and the Capital Floor?

Q2. Do you agree that 31 March 2025 is a reasonable time period for introducing the Capital Target and Capital Floor? If you disagree, what would be a more reasonable time period and why?

Q3. Do you agree with the Capitalisation Plan process for those suppliers meeting the Floor but not the Target?

What did we consult on

1.1 In November, we proposed introducing a common minimum capital requirement of £110-£220 per domestic customer by March 2025. We proposed that the requirement would be a single number to be maintained at all times by domestic suppliers. This was intended to be a short-term target and we said we would consult further on the requirement post-2025, with a view to suppliers being required to hold the full amount of capital employed they are compensated for in the price cap, when market conditions allowed.

1.2 This is because we recognised that it was reasonable to introduce the minimum capital requirement over a transition period, considering both the impact of current volatile market conditions on raising finance, and our desire to implement a trajectory that resulted in improved resilience at the most efficient cost to consumers. To demonstrate progress towards this target we proposed that before the March 2025 implementation date suppliers would be required to submit transition plans showing clear 'staging posts' or increments for how they intend to reach the minimum capital requirement.

1.3 These transition plans – capitalisation plans - would be submitted as part of the annual adequacy self-assessment, required as part of the enhanced Financial Responsibility Principle. The first of these self-assessments will be required by 31

March 2024. We proposed that these capitalisation plans would spell out how the supplier intended to build up to the 2025 minimum capital requirement. To credibly be enroute to meet this 2025 requirement, we expected suppliers to illustrate how they would be above zero net assets within about a year of the first plan.

1.4 Once the minimum capital requirement target is met, we proposed that suppliers should continue to explain how they will meet the minimum capital requirement throughout the reporting period, any projections that suggest this level will not be met and, where the supplier projects it may not be able to meet the minimum capital requirement, how it intends to remedy this to remain compliant or to come back into compliance expeditiously.

Stakeholder responses

Overall response

1.5 Stakeholder responses were broadly supportive of our proposal to introduce a minimum capital requirement. However, there were mixed views on both the implementation strategy and timescale of the policies proposed. A few stakeholders raised points about the proposed range of fluctuation in yearly financials and the potential need to use minimum capital to absorb shocks from losses, which causes a dipping in capital.

Transition period

1.6 Several respondents remained agnostic or did not make explicit referral to timeframe proposals. However, four respondents agreed with our proposed timeframe for a two-year time horizon of 2025 implementation, subject to ongoing wider market volatility. One respondent raised a concern that any delay to imposing the minimum capital requirement will mean that the consumers will continue to be exposed to potential risk for too long.

Fluctuation / year dipping

1.7 A small number of stakeholders (four) stressed the importance of the potential need to temporarily be below the minimum capital requirement to absorb losses. One supplier argued for a system of prudential regulation which allows firms to use minimum capital requirements if a severe stress materialises and allowing such firms time to build up their capital and liquidity again afterwards.

1.8 Two suppliers also raised the point that Ofgem must consider how frequently the common minimum capital requirement should be reviewed and updated and what should happen when loss-absorbing capacity is used to absorb such losses.

What we are proposing

1.9 We remain convinced that it is in the consumer interest for retail energy companies to have more capital to be sufficiently resilient to future shocks. However, recognising the diversity of business models in the current market, Ofgem's duty to give regard to supplier financeability and Ofgem's continued objective to protect competition we think there is a strong case for building some flexibility into the minimum capital requirement mechanism. We therefore continue to propose setting a minimum capital requirement but, in response to stakeholder feedback, we are proposing some changes to how the requirement is designed and how we will monitor compliance to provide some flexibility in the framework.

1.10 We have taken the view that it is preferable to offer flexibility in the timing of the introduction of the minimum capital requirement and in our approach to compliance, rather than overly weakening the level of capital or quality of capital we expect suppliers to have. Our objectives of improving the long-term capital base of the licensed supplier, increasing 'skin in the game' and protecting the consumer interest in a Supplier of Last Resort (SoLR) or Special Administration Regime (SAR) are best achieved by suppliers increasing their loss-absorbing capital. The level and quality of this capital is therefore important to meeting these aims.

Capital Floor and Capital Target framework

1.11 Taking this into account we are consulting on a new framework for managing compliance with the common minimum capital requirement. We propose setting a Capital Floor and a Capital Target from the end of March 2025. We propose that the Capital Floor is the equivalent of £0 Adjusted Net Assets per domestic dual fuel customer and the Capital Target is the equivalent of £130 per domestic dual fuel customer (i.e., £65 per domestic electricity customer and £65 per domestic gas customer). See Chapter 2 for more information on the definition of Adjusted Net Assets and Chapter 3 for more information on the level of the Capital Floor and Capital Target.

1.12 We propose that the Capital Floor and Capital Target are ongoing requirements. We will monitor compliance using data submitted to Ofgem, such as the stress-testing and monthly requests for information (RFIs), and the Annual Adequacy Self-Assessment. We propose that suppliers are also required to notify Ofgem when they are aware they have breached the Floor or Target, or when they think there is a Material risk that they will breach. This means that we will assess compliance on a backwards and forwards looking basis over a 12-month period.

1.13 Our policy intent with this framework is to ensure that suppliers have positive capital at all times, as the absolute minimum we expect from a supplier operating in the retail market, while encouraging suppliers to recapitalise in line with the Capital Target in a way that is appropriate for their specific business needs and which takes into account external economic factors (e.g., market volatility, unexpected economic downturn) which could make achieving the Capital Target particularly challenging. Through this framework, we aim to provide flexibility for suppliers while maintaining robust governance and processes to monitor supplier resilience and take action if required.

1.14 The consequences of not meeting the Capital Floor and Capital Target are notably different. We propose that suppliers must not go below the Capital Floor at any time and doing so would be considered a serious breach of the licence condition. Falling below the Capital Floor, or being likely to, would amount to a breach / likely breach of a relevant condition. Ofgem could therefore impose a Provisional or Final Order (depending on the circumstances) which would include requirements requisite to secure that supplier's compliance with the requirement to meet the Capital Floor. That could include a requirement to adhere to a Capitalisation Plan. If the supplier does not comply with the provisions of any Provisional or Final Order issued, Ofgem may consider revoking its licence[3].

1.15 Suppliers who are below the Capital Target but above the Capital Floor – being in the Intermediate Position - will not be in breach of the licence condition but will be subject to additional Transition Controls. That suppliers can be below the Capital Target and not be in breach of the licence condition is in recognition of the fact that, as we introduce this new regime, some suppliers will plausibly find it challenging to meet the Capital Target by March 2025 but are committed to recapitalising to have a viable long-term future in the energy retail market.

1.16 The Floor and Target approach also has enduring benefits when the regime is embedded, as we recognise that there will be times when it is reasonable for a supplier to temporarily dip below the Capital Target in times of stress. In those circumstances, the buffer provided by the Capital Target will be fulfilling its purpose of absorbing losses and maintaining supplier resilience in the face of

[3] As provided for in [Electricity Supply Licence Revocation Conditions] and [Gas Supplier Licence Revocation Conditions].

financial shocks. However, we do not think it will be in the consumer interest, even in times of stress, for a supplier to have a negative adjusted net asset position (i.e., below the Capital Floor) as the supplier is then in a weak position to withstand future shocks, without 'skin in the game', and with an unacceptably high risk of future costs falling on consumers.

Capitalisation Plan

1.17 Any instances where the supplier falls below the Capital Target must be temporary and so there needs to be a clear process and incentives to ensure suppliers achieve the Capital Target again. Therefore, we are proposing the Capitalisation Plan process to establish robust governance and tools for monitoring supplier resilience while they recapitalise and to enable Ofgem to hold suppliers to account.

1.18 Suppliers will be required to submit a credible Capitalisation Plan that sets out how they plan to achieve the Capital Target and over what timeframe. Each Plan will vary according to the supplier's specific circumstances, but the proposed licence condition sets out what the Capitalisation Plan must include at a minimum in order to satisfy Ofgem that there is a credible trajectory to meeting the Capital Target. After a Capitalisation plan is accepted, to monitor progress, we are proposing that the supplier must report at quarterly intervals and meet agreed Quarterly Progress Milestones. These milestones will be included as part of the Capitalisation Plan and will be specific to each supplier but could include metrics such as whether suppliers have engaged lenders/shareholders, implemented cost reductions, or made changes to risk strategies to put them on a path to meeting the Capital Target. We have provided more detail on what we would expect to be included in a Capitalisation Plan in the guidance.

1.19 Suppliers who do not adhere to their Capitalisation Plan or meet their Quarterly Progress Milestones will be in breach of the licence condition and could be subject to enforcement action.

Transition controls

1.20 Suppliers who are in the Intermediate Position will also be subject to Transition Controls in two parts. First, they will be subject to a default set of Transition Controls until such time that the supplier submits a credible Capitalisation Plan that is accepted by Ofgem. If a supplier does not submit a credible Capitalisation Plan it would be in breach of the licence condition. Second, suppliers will be subject to any Transition Controls that are included in their Capitalisation Plan until they complete the Plan and achieve the Capital Target.

1.21 The aim of the default Transition Controls is both to protect the capital position of suppliers and to incentivise suppliers to submit a credible Capitalisation Plan. The Capitalisation Plan will also provide additional oversight of suppliers with lower financial resilience than those above the Capital Target. After a Capitalisation Plan is accepted by Ofgem the default Transition Controls, other than those deemed necessary to the specific circumstances of the suppliers' path to recapitalisation and thus incorporated into the Capitalisation Plan, will cease.

1.22 The default Transition Controls that we propose a supplier will be subject to until they submit a credible Capitalisation Plan are as follows:

- sales ban[4]; and
- ban on non-essential payments.[5]

1.23 While we propose that the default Transition Controls will no longer apply automatically when a supplier has an accepted Capitalisation Plan, it is likely that most acceptable Capitalisation Plans will include measures to limit non-essential payments and growth in customer numbers. These are important tools a supplier can use to achieve the Capital Target, as together they have an impact on both sides of per customer capital ratio. Suppliers will be held to account to adhering to the measures they have set out in their Capitalisation Plans.

1.24 We may also request that a supplier in the Intermediate Position undertakes an independent audit (as set out in SLC 5B.2) if we think that the supplier has weak governance and controls or require further independent assurance on an aspect of the Capitalisation Plan. If a supplier is below the Capital Target we will also consider ringfencing CCBs. See chapter 4 for more details on the circumstances for directing CCB ringfencing.

Transition Period

1.25 We remain of the view that a transition period is reasonable given recent challenges in the sector and the feedback that we received in the consultation. Near-term financial conditions are improving somewhat due to recent falling prices and government energy support schemes. However, several suppliers are

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[4] That is a requirement that the supplier refrain from all sales, marketing and customer acquisition activity, including the acquisition of any new domestic customers or upgrading of all existing domestic customer to dual fuel.

[5] That is a requirement that the supplier refrain from making any payment, providing any loan or transferring any asset to any third party unless that payment, loan or transfer is one that: i) is required to make by virtue of a legal requirement; ii) is essential to the licensee's operation as a supplier of gas / electricity to consumers; or iii) is otherwise approved in writing by the Authority.

under-capitalised, having weathered the recent market shocks, and the market is not yet stable. Furthermore, introducing a capital adequacy regime is a significant regulatory and structural change and, looking to the introduction of capital requirements in other sectors, it is entirely reasonable to provide sufficient time for capitalisation.

1.26 We want to realise the consumer benefits of increased resilience as soon as possible but this must be balanced with the ability of suppliers to raise the requisite capital to meet the requirement. We think it is in the consumer interest to take a pragmatic approach to the pace of introducing the common minimum capital requirement, which means not setting a time horizon for implementation or approach to compliance that many market participants cannot meet.

1.27 It is important, however, that during this transition we see less well capitalised suppliers on a clear trajectory to increasing their capital base and that Ofgem has sufficient assurances that suppliers are making progress.

1.28 We therefore continue to propose that the minimum capital requirement will take effect from 31 March 2025. Before this date we will monitor suppliers' capitalisation through our regular monitoring but also through the Annual Adequacy Self-Assessment (Self-Assessment), which has been introduced as part of our reforms to the Financial Responsibility Principle. We propose that as part of this first Self-Assessment, suppliers will be required to set out how they plan to meet the Capital Floor by 31 March 2025 and how they plan to meet the Capital Target from 31 March 2025 or be on a path to meeting it.

2. Minimum Capital Requirement – Definition of Capital

Section summary

This section sets out our proposals for the definition of Capital which will be used to calculate a company's Capital level for adherence to the common minimum capital requirement. It sets out the rationale for including certain accounting metrics and financial instruments under this definition.

Questions

Q4. Have we struck the right balance between consumer interest and commercial practices by setting the minimum credit rating for parent / group working capital facilities or guarantees? How could it be improved?

Q5. What is a reasonable minimum tenor or expiry date for a parent / group working capital facility, shareholder loan or guarantee for it to be considered as long-term loss absorbing capital?

Q6. In this section we have set out our position as to which accounting metrics and financial instruments count towards Capital. However, we are aware that in other industries, such as banking, there are other debt instruments that count as capital when regulators test for financial resilience. Are there any other debt instruments available in the market that we should consider including in our definition of Capital?

Q7. How can the common minimum requirements for the basis of accounting for Net Assets, including accounting standard, choice of accounting methodology and level of assurance be improved? Suppliers are requested to set out in detail their basis for preparation of their accounts (whether UKGAAP or IFRS), why, what alternatives they could have adopted and how that would have impacted their most recent statutory Net Asset position.

Q8. Should any of the classes of intangible assets be excluded under the definition of Assets for the Net Asset calculation?

What did we consult on?

2.1 In November we proposed to use a metric for the common minimum capital requirement of net assets, defined as (fixed assets + current assets) – (current liabilities + non-current liabilities). Net Assets under this definition is often considered as a value attributable to shareholders' equity.

2.2 We noted that we had considered but were not proposing using capital employed (net assets + non-current liabilities) as the basis for the metric. This approach would have meant that long-term debt contributed towards the common minimum capital requirement. We were concerned by the risk that licensees could meet a substantial part of the common minimum capital requirement using long-term debt secured on the other assets held by the licensee, meaning that in the event of failure the capital available would be much lower than the capital employed measure suggests, leading to higher costs for consumers. This was the main reason we did not propose this metric.

2.3 We proposed that in addition to the net assets metric we would allow for suppliers to meet the common minimum capital requirement using alternative sources of funding – such as long-term debt, inter-company credit facilities and parent company guarantees – subject to defined criteria[6], and to the extent the supplier could demonstrate those sources of funding result in an appropriate level of resilience as part of the common minimum capital requirement.

Stakeholder responses

2.4 In common with the June consultation, several respondents disagreed with the principle of setting a common minimum capital requirement and/or suggested alternative approaches such as setting a liquidity requirement, but no responses suggested an alternative capital measure. For example, no respondent suggested that the capital employed metric should be used instead of our proposed net assets metric.

2.5 Some responses did question whether all assets should be considered equally. Specific comments were received on whether illiquid fixed assets, for example, should be considered as equivalent to cash. Other comments were also received about the comparability of intangible fixed assets with tangible assets.

2.6 Several respondents commented on our proposal to allow alternative sources of funding to contribute to meeting the common capital requirement. The comments received in this area covered a wide spectrum with some responses suggesting that the use of such alternative funding sources provided the more traditional retailers with an advantage whereas others suggested that we needed to be more

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[6] The criteria we included in the November consultation proposed that the funding should be sufficient to meet any risk or liabilities that are reasonably anticipated, it must be unsecured, it must be drawable in times of financial stress, it should not be able to be terminated without good cause and with a termination period and any third-party provider must have a BBB or equivalent rating.

willing to consider an even wider range to alternative sources to reflect the different business models of newer entrant suppliers. Some responses suggested that alternative sources of funding did not represent truly risk bearing capital and should not be considered at all. One area where a consistent theme did emerge was that where responses were supportive of allowing alternative sources of funding, they all said that our criteria needed to be better defined to provide as much clarity as possible on what types of alternative funding sources would be acceptable.

What are we proposing now?

2.7 In response to consultation feedback, we have carefully considered our proposed definition of capital. A more flexible approach to compliance, allowing companies time to raise capital, means that we do not believe it is in the consumer interest to have too broad a definition of capital. In Table 1 we summarise the instruments that we intend to allow as capital contributing towards the common minimum capital requirement.

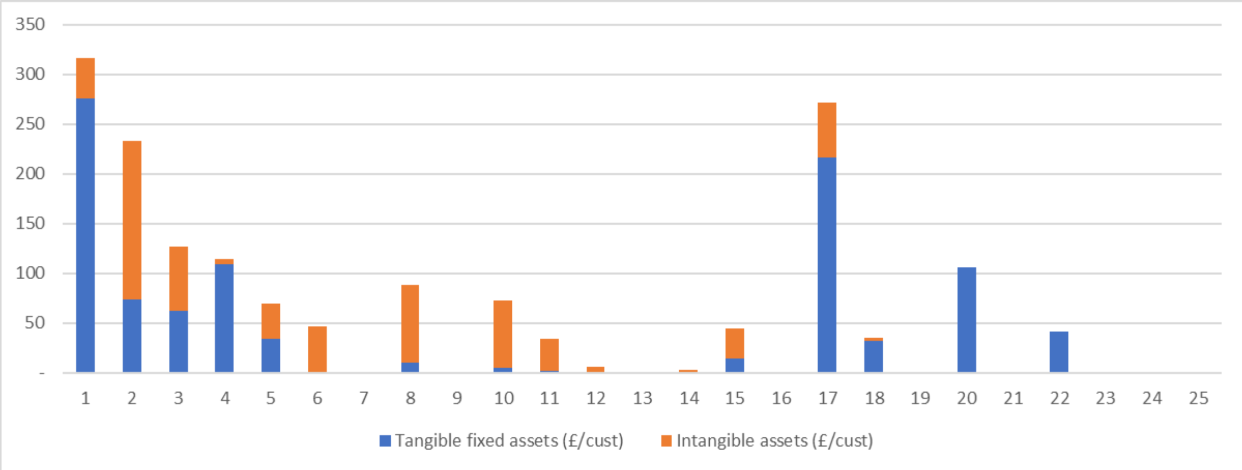
2.8 We want to ensure that shareholders retain capital in the company to drive the right behaviours and ensure that the company can suffer losses and remain solvent. Hence, we are still be minded to use Net Assets as the foundation metric for a measure of capital as it has the closest alignment to consumer interests.

2.9 We believe that a Net Assets measure best achieves our objectives by requiring shareholders to retain ‘skin in the game’. If shareholders have capital at risk as they consider their risk tolerances for investing in the company, it aligns with consumers’ reasonable expectation that shareholders ensure that the company directors are managing the company for the medium to long-term. It is also in the consumers’ interest that shareholders suffer a capital loss if the company is mismanaged and provide a capital buffer prior to company insolvency.

2.10 We considered excluding certain categories of intangible assets from the Net Assets calculation. Intangible assets such as goodwill and the cost of customer acquisition may have an uncertain value at the point of financial distress or administration.

2.11 We note that following a review of Companies House filings in some cases the majority of the suppliers’ assets are intangible and potentially of uncertain value at the point of financial distress (Figure 1). Including these intangibles in the definition of Net Assets may increase the risk that there is insufficient loss-absorbing capital when it is required.

Figure 1. Fixed assets per customer by supplier according to latest statutory accounts (2021/22)



Note: Suppliers listed anonymously from 1 to 25
Source: Ofgem analysis of supplier statutory accounts filed with Companies House.

2.12 However, our base position remains to include intangibles given their recognised value on the balance sheet of a trading company. We also do not wish to unduly increase the complexity of the definition of capital or unduly increase the uncertainty to the suppliers of what qualifies as Net Assets. We have posed a consultation question on this topic and welcome responses.

2.13 Recognising the diversity of views on whether alternative sources of funding should be treated as capital, we have sought to clarify our position by providing further criteria for the inclusion of alternative sources. We acknowledge that including some alternative sources of capital will provide flexibility to the sector, reflecting the reality of how the sector is currently funded, and we do not want to create disproportionate costs and barriers to competition in the market. We would not wish to prevent these arrangements where they reduce costs for consumers, provided that they do not unduly increase the risks faced by consumers. We must balance the cost and practicality against the twin objectives that the capital is truly loss-absorbing in the event of a market shock and reflects skin in the game.

2.14 To ensure that the alternative source of capital is provided by counterparties that can drive the right behaviours in the company, through control of risk policies and the risk management in the company, we propose that it is only is provided by: (i) a shareholder who is defined as a "Person with Significant Control" under the licence; or (ii) a parent or group company defined as a related party to the Person with Significant Control.

2.15 We have also taken note of the desire for as much clarity as possible on which alternative sources will be acceptable.

Table 1

Foundation Metric	
Capital Type	**Rationale**
Net Assets This is measured according to normal Balance Sheet reporting using suppliers' standard accounting practices. This Net Assets measure may be modified by the inclusion of the following Alternative Sources of Capital.	Net Assets best meets the consumer interest requirements to drive the right company behaviour and provide loss-absorbing capital as described above.
Alternative Sources of Capital	
Capital Type	**Rationale**
Unsecured shareholder loans on commercial terms, not subject to accelerated repayment conditions, with a minimum 12-month residual maturity.	We recognise that there may be valid commercial reasons why a shareholder may prefer to invest via long term debt versus pure equity. If that debt is unsecured it will absorb losses alongside other non-senior creditors in a default scenario. It is reasonable to assume that such debt, unlike senior ranking secured loans, provides incentives for shareholders to drive the right behaviours. Using the same logic, but the reverse outcome, our original consultation position on secured debt remains unchanged. *(see also section below on why we have decided on a minimum residual 12-month maturity)*
Drawn Parent / Group Company Working Capital Facilities from a counterparty with a minimum investment grade credit rating (See section below on why we have decided on this rating	We consider these instruments can be economically similar to a shareholder loan albeit the technical form is different if they meet the definition. Such arrangements must also be unsecured.

criteria). It must have a minimum 12-month residual maturity and not be subject to full repayment and/or cancellation.	
Undrawn Parent / Group Company Working Capital Facilities from a counterparty with a minimum investment grade credit rating, with a minimum 12-month residual maturity provided that it is not subject to cancellation and/or drawstop conditions.	Whilst this is not invested capital and hence not traditionally considered as capital, we will consider such committed intergroup arrangements if they represent a binding commitment to lend and support the supplier from the group company, with this support available to cover financial losses as and when required. Therefore, it can meet the twin criteria of driving appropriate behaviours and being available to absorb losses. Such arrangements must also be unsecured.
Unconditional, quantifiable general guarantee from a parent or group company with a minimum investment grade credit rating and a minimum 12-month residual tenor.	The status of guarantees has been one of the difficult areas for us to consider. We do not believe that specific guarantees provided by a third party in respect of a particular individual or set of transactions can be considered as risk bearing capital, but we do recognise that there may be arrangements in place where a parent or group company has provided a more general guarantee to the supplier that can be considered akin to undrawn debt or equity finance. There must also be some measure of the quantum of such a guarantee so that, for example at the extreme, a supplier could operate with zero net assets under a general guarantee and be considered to meet the common minimum capital requirement.

Minimum tenor for the Alternative Sources of Capital

2.16 When deciding on where to set the minimum tenor for the Alternative Sources of Capital we must balance the argument that for long-term debt or guarantees to be considered as a long term "at risk" investment in the company and a true stake in the long term future of the company then it should be truly long-term in nature with a tenor of three or five years plus against the practicalities, intention and cost of market participants in providing these facilities or guarantees.

2.17 We have discounted any facilities or guarantees with a tenor of less than 12 months as this is typically considered under accounting rules and across finance market participants to be short-term in nature and so cannot be considered as long-term loss absorbing capital. Available capital should provide suppliers with the confidence to invest over the long-term and to have confidence in their long-term sustainability and not be continually facing a cliff edge on their capital position.

2.18 We note that some companies have standard intercompany working capital facilities with a fixed 12-month tenor that refinance every six months or year which are taken into account as funding sources in going concern statements. We recognise that these are important sources of liquidity. We understand that there is an argument that these could be considered as "soft" long-term support for the subsidiary from the group and should be considered as capital for that reason. However, we are seeking to provide certainty over what is considered as capital to market participants and consumers, and it would be impractical to take into account any subjective criteria for what qualifies as hard or soft support for a subsidiary from the group given the possible risks to consumers involved with this judgement.

2.19 We propose to set the minimum level to ensure that there is always a residual 12-month tenor for the following reasons:

(i) traditional accounting treatments of long-term investments and long-term debt, as well as measures of Capital Employed requires that assets or debt must have an investment horizon or maturity of at least 12 months before it can be considered to be capital;

(ii) the Alternative Sources of Capital should be committed at all times for the next 12-month cycle through summer and winter to ensure companies can forecast, plan and invest through the cycle with certainty over their capital position; and

(iii) it is a reasonable consumer assumption on switching to a new supplier, particularly if purchasing 12-month or longer fixed price tariff, that they are doing so for at least a 12-month period with the expectation that the supplier has committed capital for the same period.

2.20 We note that a minimum 12-month tenor might in practice require companies to provides intergroup facilities with a two-year tenor that extends every year rather than evergreen 12-month facilities (with the effect that the tenor is always longer than 12 months). We do not think this is a reason to reduce the 12-month tenor requirement.

Minimum credit rating criteria

2.21 We are minded to include undrawn committed credit facilities from related parties as part of the capital base. This means that there needs to be a good degree of assurance that the facility will be available when called upon. This assurance requires two factors – the first is the willingness to lend, and this is why we are minded to impose the conditions that the facilities must be committed, unconditional and not have accelerated repayment or drawstop conditions. The second is the ability to lend, or the financial strength to be able to do so. Traditionally BBB- / Baa3 or equivalent has been regarded as the minimum rating threshold to be regarded as Investment Grade, where the risk of default is considered minimal, particularly over 12-month periods. We have previously noted that Net Assets is our preferred source of capitalisation but where we are minded to permit undrawn credit facilities as a substitute we must have a high degree of assurance that those credit facilities will be available when called upon and so we are setting a minimum Investment Grade rating criteria for such facilities. In the case of a split rating, we will base our assessment on the lower rating. A company with a split rating of which one is not investment grade rated will not be acceptable. We recognise that this is a high bar for the sector but note that the providers of such facilities have the option of replacing such facilities with drawn loans which are not subject to the minimum credit rating criteria.

2.22 We propose to use the term Adjusted Net Assets as the approved measure for the purposes of the common minimum capital requirement. Adjusted Net Assets means Net Assets plus any approved Alternative Sources of Capital. Where a supplier proposes to use one or more of the Alternative Sources of Capital to meet the minimum requirements approval to do so will be required in writing from Ofgem. For the avoidance of doubt, although approval of Alternative Sources of Capital is required for the purposes of meeting these regulatory capital requirements, it remains each supplier's responsibility to maintain capital and liquidity of sufficient amount and quality to meet its liabilities.

Alternative Sources of funding that we are minded to reject

2.23 Below are some of the other alternative sources of funding that we have considered but are minded to reject as contributing towards the required levels.

Table 2

Alternative considered	Rationale for rejection
Secured Debt	Our consultation document in November explained our rationale for rejecting. Long-term debt and other liabilities often benefit from contractual agreements which provide the lender with preferential rights over the other assets held by the licensee in the event of the debt or the associated costs not being repaid in accordance with the contractual terms and conditions. Where a lender exercises such rights, the net assets held by the licensees may as a consequence end up being much lower than indicated by a net assets measure which does not deduct long-term liabilities. We have not received any evidence or arguments to change this view.
Third-party debt, from a party that is not a parent or group company	Whilst third-party debt potentially introduces another professional party who will have 'skin in the game' in respect of their debt investment, we have excluded it from our definition of capital for three reasons: (i) it is uncertain how much, if any, influence or control a third party debt provider may have over company's risk management policies and strategy once invested; (ii) debt is generally tradable and so the third party and their motivations for holding the debt may change over time in particular at times of financial distress; and (iii) depending on default clauses or triggers in the third party agreements, the debt holder may be able to act to the detriment of the shareholders and consumers in order to seek the return of their debt.
Third-party guarantees, from a party that is not a	We note that third party guarantees can have a significant benefit in eliminating the need to collateralise commodity hedges and so can significantly reduce cash flow risk for a supplier. Our proposals on setting a common minimum capital requirement

Alternative considered	Rationale for rejection
parent or group company	are not suggested to be sufficient to absorb all risk faced by a supply business. Even with such guarantees in place a supplier is still exposed to the underlying cost of the hedges as well as all other risks in the business. We do not believe that such guarantees can be considered as capital. This also has close similarities to the final alternative considered below.
Other risk reducing agreements and facilities	We note above that our proposals on setting a common minimum capital requirement are not suggested to be sufficient to absorb all risk faced by a supply business. There are risks, particularly tail risks, that all supply businesses face that are will be greater than the minimum level of capital being proposed. Some respondents have argued that they have particular agreements in place which reduces the level of risk they face, and we accept that to be true. However, we have seen no evidence that agreements available to suppliers are able to reduce the risk companies face below the level that our common minimum capital requirement is designed to cover. Therefore, we do not believe that there should be a proportionate reduction in the level of capital to be held either by including some capital value in these agreements as part of the capital base or by reducing the common minimum capital requirement to reflect these agreements.

Interaction with RO Ring fencing

2.24 We would like to clarify that it is our intention that RO ringfencing does not have any impact on the measure of Net Assets to be used to determine whether the common minimum capital requirement has been met. Notwithstanding that RO funds are to be ringfenced because these funds are matched by a current liability the net impact on the Net Assets measure is zero. No adjustment is needed to either Gross Assets or Gross Liabilities to reflect the RO ringfencing regulations for the purpose of measuring Net Assets.

3. Minimum Capital Requirement - Level of capital

Section summary

This chapter sets out our objective of having a Capital Target, to ensure suppliers have a buffer of capital that they can use in times of severe but plausible shocks to ensure they stay above the Capital Floor.

We propose to set the target at the equivalent of £130 Adjusted Net Assets per domestic dual fuel customer (i.e., £65 per domestic gas customer and £65 per domestic electricity customer).

Questions

Q9. Do you agree with a Capital Target equivalent to £130 Adjusted Net Assets per domestic dual fuel customer by March 2025? If you disagree, please provide justification and supporting evidence.

Q10. Do you agree with our changed position the Capital Target to be on a 'per electricity and gas customer', rather than 'per dual fuel customer', basis? If you disagree, please provide an alternative approach and supporting evidence.

Q11. Do you agree with splitting the Capital Target of £130 equally between electricity and gas in line will recent price cap typical bill values? If you disagree, please provide an alternative approach and supporting evidence.

What did we consult on?

3.1 In our November consultation, we proposed a common minimum capital requirement, set at a level informed by our view of the amount of capital needed by an efficient, well-hedged supplier. We said that in the long-term we expect this level to be consistent with the return under the price cap. It would also therefore depend on any future reform of the price cap, in addition to other material changes to the market that affect the common risks facing Suppliers.

3.2 However, we were aware of the need for a sufficient transition period considering both the impact of current volatile market conditions on raising finance, and our desire to implement a trajectory that results in improved resilience at the most efficient cost to consumers.

3.3 We proposed setting a shorter-term target for domestic suppliers to have £110-220 per domestic customer of Adjusted Net Assets by end of March 2025, with suppliers required to submit transition plans showing a clear trajectory for how they intend to reach that target.

3.4 The upper bound of this range (£220) was consistent with the average level of capital suppliers were compensated for under the price cap before the energy crisis. We provided a broader range for this initial staging post, with a lower bound of £110, recognising the need to balance the potential destabilising impact of new capital requirements within current volatile market conditions against our desire to implement a trajectory that results in improved resilience at the most efficient cost to consumers.

Stakeholder responses

3.5 Stakeholder responses had significantly diverse views on the level, pace, and broader approach to setting a common minimum capital requirement.

3.6 Stakeholder views varied considerably on the level of capital that should be required. A minority of stakeholders argued the proposed level was too low because in their view suppliers would still have insufficient capital to protect consumers in the event of stress situations. A number of stakeholders highlighted the comparatively broad range of £110-220 per customer and encouraged us to narrow down this range to help provide certainty. Another group of respondents raised material concerns that even at the lower bound of £110, significant capital raising from investors would be required against a backdrop of market circumstances that continue to be challenging.

3.7 Of those that expressed a view on pace of implementation, a minority of stakeholders argued that the requirements should be implemented on an accelerated timescale to protect consumers with alternative proposals including that 2025 should represent the point minimum capital requirements are finalised rather than being a transition period, or transition requirements being implemented prior to 2025. Another group were supportive of the March 2025 timeline as balancing speed of implementation and consumer protection with the need for sufficient time to raise capital or secure other mechanisms of demonstrating compliance. Other stakeholders argued that given the current financial position of some suppliers in the sector, reaching a net zero and the subsequent 2025 target would not be achievable.

3.8 Finally, other respondents chose not to comment at this stage in detail on the pace or level of the proposals given perceived uncertainty in the broader policy context, including highlighting that we stated we would review the approach to the common minimum capital requirement through further consultation that would take into account factors including the pending decision on the November 2022 consultation on the Earnings Before Interest and Tax (EBIT) allowance in the price cap. Stakeholders also highlighted the need for clarity on approach post-2025. Other respondents challenged the overall basis for market-wide capital requirement, arguing instead it should be a backstop mechanism that could be imposed where needed by direction.

What are we proposing now?

3.9 As set out in Chapter 1, rather than a single minimum capital requirement, we plan to set a Capital Floor and Capital Target. Following implementation, all domestic suppliers will be required to remain above the Capital Floor at all times, and those below the Capital Target will be subject to Transition Controls.

Capital Floor Level

3.10 The aim of the Capital Floor is to set an absolute minimum level of capital below which we do not think a supplier should fall and where to do so would not be in the consumer interest. We propose setting the Capital Floor at zero (£0) Adjusted Net Assets per domestic gas and electricity customer. Our rationale for this level is we believe that a supplier must have some loss-absorbing capital, alongside other risk management tools, to withstand shocks. A supplier in a negative net asset position and therefore unable to pay its debts as they fall due is technically insolvent and is in a vulnerable position should there be further shocks. The Oxera report showed that all suppliers who went on to fail had negative, and deteriorating, net equity positions.

3.11 Some suppliers disagree that positive net assets are required at all times because energy supply is a seasonal business. While we accept that there are seasonal variations in suppliers' financial positions, we do not think it is in the consumer interest to have net liabilities at any time because of the unpredictable timing and nature of shocks. Consumers expect that their energy supplier is financially solvent such that they are better able to withstand stress events.

3.12 Some suppliers argue that having positive capital is not required if they have other risk mitigation strategies which protect them from market risks, such as adequate hedging and collateral-free trading agreements. While we accept, and encourage, the use of a diverse range of risk mitigation strategies, we do not think these strategies negate the need for the licensed supplier to have positive capital.

3.13 Notwithstanding the resilience impact of having a solvent balance sheet, we think there are important consumer benefits derived from the licensed supplier not having net negative capital. We have consistently said that an objective of these reforms is to address the moral hazard by ensuring that investors have some capital at risk and suppliers are not taking excessive risks with consumer money. Requiring suppliers to have at least positive capital is the very minimum to achieve that aim. Furthermore, in the event of a SoLR/SAR, having had positive capital prior to the shock that led to the event is in the consumer interest as it should reduce mutualised costs/improve the chances of a successful SAR.

Capital Target Level

3.14 The Capital Floor set out above is the absolute minimum we think suppliers should have at all times to participate in the retail sector in the interest of consumers. Nonetheless, at the proposed level of zero (£0), it cannot act as a loss-absorbing capital buffer in a sufficient way to protect consumers. The enhanced Financial Responsibility Principle makes clear that suppliers need to have an appropriate amount of Capital and Liquidity to meet reasonably anticipated payments as they fall due for their specific business. However, reflecting the incentives firms have to run their business in a less prudent manner than the consumer interest would indicate, there is a clear role for Ofgem as regulator to specify a common minimum for that target. This will provide a loss-absorbing buffer for all firms in times of stress. This is the aim of the Capital Target. After the introduction of the Capital Target, firms should still judge the adequacy of their capital in a prudent manner, as the common minimum is not intended to cover all the risks that firms could choose to take.

3.15 As set out in Chapter 1, the Capital Floor must be maintained at all times, whereas a supplier can be below the Capital Target but will need to adhere to a Capitalisation Plan to demonstrate it is on a path to meet the Capital Target. This is to recognise that suppliers may need to dip below the Capital Target in times of stress but also because we recognise that it will take time for some suppliers to recapitalise following recent energy market volatility.

3.16 In light of stakeholder feedback on the original range of £110-£220 we proposed for the common minimum capital requirement, we have undertaken further analysis to refine our view of the level of capitalisation required to meet these aims.

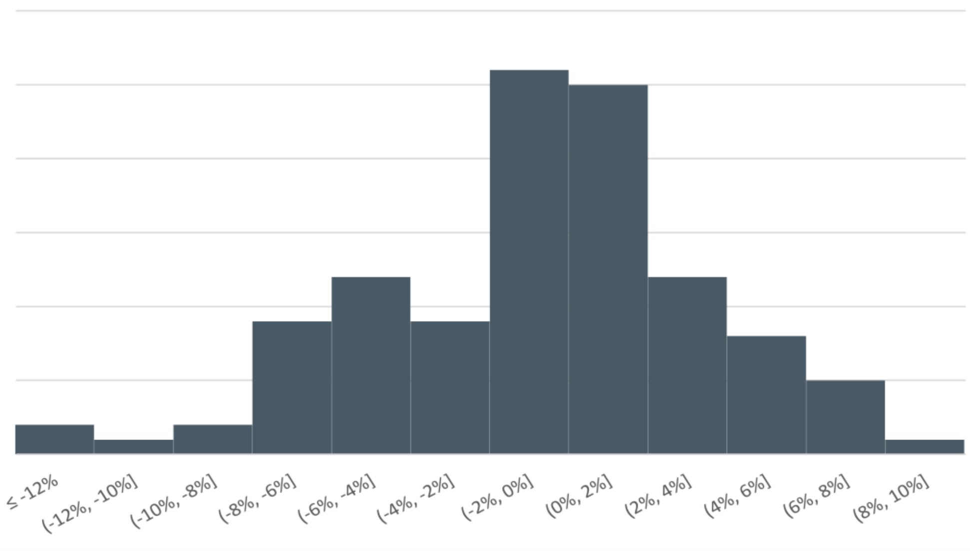
3.17 Our analytical approach has been to use a combination of modelled and observed data, from both an aggregate value-at-risk approach of the amount of capital that may be required to withstand severe but plausible shocks to a bottom-up analysis of individual capital elements.

Aggregate capital requirements to withstand severe but plausible shocks

3.18 The intention of the capital target is to act as a capital buffer so that if a severe but plausible market shock occurs suppliers have greater resilience. In considering the effective level, we have considered the risks all suppliers face, including those who are well-hedged, when sourcing and supplying energy to their customers. In addition to our existing models that estimate the efficient level of capital for a notional supplier[7], the capital required by current suppliers during the recent shocks aids our understanding of the business models employed and how they differ from our notional supplier.

3.19 We reviewed the operating profits/losses incurred by domestic suppliers[8] over the last seven years as a proxy for the possible impact on retained earnings of shocks like the COVID pandemic and energy crisis. The aggregate distribution, as shown in Figure 2, suggests that the 5th percentile operating loss could be about -9%. At typical annual bill levels of £2,000 (inc. VAT), which is the approximate level implied by recent wholesale prices, that would be equivalent to about £145 loss per domestic dual fuel customer.

Figure 2. Observed distribution of domestic supplier annual EBIT margins (2016-22)



Source: Ofgem analysis of financials from 16 suppliers.

[7] Such as the wholesale risk model used in the development of the quarterly price cap that Ofgem continues to license.
[8] As published in Consolidated Segmental Statements, statutory accounts, and provided to Ofgem in response to regular requests for information.

3.20 We recognise that these losses were highly dependent on their individual management decisions (e.g., on pricing) and some of them reflect investment of profits for growth. At least one supplier has publicly stated that they chose not to make a profit. We also believe that other changes we are making to improve supplier financial resilience should reduce the level of risk taken by suppliers. Hence, the above figures are an over-estimate of the efficient level of a common minimum capital target.

3.21 Taking this into account, our minded to position is to set the Capital Target at the equivalent of £**130** Adjusted Net Assets per domestic dual fuel customer (i.e., £65 per domestic gas customer and £65 per domestic electricity customer).

3.22 We recognise that there is a degree of uncertainty to setting the capital level. Further market developments, by 2025, may influence the risk exposure in the retail sector. Our intention is not to define how suppliers should invest their capital rather to set a capital target for suppliers to achieve by the most appropriate means. We intend to review the capital target level if there are significant changes in regulation, government policy, or other events that mean it is in the consumer interest to do so (such as the consultation on the future of the price cap announced by the government[9]).

Analysis of capital elements

3.23 To complement our considerations of impact on notional suppliers, we have reflected upon the diversity of supplier business models. We recognise that no suppliers need the exact same amounts of capital at all times, and we have specifically designed our regime to account for this. We have analysed the major uses of capital[10] across existing suppliers to satisfy ourselves that the proposed level of the Capital Target capital meets our objectives for the diverse range of business models.

3.24 We have broadly considered how suppliers use capital by investing in fixed assets, working capital and cash collateral deposits, which are consistent with the components being considered in the review of the price cap EBIT allowance[11]. Nevertheless, here we have a different application, as the proposed Capital

[9] Powering Up Britain: Energy Security Plan (March 2023)
[10] For the avoidance of doubt, we do not propose to set limits on the individual elements of capital. The Capital Target applies only in aggregate. We believe that to set finer targets would over-constrain the flexibility of suppliers to manage their own risks and would restrict diversity of business models.
[11] Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance | Ofgem

Target will be a requirement applying to all domestic suppliers rather an allowance formed on our best view of an efficient notional supplier. To inform our view of the appropriate level of capital, we have reviewed financial data of existing domestic suppliers[12].

3.25 On fixed assets, existing price cap allowances for depreciation and amortisation cover fixed assets of about £90 per domestic dual fuel customer. We observe that some suppliers currently hold much more or much less than this amount, although it appears to be broadly representative as the weighted average of suppliers in Figure 1 is close to this amount.

3.26 Consistent with our earlier proposal, we propose to exclude wholesale trading collateral from our target capital level on the basis that some suppliers are not required to post collateral as part of their wholesale market access arrangements (instead they pay a fee and offer other security). Including our view of wholesale collateral within the target would therefore be excessive for such suppliers. Nonetheless, access to wholesale markets remains critical for suppliers to effectively manage their risks, and the enhanced FRP requires that each supplier has adequate capital and liquidity to manage these risks, which may in some instances include access to funds for collateral. We have observed that many suppliers post cash collateral for access to electricity and gas network collateral, typically about £10 per dual fuel customer.

3.27 We recognise that working capital can fluctuate over the course of a year. We observe that some suppliers have periods of negative working capital while others have shown access to working capital is required to trade through periods of stress. We observe that at least £-20 to £40 of working capital per dual fuel customer appears to be required.

3.28 As noted above, we believe that suppliers are likely to be able to take different approaches to ensuring their own resilience in ways that interchange the different components discussed above. Hence, we do not believe it is appropriate to sum the lowest values in the above ranges. But we believe that we have shown that the proposed Capital Target level is consistent with the full range of sustainable business models.

[12] Including responses to ongoing monthly FRP RFI (historical data and supplier forecasts), stress-testing RFI (historical data and scenario forecasts), statutory accounts and other fillings with Companies House, and other company publications such as investor reports.

Capital Target relationship with the price cap

3.29 Our proposed Capital Target is consistent with *but distinct from* the level of capital implied under the price cap. Firstly, the price cap applies only to standard variable and default tariffs, and the risks (and associated capital needs) of serving customers of other tariffs differ. For this reason, we plan to review the market developments of tariffs, including the future of price protection, when considering the future iteration of the Capital Target after implementation.

3.30 Secondly, to arrive at a representative figure for the EBIT allowance, the price cap necessarily relies on the construct of a single, notional efficient supplier. The Capital Target applies to all domestic suppliers at all times, and so must be robust to a range of different business models and take into account the plausible means by which a supplier may de-risk their business, including alternative forms of capital.

3.31 Finally, the price cap implies an average level of capital employed by this notionally efficient supplier. In practice, the level of capital for this notional supplier – as for real suppliers – may fluctuate throughout the year. Our capital target applies throughout the year, and so must be set at a level below this average.

Application of the Capital Target per electricity and gas customer

3.32 In our November consultation we proposed a minimum capital requirement set on a per customer basis that would apply equally to dual- and single-fuel customers. Whilst we considered other options, we thought this approach had the benefit of being transparent and easily understood. On reflection, we believe the risk of effectively double-counting protections (and the excess costs that would imply) mean that a more sophisticated approach is justified. We have changed our position to setting the Capital Target on a single-fuel customer basis.

3.33 To set the Capital Target on a single fuel customer basis, we need to consider how to express the Capital Target at the electricity and gas customer level. Broadly speaking, in recent years the price cap has implied an approximately equal dual fuel bill split between gas and electricity[13], assuming Typical Domestic Consumption Values (TDCV). On the basis of current forward prices, a similar relationship looks likely in the upcoming price cap period, suggesting that an even split of the target across gas and electricity customers is a reasonable simplifying assumption.

3.34 We have considered introducing further sophistication still, for example varying the target by volume or based on other underlying variables such as price. For the initial target, we believe that such an approach may introduce uncertainty and variability to the measure in a way that does not clearly provide further benefits to consumers. Given this, our intention to apply this more straightforward approach as a first staging post, **setting the Capital Target at £65 per domestic electricity customer and £65 per domestic gas customer**.

3.35 As stated above, we intend to review the capital target level if there are significant changes in regulation, government policy[14], or other events that mean it is in the consumer interest to do so.

Domestic and Non-Domestic suppliers

3.36 While our proposed Capital Floor and Capital Targets will apply only to suppliers of domestic customers, all suppliers are subject to the requirement under the enhanced FRP to ensure they hold sufficient capital and liquidity to meet liabilities as they fall due, whether in relation to domestic or non-domestic customers.

3.37 As we noted in our November consultation, we recognise that some firms supply energy to both domestic and non-domestic customers through the same licenced entity. Our proposed guidance will require such suppliers to explain in their Annual Adequacy Self-Assessment any split of assets between the supply business for non-domestic supply versus domestic supply, to help show how the Adjusted Net Assets calculation for the Capital Floor and Capital Target maps across the business, and if there are any implications for the impact of the measure on resilience.

3.38 We consider that this mitigates the risk that suppliers will lean heavily on shifting assets to meet requirements related to their domestic customers at the expense of not having sufficient assets on hand to also meet the risks in their non-domestic business.

[14] For example, when the government's policy on rebalancing gas and electricity prices, as announced in 'Powering up Britain', is implemented.

4. Customer Credit Balances Ringfencing

Section summary

In this section we set out our revised proposals in relation to the power to direct CCB ringfencing. We set out the feedback we received from the November statutory consultation, how it informed our thinking and what our proposals are as a result. We outline the resilience thresholds that will alert us to the potential need for ringfencing as well as the circumstances by which we will consider issuing a direction to ringfence and determine the appropriate Adjustment Percentage.

Questions

Q12. Do you agree with our proposed reporting triggers? If you believe alternative triggers would be more effective, what are they and can you provide a calculation methodology?

Q13. Do you agree with our proposal for consideration of Consumer Interest issues where a CCB trigger is reached? Please tell us if you have further views on what an appropriate approach to making a decision to direct CCB ringfencing would comprise of.

Q14. Do you have views on the timing of implementing the triggers? If you consider the Capital Target trigger should be brought in earlier or later, please provide further thinking.

Q15. Do you agree with our approach to determining the level of ringfencing we would require? If not, do you have alternative suggestions?

Bespoke ringfencing

What did we consult on?

4.1 Our revised impact assessment found that a minimum capital requirement alongside market-wide RO ringfencing would have higher net consumer benefits than market-wide CCB and RO ringfencing. We agreed that market-wide CCB ringfencing would be untargeted and impose costs on all suppliers – including efficient suppliers – in a way that on balance we did not believe to be in the interests of consumers at this time. We also considered the impact of “inactive” capital that could be more effectively deployed and acknowledged 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 some use of credit balances to be part of an efficient business.

4.2 We maintained that concerns relating to reliance on CCBs can also be partly addressed by building on existing requirements, for example the strengthened rules around how suppliers can set Direct Debits. These stronger rules, which help limit the level of CCB accrued, together with capital adequacy policy developments that form part of our Strengthening Financial Resilience proposals, should reduce excessive reliance on CCBs for working capital and the associated risk of mutualisation costs and negate the need for market wide ringfencing.

4.3 We recognised that the approach to ringfencing CCBs would be necessarily different to that of RO because of the very different purposes that the funds serve. We see a principled case for ringfencing RO money that was never intended to support suppliers' business operations and is instead a clear 'pass through' arrangement intended solely to fund a government renewables scheme which could easily circumvent suppliers altogether were the scheme designed in a different way.

4.4 As a result, in November 2022 we proposed directing suppliers to ringfence CCBs only where our supervisory financial monitoring and assessment of the supplier's circumstances suggested that the supplier had an over reliance on CCBs. This would be measured by setting threshold triggers for CCBs which were where CCBs represented more than 50% of total assets or where the proposed FRP standards were not being met, or where either of these thresholds were at risk of not being met within the following 12-month period.

Stakeholder responses

4.5 Stakeholders were broadly supportive of the shift away from industry-wide ringfencing and recognised the benefits of a directional approach based on individual supplier assessment. Four stakeholders, however, retained a preference for an industry-wide approach, and a significant number of additional concerns were raised on the transparency and specificity of when we would utilise the powers to direct ringfencing.

4.6 A number of stakeholders welcomed the proposed shift to ringfencing by direction, alongside the focus on ensuring suppliers are adequately capitalised. One stakeholder noted that the key to success hinges on the ability to act promptly and ensure protection mechanisms are insolvency remote. Further observations included an acknowledgement that a risk-based approach ensures that unnecessary costs are not passed on to customers, where their supplier is acting prudently. It was suggested by one stakeholder that a focus should be put on new entrants to ensure they are adequately hedged and financed when they enter the market.

4.7 Where stakeholders supported our proposals, there were challenges on some of the design and implementation features, and requests for further consultation and engagement on these details. The stakeholders who maintained support for an industry-wide approach to ringfencing believe that we had failed to justify why we had chosen not to require a cross market approach. There is residual concern that an over-reliance on CCBs remains an issue, with further worry that proposals do not sufficiently protect customers from the costs of credit balances becoming mutualised. A number of respondents put forward alternative proposals including:

- Obligate new entrants to ringfence for 3 years with a phased relaxation of ringfencing after that.
- Implement industry-wide ringfencing until capital adequacy measures are in place.
- Introduce a requirement for the supplier to tell their customers if CCBs are used as a source of working capital or not.

4.8 We received several comments that the proposals would not address the risks around moral hazard and suppliers using CCBs as risk-free working capital. To address this issue, respondents also made the following suggestions:

- Improved regulatory oversight of how CCBs are used.
- Stop upfront energy payments.
- End the protections of CCBs that customers of failed suppliers receive and ensure the responsibility for returning CCBs to customers remains with the failed supplier in the event of disorderly exit.

What are we proposing now?

4.9 We continue to believe that concerns relating to reliance on CCBs can be addressed by building on existing and associated new requirements, such as our work on capital adequacy and strengthened rules around how suppliers set Direct Debits. Our revised impact assessment published alongside this document shows that we would expect the common minimum capital requirement alongside market-wide RO ringfencing to have net consumer benefits of £63m per year on average over the next six years, £27m more than market-wide CCB and RO ringfencing. We have strengthened the rules around how suppliers can set Direct

Debits. In parallel to this, in the summer of 2022 we undertook a Market Compliance Review[15] focussing on consumer Direct Debits and following that, opened formal compliance engagement with 12 suppliers to address the concerns that had been raised. By February 2023, 95% of these concerns had been satisfactorily resolved.

4.10 We expect that the effect of our Strengthening Financial Resilience policies will result in an overall improvement in supplier resilience. As part of this overall package, **we continue to believe that introducing the power to direct ringfencing of CCBs in certain circumstances is in consumers' best interests**. We are proposing that this should be available in circumstances when suppliers are not meeting the Capital Target to address the concerns about reliance on CCBs as a source of working capital. In addition, we have identified a further trigger that will allow us to identify unsustainable business practices early, by identifying if suppliers are not maintaining sufficient cash to honour customer requests to settle CCB balances at the level that might be expected in a *severe but plausible switching scenario* and when a *high volume of refund requests* are received. We are confident that through our reporting and monitoring framework moving forward, we will have better insight into the use of CCBs.

Triggers framework

What did we consult on?

4.11 We proposed to introduce a trigger for CCB ringfencing where our supervisory financial monitoring and assessment of the supplier's circumstances suggested that suppliers held CCBs that were more than 50% of total assets, or where the FRP standards outlined in SLC4B.1 to SLC 4B.6, were not being met, or were at Material risk of not being met within the next 12-month period.

4.12 The proposed approach would allow us to monitor levels of reliance and to respond as needed. Where suppliers exceeded the threshold, we proposed that we would consider directing protection of CCBs in line with the draft SLCs that were published alongside the November consultation.

4.13 We thought this approach would allow us to be proactive with suppliers to address over-reliance on CCBs, and to respond in a clear and timely manner where suppliers breach FRP requirements to manage costs at risk of mutualisation. We said that we would continue to review these triggers to ensure

[15] https://www.ofgem.gov.uk/publications/direct-debit-market-compliance-review-progress-update

they achieve the intended outcome of encouraging suppliers to avoid over reliance on CCBs and therefore this number was subject to change.

4.14 The CCB specific trigger metric was based on the licensee's Total Assets and their CCBs from domestic customers. Our review of failed suppliers indicated that they held CCBs at an average of >60% of total assets between June 2020 and June 2021 (apart from March 2021 when the average was 40%). We considered that a trigger point at 50% was the appropriate level to monitor and understand potential supplier reliance on CCBs. This trigger point was set sufficiently below the levels of CCBs held by failed suppliers to provide confidence that early intervention would be possible.

4.15 We said we thought it was also consistent with the existing FRP guidance that suppliers should not be "overly reliant" on CCBs. In the case where a licensee supplies both domestic and non-domestic consumers, suppliers would explain any split of assets between a licensee's domestic and non-domestic supply business.

Stakeholder responses

Relevance of the triggers

4.16 There was a mixed response towards our proposed triggers and our framework for intervention. Stakeholders raised a number of concerns with the threshold of setting CCBs as no more than 50% of total assets, with one of the key issues being a view that the basis for using a percentage of total assets measure had not been clearly explained in the November statutory consultation. Several other concerns were raised including the need to factor in the normal fluctuation of CCBs, tariff prices and customer numbers over the course of a year and the potential bias of a total assets approach to legacy suppliers with more long-term fixed assets. There was a concern that one trigger breach event may lead to a direction to ringfence without consideration of the supplier's overall health.

4.17 With regards to the enhanced EFPR triggers that were proposed in the November statutory consultation (SLC 4B.1 - 4B.6) stakeholders were concerned about the broad nature of the standards and were uncertain about when a trigger would be breached.

4.18 Alternative proposals from stakeholders included:

- Assessment of end of winter balances as an indication of over reliance on CCBs.

- Introduction of a trigger window (for example trigger breaches over 3 months) to differentiate between isolated trigger incidents and enduring resilience issues.
- Use of current assets or another liquidity measure, rather than total assets, to level the playing field between the differing supplier business models.
- Use a threshold expressed as a percentage of gross consumer trade debtors (excluding bad debt provision) as this is more readily understood and less likely to be gamed and it reflects the balance between money owed by customers and money owed to customers.
- In the absence of market-wide ringfencing, lower the proportion of CCB in relation to total assets to 25%.

Timing of triggers and monitoring

4.19 A number of stakeholders believed that the threshold triggers outlined for CCB ringfencing would only alert Ofgem to the need for ringfencing once the supplier is at material risk of failure. At that point it may be too late to ringfence due to the proximity of the supplier to the zone of insolvency, or the adverse effect that ringfencing would have on the supplier's ability to finance their activities, to the extent that it could cause the supplier to exit the market. Further concerns were expressed on the volume of reporting requirements placed on suppliers and the ability of Ofgem to resource the monitoring framework effectively. One stakeholder suggested a monitoring exemption for investment grade suppliers, as their risks are already monitored by external credit rating agencies.

What are we proposing now?

4.20 We carefully considered the views of our stakeholders and further investigated alternative trigger thresholds to identify if there were better indicators of the responsible financial management of CCBs that would allow us to be more proactive with suppliers to avoid over-reliance on CCBs, and to respond in a clear and timely manner where suppliers breach the requirement, to manage the risk of CCB mutualisation.

Capital Target Trigger approach

4.21 We propose to use the Capital Target of equivalent of £130 per dual fuel customer (as described in Chapter 4) as a trigger threshold for considering whether to direct a supplier to ringfence some or all of its CCBs. The Capital

Target helps to ensure that the supplier is not overly reliant on CCBs as a source of working capital. Using this as a trigger provides an effective indication of the financial position of the supplier and their ability to maintain resilient business practices. By maintaining sufficient capital levels, we would expect to see a decreased reliance on CCBs as working capital and so this trigger can be seen to directly support our policy intent.

Cash Coverage Trigger approach

4.22 This trigger specifically aims to ensure suppliers have sufficient capital to fulfil their obligations to their customers with respect to their CCBs. Given the focus on sustainable business practices we propose that suppliers maintain sufficient cash to settle CCB balances at the level that might be expected in a *severe but plausible switching scenario* and when a *high volume of refund requests* are received.

4.23 Our Cash Coverage Trigger will require suppliers to ***maintain monthly cash (in the bank) balances at a level equal to or greater than 20% of gross CCBs net of unbilled consumption owed to their Fixed Direct Debit customers.***

4.24 We believe that this threshold will give a more direct and meaningful indication of sustainable business practices in relation to CCBs than the alternative proposals we have considered (such as total assets and current assets thresholds).

4.25 A further benefit of this approach is that it applies consistently across varying business models regardless of supplier size.

Rationale for the Cash Coverage Trigger approach

4.26 We believe that there are at least two distinct possible calls on supplier cash balances related to the refund of CCBs:

(1) When a customer switches to a new supplier, the incumbent supplier must refund credit balances to the customer who is leaving[16].

(2) Suppliers must refund any credit balance in a timely manner to a domestic customer upon request by the customer 'save where it is fair and reasonable in all circumstances for the licensee not to do so', according to current SLC 27.16.

4.27 We believe that both risks apply to all suppliers, even if they have had a relatively more loyal customer base in the past. Since this requirement only

16 https://www.ofgem.gov.uk/information-consumers/energy-advice-households/check-if-you-are-owed-money-your-energy-bill

applies to the CCBs of Fixed Direct Debit customers, we do not think it will constrain nor favour business models that offer different payment methods.

4.28 Given the uncertainty over future wholesale market prices and government support schemes, we have considered various scenarios. As of early 2023 there are around 12 million customers that were previously engaged who have defaulted onto default tariffs owing to the strong protections that the default tariff price cap and government's Energy Price Guarantee (EPG) have offered during the energy crisis. Many other consumers are likely to take action to save on their energy bills at times of relatively high prices[17]. As wholesale market prices fall, competitive tariff offers significantly below the price cap / EPG levels are likely to re-emerge.

4.29 Even with the Market Stabilisation Charge[18] (MSC) in effect, suppliers could be exposed to large numbers of customers asking for refunds of their CCBs. Whilst these balances will be relatively low in the late winter/early summer, such severe switching events could plausibly happen at any point during the year. It would appear plausible that at least several million domestic customers change tariffs/suppliers over six months (the rough timescales on which suppliers may need to raise replacement funds). Whilst some of these may be internal switches of tariffs (i.e., not requiring a refund), up to half of switches could plausibly be to other suppliers[19], leaving suppliers with a risk exposure. Hence, we think there is a reasonable case for suppliers being prepared to refund 20% of gross CCBs net of unbilled consumption at all times through appropriate cash coverage.

Trigger implementation timing

4.30 The Cash Coverage Trigger will take effect at the same time as the CCB ringfencing policy. The Capital Target Trigger will take effect when the Capital Target requirements become effective on 31 March 2025.

Are the triggers early enough?

4.31 As mentioned earlier in this chapter, some stakeholders raised concerns about the ability of the triggers to raise an early enough alert to allow intervention with a direction to ringfence CCBs.

[17] For example, 52% of households said they definitely will or probably will compare energy tariffs in the next three months, according to Ofgem's latest Household Consumer Impacts of Market Conditions Survey (fieldwork Nov/Dec 2022, to be published Spring 2023).
[18] https://www.ofgem.gov.uk/publications/market-stabilisation-charge-dashboard
[19] For example, 25% of households said they definitely will or probably will switch tariff with a new supplier in the next three months, according to Ofgem's latest Household Consumer Impacts of Market Conditions Survey (fieldwork Nov/Dec 2022, to be published Spring 2023).

4.32 Whilst there is a requirement for suppliers to self-report a trigger breach, we are confident that our monitoring framework, which includes a monthly financial reporting RFI, and quarterly stress testing as well as annual self-assessment is sufficient to identify issues at a point where ringfencing can still be directed if considered necessary. With this ongoing monitoring and resilience forecasting, we do not expect that suppliers will already at the point of failure when triggers are breached. However, we do understand that there may be exceptions when this may be the case, and in these instances, and depending on the nature of the resilience position, we are likely to utilise BAU enforcement powers to minimise consumer risks.

Triggers we are not proposing to take forward

CCBs as no more than 50% of total assets

4.33 We acknowledged concerns that this threshold could affect suppliers with different business models in a potentially inconsistent way. We were therefore keen to identify alternative triggers that would better align across business models as well as aligning more directly with the appropriate financial arrangements in relation to CCBs. As a result, we are not proposing to take this trigger threshold forward.

FRP standards triggers

4.34 We listened to the views of stakeholders with regards to the need for clear and unambiguous CCB ringfencing direction trigger thresholds and in response to that feedback and because we have identified more specific thresholds, we are no longer proposing that the enhanced FRP standards (SLC 4B) will be used as trigger thresholds for CCBs.

CCBs as a percentage of current assets

4.35 We reviewed the option of setting a CCB threshold as a percentage of current assets at a level of 10% below the average percentage held by failed suppliers. We acknowledged the stakeholder view that using current assets as a threshold would be a better indicator of over reliance than the previously proposed total assets threshold. We noted that there was a perception that the current assets threshold would remove any bias towards legacy suppliers who may hold more long-term fixed assets, and which would consequently allow them to hold higher levels of CCBs.

4.36 We used supplier CCB and current assets data and data forecasts to analyse the supplier position at different points in the year in relation to this trigger and found no significant bias between suppliers of different sizes.

4.37 We still believe that setting a threshold based on current assets would i) allow any changes in resilience to be identified early enough to take action if required; ii) reflect the responsible management of CCBs within the wider financial context; and iii) remove the perception of business model bias. Nevertheless, following further review of alternatives, we identified alternative triggers that offered the combined benefits of directly addressing the suppliers' management of CCBs on an ongoing basis with a wider resilience threshold. As a result, we are not proposing to move forward with a current assets trigger.

Power to direct an Adjustment Percentage

What did we consult on?

4.38 In making the decision on what level of CCBs to be ringfenced, which we call the Adjustment Percentage, we proposed to consider consumer interests and have regard to supervisory financial data to determine, an amount between 0% and 100% which:

- Would not have an adverse effect on the licensee's ability to finance its activities such that the level of required ringfencing is likely to cause the licensee to exit the market due to insolvency.
- Would minimise any possible mutualised costs that could be caused should the supplier exit the market.

4.39 Before directing a supplier to ringfence their customer credit balances, we proposed to notify the supplier in writing, indicating the date when the direction should take effect. We would also indicate a time period – not less than seven days – within which representations regarding the direction can be made by the supplier.

Stakeholder responses

4.40 A number of stakeholders said that the process through which we would make a decision to direct and calculate the Adjustment Percentage was broad and discretionary and should be further explained. They said that further clarity should be provided on what would be considered as over reliance. Responses suggested that, without additional clarification, the process by which a direction decision is made appears to lack objectivity. One respondent said that directing hard ringfencing of CCBs would not be needed if Ofgem were to have an adequate minimum capital calculation, which correctly reflects the relevant business model, whilst another emphasised the need to ensure that the monitoring framework aligns with supplier business models.

What are we proposing now?

4.41 Although we are not amending our proposal on how we will *make a decision* to direct ringfencing, we provide further details on how we will consider representations from suppliers, and how we will decide what level of ringfencing to direct.

4.42 If the supplier hits either of the CCB triggers, we will have an obligation, subject to certain exceptions, to direct ringfencing. We will engage with the supplier to further analyse the circumstances of the trigger event and the overall resilience picture. We will consider the wider sector environment such as the normal fluctuations of CCBs, for example, going into a winter period or coming out of a winter period.

4.43 We will consider any representations from the supplier where they consider that ringfencing or the proposed Adjustment Percentage would not be in the Consumer Interest. The supplier will have up to seven days after receiving notice of our intent to issue a direction to submit their representation.

4.44 Consumer Interest is the likely impact of any ringfencing on Resilience, Prices, Quality and Standards, and Low-Cost Transition to Net Zero.

- Resilience considers the impact of any adjustment on the proportion of the market at risk of failure and the likely Mutualised cost that would result.
- Prices means the impact of any adjustment on charges for the supply of electricity and / or gas.
- Quality and Standards relates to the impact of any adjustment on the level of competition, innovation, and customer service in the market.
- Low-Cost Transition to Net Zero considers the impact of any adjustment on the ability of licence holders to progress towards an energy system which relies on renewable zero-emission sources and facilitates the use of zero-emission technologies.

4.45 We would consider the consumer interests carefully before directing CCB ringfencing. Where we do not receive representations, or we do not agree that ringfencing CCBs would be detrimental to the Consumer Interest, we may issue a direction to ringfence CCBs.

4.46 In deciding what level of ringfencing to Direct, we had previously proposed a discretionary approach which could see the Adjustment Percentage set between 0% and 100% dependent on our assessment of the overall resilience position in relation to CCBs and the benefits to consumers in protecting them. We listened to the stakeholder feedback from the November 2022 statutory consultation which challenged whether our approach would provide sufficient protection from mutualisation and, in addition we acknowledged the preference for greater certainty on the adjustment percentage.

4.47 To determine the Adjustment Percentage, we will assess whether the licensee has sufficient working capital to pay its employees and those suppliers whose goods or services are essential to the continued operation of its supply business and to meet other essential monetary obligations such as interest and tax. In deciding this level, we will also consider any representations received about the Consumer Interest.

4.48 Our approach to deciding whether to use these powers, and at what level to ringfence, will apply to both the Capital Target and the Cash Coverage Trigger. Where the Capital Target Trigger has been reached, the supplier will also be expected to provide a Capitalisation Plan.

4.49 In the case of the Capital Target trigger, if we decide not to direct ringfencing we will expect an updated view on the Consumer Interest considerations through the Quarterly Reporting Cycle. Where only the Cash Coverage Trigger applies, and we have decided not to direct ringfencing, we will put in place reporting requirements to keep this assessment under review and will retain the power to direct ringfencing if the situation changes.

Frequency of calculation

What did we consult on?

4.50 To reduce the risk of over or under calculation in cases where a direction to ringfence CCBs is issued, we favoured a monthly reporting cycle using actual data to keep the levels of protection close to the amount of CCBs held and remove the risk of forecasting errors.

Stakeholder responses

4.51 We did not receive feedback on the frequency of the calculation.

What are we proposing now?

4.52 Our position on the frequency of calculation has not changed and we therefore continue to proceed with a monthly calculation and reporting cycle which will reflect the expected fluctuations in credit balances across the year and therefore reduce the risk of under or over protection.

Defining customer credit balances

What did we consult on?

4.53 We considered a range of options for the calculation of the protected amount and proposed basing the calculation on gross customer credit balances net of the unbilled consumption (of all Fixed Direct Debit customers) multiplied by the Adjustment Percentage (the percentage Protection required). This definition being both impactful on reducing mutualisation costs and effective in reducing access to CCBs as risk free working capital.

4.54 It was our view that a calculation based on gross credit balance net of unbilled consumption strikes the right balance between protecting a suitable amount of CCBs and the costs of protection and alternatives such as only protecting net credit balances would not provide sufficient protection in the event of supplier failure.

Stakeholder responses

4.55 One stakeholder expressed a preference for a gross credit balance net of debt calculation, whilst another suggested an account level calculation that included prepayment (legacy and smart) customers to reflect costs at the risk of mutualisation.

What are we proposing now?

4.56 We remain of the view that Gross Credit Balance net of Unbilled Consumption is the most suitable definition for prospective ringfencing arrangements. This is primarily because this approach would protect a meaningful[20] amount of CCBs in the event of supplier failure throughout the year. It is therefore more likely to inhibit the use of CCBs as risk-free working capital and disincentivise excessive risk taking and poor business models. We also recognise debit balances will

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[20] Due to the seasonal variance of energy use, there will be periods throughout the year where a supplier would be required to protect zero credit balances for 'Net Credit Balance', as debt balances are netted off against credit balances.

ordinarily be pursued by the administrator and not be recoverable by the SoLR in the event of supplier failure, which means that the net credit balance approach may not reduce CCB cost mutualisation materially when a supplier fails.

Implementation of protection mechanism

What did we consult on?

4.57 Under our revised CCB ringfencing proposals we intended to implement a requirement for the CCB ringfencing protection mechanism to be set up, validated by Ofgem, and made live within 28 days from the issuance of a direction. We believe this is an appropriate timeframe given any direction will be triggered by concerns over financial resilience and the resulting CCB ringfencing protection therefore needs to be in place as quickly as practicable to secure CCB funds are protected.

Stakeholder responses

4.58 One concern was raised in relation to the 28-day implementation period where a ringfencing direction was issued, with the view that this time scale was too short and may be damaging for negotiations with providers of capital.

What are we proposing now?

4.59 We continue to believe that once a ringfencing direction has been issued it is important that protection is put in place as soon as possible. On this basis, and because we received limited feedback on this, we do not intend to adjust our proposal on the implementation period.

Table 3. Timetable for implementation and ongoing Protected Amount calculation

Relevant Period	Initial Period	Subsequent calendar month
Direction takes effect	Day 1	NA
Calculation data from close of business	Day 2	Last day of the previous calendar month
Support arrangements & calculation submitted to the Authority	Day 14	Day 14 of month
Credit Balance Support arrangements go live	Day 28	Day 1 of following calendar month

Termination

What did we consult on?

4.60 Under our proposal the obligation for CCB ringfencing under direction would continue until revoked by the Authority. A revocation notice would be issued when the Authority was satisfied that the licensee was able to meet its financial resilience obligations or when there was no longer a risk that the licensee would fail to meet the required financial resilience standards SLC 4B.1 to 4B.6 within the next 12-month period (as appropriate).

Stakeholder responses

4.61 We received no feedback on our proposals for the termination of a ringfencing direction.

What are we proposing now?

4.62 Our proposals for the termination of a ringfencing direction remain the same with an obligation to continue to ringfence according to the direction issued until revoked by the Authority.

Protection mechanisms

4.63 We proposed a menu of protection mechanisms to ensure availability of a mechanism appropriate to varying business models. We agreed that a templated approach for the arrangement of protection would be most efficient for suppliers and committed to publishing drafts[21] with a view to collating views prior to finalising the format. We are publishing final protection mechanism templates in respect of RO ringfencing alongside the decision to implement the RO ringfencing licence modifications. Given that CCB ringfencing is subject to further consultation, the templates previously consulted on[22] have been amended to remove references to CCBs. If we proceed to implement CCB ringfencing licence modifications following this consultation, we expect to publish the final template protection mechanisms in respect of CCBs alongside that decision. We have removed the Escrow option from the menu in respect of RO and we expect to do the same in respect of CCB if we do proceed.

[21] Statutory Consultation - Strengthening Financial Resilience | Ofgem
[22] Published for consultation on 3 March 2023 and available: here

Appendices

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Appendix 1 - Documents published alongside this consultation

- SLC 4B gas and electricity licence text
- SLC 4B licence notice
- SLC 4D gas and electricity licence text
- SLC 4D licence notice
- Consultation guidance
- Updated Impact Assessment and model
- Stakeholder responses

Appendix 2– Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk.

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e., a consultation.

4. With whom we will be sharing your personal data

None.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for six months after the project is closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it

- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content, and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information for more information on how Ofgem processes your data, click on the link to our "ofgem privacy promise".