

10 May 2023

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Dear David,

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

We write in relation to the above Statutory Consultation. Our response encompasses our comments for the Statutory Consultation, the draft proposed modifications to the standard Supply Licence Conditions, the revised draft Guidance on the Operational Capability and Financial Responsibility Principles, and the Revised Impact Assessment.

Utilita is a smart prepay supplier, specialising in providing a high-quality service to a traditionally poorly served sector of the market. We have around 800,000 customers of whom over 316,000 are on the Priority Services Register ("PSR"), significantly higher than the industry average. Our understanding of our customers and their needs is exceptional and has been built up over many years. Our core offering is smart prepay, which provides extended Friendly Credit and Emergency Credit, a range of options for topping up and excellent visibility of customer information via our App and the In-Home Display (IHD). Our smart prepay service automatically includes access to our award-winning App, My Utilita.

My Utilita offers facilities such as PowerUp (which allows customers to access top up credit on-demand), our budgeting tool called Savings, energy efficiency support via Smart Score, as well as easy access to on-line top-ups and other features. My Utilita is specifically designed to support the needs of our customer base, including those who are vulnerable – and, just as importantly – those who are in a Vulnerable Situation or who may become vulnerable.

We welcomed the opportunity for a meeting with the team to discuss the consultation document and associated materials. In that meeting (3 May), we set out clearly our concerns, which related to the proposals, as well as how they will be funded, transitioned, and tailored to the risk profile of individual suppliers. These concerns build on many of our previous submissions relating to the adequacy of the prepay price cap. While we have not reproduced our historical submissions here, we restate the points made and refer Ofgem to those documents. We would be happy to provide any copies requested.

Utilita remains of the view that a Minimum Capital Requirement regime, incorporating common Targets and Floor, is not compatible with a price capped environment, where the price cap precludes suppliers' recovery of efficient costs.

Ofgem should:

- ensure suppliers can recover their efficient costs
- ensure suppliers are properly remunerated for the risks they are taking
- allow suppliers to manage their risks (including price) accordingly, and
- rely on market forces, competition, and innovation to ensure fair prices for consumers.

This would be consistent with the intent of the price cap legislation, which was for Ofgem to set a cost reflective price cap that would protect SVT/default customers from the “loyalty penalty” while being compatible with competition.

There are two ways of improving Supplier Capital – new investment and retained profits. New equity and (retained) profits are closely linked. Suppliers have been loss making for several years, as demonstrated by the information sheets published periodically on the Ofgem website, so it is unclear how suppliers are to raise new equity in the relevant licensed entity, when Ofgem has not adjusted the price cap to allow suppliers to make – and retain - a normal profit.

Ofgem’s price control regulation differentiates between Standard Variable Tariff (SVT) and Fixed Price¹, and within SVT further segments customers into three groups. Ofgem clearly recognises that there are distinct differences in cost and risks associated with these segments and has given no justification for why a common Capital Target is nonetheless considered to be appropriate. Ofgem must be consistent in its approach. For example, Ofgem recognised that the cost of unexpected SVT roll off did not apply to SVT PPM customers and so excluded that group from a cost allowance adjustment. On the same basis therefore, it must also exclude the imposition of a Capital requirement for unexpected SVT costs for price-capped SVT customers.

Ofgem has clear precedents for adjustments relating to customer segmentation within the recovery of debt as well, on a similar basis. The PPM SVT, for example, does not include a bad debt allowance as it is assumed (erroneously) that debt is only accrued while under a Fixed Price contract or credit SVT.

We highlight these cases because we do not agree with Ofgem’s assessment that it is too complex to have different capital allowances by customer type. On the contrary, it seems to us to be simple. Ofgem already has information on suppliers’ customer segmentation and it is in the interests of customers - particularly vulnerable SVT PPM customers - to recognise the material differences in risks faced by suppliers of these different customer groups when setting capital requirements.

Among the recent consultations, Ofgem has shown only very limited regard for differing business models, though it has considered size of business. We disagree with this approach. There is no reason splitting the market by size of supplier alone is relevant for this consultation. Risks faced by the business: for example, the split of SVT and Fixed, payment method and hedging practices must be key differentiators.

Ofgem asserts that the price cap includes the necessary costs. However, the price cap is for SVT and explicitly will not (and should not) include the costs/risks of unexpected SVT for example. These costs – and the associated Capital requirements – should only be held in respect of (and borne by) FTC customers. FTC customers receive the benefit of such approaches and must rightly bear any associated costs.

The proposals as put forward will clearly favour very large, vertically integrated suppliers, with highly profitable upstream businesses (or protected network businesses which receive guaranteed revenues) or suppliers who have investors which are prepared to make significant short-term losses. This is clearly evidenced by publicly available information – for example, published accounts – and does not reflect the risk posed to consumers by the supplier business. While no investor will be willing to lose money indefinitely, this approach will allow investors with deep pockets to restrict the market and weather short-term losses – but such investors will expect to fully recoup their losses and make

¹ Fixed Price is often referred to as Fixed Term Contract or FTC

extended supernormal profits in due course. We believe that such market restriction and its associated regulatory impacts cannot be in the interests of present and future consumers, and indeed poses significant risk in the long term to all consumers, including those who are financially vulnerable.

In addition to the above, Ofgem has not addressed the under-recovery of efficient costs in the existing PPM price cap due to cross subsidy between payment methods. In its consultation *Protecting energy consumers with prepayment meters* (May 2020), Ofgem set out its view that efficient PPM costs in 2014 for dual fuel customers exceeds the current PPM uplift in the prepayment price as calculated by the CMA by £0 to £17. £17 is, in fact, an under-statement of the PPM uplift, had it been calculated in a consistent way with Ofgem's assessment of the operating costs associated with customers in receipt of standard credit and direct debit tariffs. The result of the understated prepayment uplift inherited from the CMA is that Ofgem considers the direct debit and standard variable caps are set £4.16 above the level of efficient costs.

Since then, supplier obligations and costs of operation under mandated industry programmes have increased, further increasing the losses suppliers, and particularly prepayment suppliers, will make under normal market conditions. This issue includes the degree to which previous Impact Assessments understated the cost of delivering such requirements: in particular, the costs of providing the vastly increased levels of additional support needed by prepay consumers who cannot afford to top-up their meters and consequently demand extensive, free support. While the cost-of-living crisis has undoubtedly impacted such customers, and some Government support has been given, the increased obligations and demands for help both predated and far exceeded the support available through Government channels, increasing the unfunded burden on suppliers.

Until the errors in the price cap are corrected, and efficient suppliers can recover their costs, it will be impossible to raise any new capital for financial resilience, regardless of the length of the transition period. Only suppliers with stronger balance sheets, i.e. the large or very large suppliers, will be able to raise the necessary capital by taking a long-term view of a return to economic rationality in price capping; the result will be the restriction or even market exit of efficient and innovative suppliers and the preclusion of new efficient suppliers from the market.

As well as failing to address the under-recovery of efficient costs in the PPM price cap due to cross subsidy between payment methods, and failing to address the erroneous Smart Metering Net Cost Change ("SMNCC") allowance, Ofgem has not made provision to take forward appropriate changes to the price cap in advance of transition, to allow suppliers to build resilience. There are several critical areas to be addressed in this space, including the appropriate assessment of efficient costs and whether or not the current 'notional efficient supplier' remains a serviceable construct in the light of the enormous changes in supplier participation in the industry since the assessment was made. Simple logic states that a bottom-up reassessment of the price cap is essential in advance of the imposition of such onerous new obligations.

While Ofgem has indicated a price cap work programme, which is welcome, the areas of work which are critical to underpin the type of regime proposed in the current statutory consultation will not be considered – far less addressed – until late in the transition period.

Ofgem therefore continues to effectively discriminate among suppliers and to cherry pick which business models it supports. In failing to create a neutral framework without unfair cross subsidy, which would allow a range of competitive business models (including prepay specialists) to thrive, it will disadvantage the most vulnerable in society and foreclose that sector of the market to competition. Conversely, by continuing to support suppliers specialising in Direct Debit, fixed contract offerings, cross-subsidised by the inclusion of costs that are properly attributable to prepay customers in the operating cost allowance within the DD/credit SVT price cap, Ofgem may in fact drive more risky behaviours at an industry level.

This submission includes both this covering letter and Appendices 1 and 2. Appendix 1 sets out our answers to specific questions raised by Ofgem. Appendix 2 provides sections relating to the new proposed Guidance, the Revised Impact Assessment (RIA), and commentary on licence drafting.

As a point of general feedback, we have found Ofgem's approach to this consultation and decision process to be onerous. The plethora of documents, repeated iterations of untracked Guidance, overlays of licence drafting and tight timelines (both for response and implementation) have made the process highly complex.

The RIA is used to support the published decision on the Enhanced Financial Responsibility Principle (EFRP) as well as this consultation. However, a number of statements in the RIA also appear to foreshadow future decisions, for example on EBIT, and hence suggest that some issues may have been pre-determined prior to consultation.

Finally, we offer several important concluding observations on the overall approach within which we ask Ofgem to consider both this letter and our Appendices.

The Minimum Capital Requirement (MCR) approach overall does not seem targeted or proportionate to the problems identified, which seem to be about a subset of suppliers failing to hedge and instead relying on CCBs and RO amounts excessively to fuel unsustainable pricing/growth. We believe that there are more targeted and proportionate means of dealing with these problems – some of which Ofgem has already implemented, such as changes to Direct Debit rules - which could be tightened, if necessary, e.g., to prevent suppliers charging upfront. These rules would not have the unintended consequences on suppliers who simply have different business models - and therefore would be more proportionate and targeted and would not impose unnecessary and inefficient costs on consumers.

The MCR – and accompanying Revised Impact Assessment – do not consider the existence of the EFRP as part of the current baseline against which the MCR is considered. We believe that this may be an error. We appreciate that it may be an unintentional consequence of the approach taken of separating out the EFRP decision and re-consulting on the MCR, while using the same RIA. However, we are of the view that the EFRP needs to be considered as part of the status quo and as part of the 'do-nothing' counterfactual against which Ofgem should assess and then decide whether to implement the MCR.

Ofgem acknowledges in the text of the consultation that "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". We therefore ask Ofgem to set out explicitly in a further updated Impact Assessment what the "common risks" are that Ofgem is seeking to cover by the imposition of the additional MCR. We do not consider that this test of a need to address "common risks" is met by the current MCR RIA.

We believe that there are significant risks associated with the MCR as proposed. Ofgem needs to consider the unintended consequences very carefully – this policy could trigger supplier exits, which is the very thing that it is intended to prevent and therefore would make the policy disproportionate. Recent history underlines the importance of regulatory best practice principles. There have been a series of interventions in the supply market such as an excessive focus on switching and the price cap which have had unintended consequences, which we should learn from. As an industry, we are lurching from one intervention to another – another intervention will not solve the issues without fixing the fundamentals.

Finally, we believe that Ofgem's "backstop" "skin in the game" argument is flawed when it comes to existing suppliers. Much has already been achieved. Existing suppliers have built up businesses and weathered the recent storms while continuing to protect and serve their customers. Failure of supply businesses does have reputational consequences for individuals and Ofgem's Fit and Proper Persons regime supports this point. Indeed, the EFRP, appropriately implemented, means that investors will have skin in the game, albeit proportionate to the risks that they impose on consumers. We do not say

suppliers are perfect, or do not need regulating – far from it – but that regulation must be proportionate, evidence or principles-based (as appropriate) and deliver effectively for consumers.

We trust this submission has been helpful and while we welcomed the opportunity for a discussion in advance of submission, we would, of course, be happy to meet again to discuss any points in more detail if Ofgem would find that useful.

Yours sincerely,

By email only

Alison Russell
Director of Policy and Regulatory Affairs

Appendix 1: The Statutory Consultation Questions

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

We do not agree with the proposed approach. We recognise the notional parallels with the approach taken in the financial services space, but while we do not disagree with the concept, setting an amount per customer does not differentiate between different types of suppliers or their customers and the needs those customers have. Whatever approach is taken should place the consumer at the centre. Customers have the right to expect robust, effective services, tailored to their needs, at a fair price, provided in a way which is suitable to them.

The critical point that Ofgem's approach ignores is that individual business models can and should exist – and that regulation should be aimed at achieving an outcome where businesses evaluate their requirements and risks and ensure that their chosen business model addresses those risks properly. Any 'model' selected by Ofgem to use as a framework for strengthened financial resilience should, by its very nature, provide for such individuality so as to provide an effective and healthy competitive market.

Implementing a Capital Target and Floor (based on a standard financial definition of solvency) would be a sensible approach in a market where sustainable pricing and effective competition were possible, and hence where market participants are able to raise such capital. However, currently, this is not possible given the operation of a price cap that imposes supplier losses and at best, allows minimal margins, and where there is an over-reliance on cross subsidy of payment types. We believe that price caps (of the type currently used in the energy market) operating in the same space as a capital target and floor are fundamentally incompatible. One can have either one or the other, but not both.

The model proposed by Ofgem is too simplistic and does not take into account the differing business models which exist in the energy supply market, with their varying approaches to managing risk. As we have set out above, Ofgem should take a customer centric view, putting the customers' needs at the heart of a framework which allows for flexible business models.

Its current approach risks both failing to protect vulnerable customers and burdening them with unnecessary costs. For example, Utilita's business model operates a Standard Variable Tariff (SVT) for predominantly prepay customers where the energy is fully hedged in accordance with the price cap and then purchased upfront by customers before use. This model carries less risk than a model in which the supplier operates predominantly fixed term tariffs for credit and Direct Debit customers. In that scenario, the risk lies in the energy volume volatility and the potential for customers to roll off the fixed term contract onto a cheaper (loss-making) SVT at the expiry of their fixed term tariff, if the supplier has not hedged accordingly. This, much riskier, model may then require significant reliance on a bailout, but is not a model under which Utilita operates.

A single (common) Capital Target does not therefore, reflect business risk or provide flexibility for suppliers and does not work. Ofgem should not rush through policy without carefully assessing and planning for the impacts of a "one-size-fits-all" approach. Ofgem requires that suppliers take into account individual customers' needs. We agree that this is absolutely what should happen – but this approach should continue throughout all levels of the regulatory framework, including segmenting by the most important criteria in assessing business model risk – SVT vs Fixed Term Contract and Hedging Policy.

Moreover, the consultation does not sufficiently explain the calculation of the Capital Target which makes it difficult to offer further comments at this late stage in the consultation process. A calculation is provided, which is based on the historical performance of selected energy retailers over a few years, but this is very simplistic, and in some cases appears arbitrary. Such an unadjusted historical analysis gives no indication of a universal minimum capital requirement.

We do not oppose a Capital Floor as a matter of principle, though our statements elsewhere in this submission are restated in respect of allowing a transition period under an adjusted price cap before formal assessment by Ofgem takes place. We further note that we do not accept the principle that there is a common Minimum Capital Requirement, rather we are accepting the principle of a £0 net asset position, on the basis that a business with negative net assets is not balance sheet solvent.

In the interim, we consider that a collaborative and transparent approach to risk and reporting with Ofgem is required. This will require that Ofgem works with suppliers constructively to build supplier confidence that increased openness and transparency will not lead to public naming and shaming based on incomplete evidence. This is based on a Capital Floor being set at, and remaining at, £0 net assets and that this value is contained within the formal licence drafting. Any change to this principle i.e. that a Capital Floor should be anything greater than £0 net assets, must follow the statutory licence modification procedure.

We firmly believe that the Capital Target should be set on a tailored basis to properly reflect the risk associated and evidenced by the supplier's business model. This will lead to effective and economic resilience by supplier rather than an approach which favours only very large suppliers as described above.

A tailored, risk-based approach will naturally lead to a risk and cost reflective Capital Target by supplier *ceteris paribus*, this should mean that for low-risk business models, with no roll-off risk and robust Hedging Policies rigorously applied, the resulting Capital Target by supply point will be set much lower. The Capital Target model, and Capital Targets produced, need to be agreed and then funded appropriately for an adequate period before a start date for a transition plan is determined. We propose that funding arrangements under the price cap should be in place for a minimum of 8 contiguous price cap periods as the transition period before implementation of the Capital Target.

In addition, we note that under the RIA (please see Appendix 2 and elsewhere in this submission), Ofgem states that no additional allowance will be made in the price cap methodology for capital adequacy on that basis that 'sufficient' returns are provided to hold a 'specific' level of working capital.

We consider that this is demonstrably not the case based on publicly available information and Ofgem's own published material. We therefore consider that this approach is both fundamentally flawed, and risks prejudging future consultation processes.

We ask that Ofgem provide clear evidence of the available working capital since the inception of the price cap, including the underlying calculations and full model. Price caps have only been in place for SVT Tariffs, we are therefore concerned that to use the existing cap to imply the cost of capital for when unexpected SVT is included for example is simply incorrect. Unexpected SVT is obviously a cost of fixed price contracts. Vulnerable customers on SVTs cannot be either expected or allowed to pay this additional cost which has benefitted only those customers more able to engage with the market, who have received lower prices and borne fewer costs.

2. 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?

We do not agree with the Capital Target and Floor proposals without an appropriate adjustment to the price cap to allow suppliers to recover their efficient costs and build up their reserves. Any imposed, arbitrary timescale applied without the necessary price cap adjustments taking effect sufficiently in advance of the commencement of the transition period will set suppliers up to fail.

This question is difficult to answer more definitively where there are still so many points of clarification to be determined. In order for us to provide a robust answer in support of a more reasonable timeline, we need certainty on whether the price cap periods will be set to allow suppliers a reasonable margin. For example, at present, suppliers cannot accrue necessary capital and repair balance sheets. As per our response to Question 1, if we have a price cap adjustment, and a flexible Capital Target that is

designed around the range of business models available (those existing and for new entrants), then we recommend 8 contiguous price cap periods of adjusted price cap operation as the transition period in advance of implementation.

Unfortunately, the price cap work programme does not provide for an early resolution to this issue, with the EBIT workstream having been deferred and other aspects of price cap review not scheduled until later in 2024/2025. As a worked example, if the necessary funding and price cap adjustments were in effect from 1 October 2024, we consider that a Capital Target and Floor could sensibly be implemented from either 1 October 2026 or 1 April 2027.

While we agree that there may be merit in having a Capital Target and Floor (where it is appropriately funded and implemented as per the points we have set out above and below), there should be a “deadband” applied (this could be a small percentage margin of error and/or a set number of weeks/months’ grace to allow for normal movement). This is important as Ofgem is considering quite onerous, potentially automatic, penalties such as a ban on sales or restrictions on trade where suppliers experience minor infractions of the rules. Activities such as sales, while clearly controllable, do have lead times for cessation or re-launch and associated cost impacts. The outcome of such automated penalty approaches may be that suppliers will need to run with a surplus to avoid unnecessary stop/start. This surplus is likely to be both unfunded under the price cap and inefficient, adding to consumer costs over the longer term.

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

As above, while this may be conceptually viable, and has parallels to the financial services sector, the approach relies on the capability to finance a capitalisation plan. On this basis we do not support the proposals as set out. Without the prospect of at least economic normal profit margins, (i.e. without adjusting the price cap to allow for this) it will be very difficult, if not impossible for supplier ‘challenger’ entities to raise Capital and therefore, any plan to capitalise is likely to fail.

The proposed Capitalisation Plan process is also onerous and, given the lack of a deadband, is likely to lead to inefficient cushions and extra costs. Please read this response in conjunction with our response to Question 2 regarding the proposal for a deadband to allow for small amounts of “flex” to minimise the risk of inefficient costs. The Capitalisation Plan process also requires Ofgem to approve the plan and make judgments such as whether the plan is on a credible trajectory. We would question whether Ofgem, as an economic regulator, has sufficient expertise and skilled resources to make numerous such judgments on complex financial matters and on a timely basis.

The process will require suppliers to have a credible plan that is accepted by Ofgem and, even where they are on the right trajectory in line with said plan (and assuming the price cap allows this), suppliers will not be allowed to grow and will be subject to significant restrictions on trade. While this may be reasonable pending agreement of a Capitalisation Plan, it will be important to consider proposals to support the supplier in achieving key milestones, hence we do not agree that such restrictions should automatically be in effect for the duration of the Plan. For example, if progress can be achieved through using short term upfront costs such as modest incentive schemes or IT investments to achieve operational change and efficiencies, we question whether such activities should require written authority approval.

In addition, sales and growth may be the only thing that a supplier can do to achieve its Capital Target after a particularly tumultuous period. Ofgem should consider whether a ban on sales and therefore growth would further damage the suppliers’ ability to bounce back from such a market shock, particularly if the majority of suppliers have faced the same difficulty. We consider this would actually inhibit customer acquisition and further reduce competition in the market.

A transition plan will also only work where the price cap allows suppliers to make reasonable margins under their own control. For example, a suitable price cap that is higher than now, which would allow an

efficient company to price below the cap, and a struggling one to price at the cap to be able to recover from a state of falling below the Capital Targets and Floor.

We also disagree with the transition proposals. Please see questions 1 and 2 above. The proposed implementation from March 2025 is not matched by proper enabling arrangements, leaving limited time for suppliers to meet the requirements before they are placed in 'special measures'. As recommended above, the transition period needs to be at least 8 contiguous price cap periods prior to implementation.

In addition, we request clarity on the proposed approach to transition controls and Capitalisation Plans, as we are unsure, based on the drafting, whether these are intended to apply in the transition period, or only when it has already passed, and implementation has occurred.

Ofgem should be mindful of the sensitivities of publishing any perceived or actual supplier non-conformances. If implemented as proposed, suppliers will be attempting to "do the right thing" in trying to meet these new and onerous obligations. If Ofgem continues with its current approach of public supplier ranking assessments, based on initial (and potentially incomplete) submissions leading to potentially incorrect conclusions, Ofgem may inflict unintentional reputational damage and itself exacerbate or perpetuate any difficulties the supplier may be facing.

4. 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?

We fundamentally disagree with using parent or group working capital facilities or guarantees when measuring costs and funding required. The approach discriminates in favour of very large or vertically integrated suppliers and actively disadvantages independent suppliers who do not have parent or group companies to rely on. This distorts competition, making it harder for independent companies to compete on an open playing field, reducing innovation brought by disruptors into the industry. Tests should be met at a licensed entity level to prevent large companies effectively foreclosing the market to new and existing competition. In addition, tests should reflect the risk posed to the industry by the supplier and its particular business model. Tests should be applied in a way that allows a supplier to demonstrate how its approach is appropriate, and hence does not pose an unacceptable risk to consumers.

In order to ensure that Ofgem are treating customers fairly and not favouring certain business models, Ofgem must ensure that independent suppliers are able to operate in the market. The test for a "group working capital facility or parent guarantee" should therefore be that the supplier is indifferent between raising new capital and the guarantee. Ofgem are under a duty to ensure the viability of independent suppliers and therefore consideration of any sort of guarantee seems unnecessary.

We believe Ofgem have the balance fundamentally wrong. In normal competition, there is a requirement on consumers to pay for the services provided and suppliers of services are allowed to take risks and experience the rewards or consequences of those risks (which are borne both by the supplier and consumer in unequal measures). This is not the case for energy supply. Ofgem is tightening the protections for consumers to the detriment of a properly functioning market, which incentivises customers to not pay for their energy, allows prices to be below cost, and precludes suppliers from making a normal profit. All of this risk sits with suppliers. Effective competition - where suppliers are allowed to take some risks and where there is a balance of cost and risk which is shared both by the supplier and consumer - is in the consumer interest and critical to rebuilding a competitive market.

5. 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?

We fundamentally object to the inclusion of a parent or shareholder guarantee (see our response to question 4).

Without prejudice to that objection, we note that in the financial services sector, we note that transferable debt instruments (e.g., Additional Tier 1 or Tier 2) or other qualifying subordinated loans (e.g., in the lighter touch regime for non-MiFID investment businesses) need an original maturity of at least five years. When capital instruments are due to be redeemed, often there is a requirement for regulatory permission and a need to replace them with instruments of greater or equal quality, unless certain conditions are met. A maturity of at least 12 months is the period used for eligible liabilities in the bank MREL regime.

If this approach is to be considered, 12 months may be a reasonable minimum tenor, though as is noted in the consultation document, in practice firms would either need to be constantly re-financing these debts, or else, for example, take out a two-year qualifying loan, which renews automatically every year. We consider that this would potentially add additional cost.

- 6. 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?**

We are not aware of any other debt instruments available in the market that would be applicable to Utilita at present. However, restricting alternative financing options to shareholders and parent companies favours those businesses and groups whose shareholders are able to provide this capital.

All long-term unsecured debt should contribute towards "capital" and debt holders would have "skin in the game" with their capital at risk. While this will come at a greater cost, it provides a greater range of options and allows for "other" debt instruments in the future. This approach will allow different business models to develop in the future through innovation while protecting consumers and ensuring that debt and equity holders have "skin in the game". If debt is unsecured there is no reason to exclude it simply because it was not provided by a shareholder or parent company.

- 7. 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.**

We believe the most accurate and compliant method is to use the Statutory Accounts and Annual Reporting metrics. This is something all companies must do through existing legislation and will not add additional reporting burdens on suppliers (which would further increase costs).

While there are differences in IFRS and FRS, at a net asset level these are likely to be immaterial and these standards continue to converge.

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

No, Ofgem should not exclude intangible assets. If this approach was to be taken, then it must also reconsider types of liabilities. Cherry picking assets and not reconsidering liabilities will increase the cost to consumers.

However, we agree that Goodwill should be excluded from the ANA calculation, as this would generally not have concrete value in a distress situation.

9. 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.

We disagree with the proposed £130 Capital Target. It is far too simplistic – if such an approach is to be followed, it must be flexible and appropriate, capable of being applied in a way which fairly reflects the customer base, operating model, and risk appetite of individual suppliers as well as the risk posed to customers and the wider industry.

Ofgem has had no regard to the very different nature of customers and products, this is at odds with currently having 3 different SVT price caps and far less restricted fixed price contracts that are not covered by price cap regulation. A single target will mean the different risks and costs faced by different customers will spread. This will disadvantage SVT PPM customers specifically as they will, for example, incur the cost of Unexpected SVT (as we have set out above).

Ofgem has a duty to protect vulnerable customers. We believe that by not considering the difference in risks between different business models, it is exposing vulnerable customers to additional – unnecessary – costs. If Ofgem was to properly segment customers, and consider all aspects of supplier business models, it would have the added benefit of reducing the price gap between SVT and Fixed Price, ensuring each customer segment pays a fair price for the services and price received.

In the proposed approach, by way of example, Ofgem is not reflecting any of:

- the size of that customer's typical bill
- whether they are in credit or debit at any given point in time (which clearly fluctuates over the year where customers have selected a credit type payment method)
- the impact of any Government support programme(s)
- that energy company's attitude to risk (albeit we understand that the intention is that should be addressed through Pillar 2)
- the customer profile of that energy company and support needs of the customers

If Ofgem is seeking to take an approach akin to the financial services sector, it is critical to recognise both similarities and divergences. The variables above are all (in different ways) reflected in analogous financial services regulatory capital calculations.

In addition, the proposed approach fails to accommodate different supplier business models or specialist suppliers. For example, suppliers who are primarily Direct Debit, fixed term contract suppliers, will carry greater risks for customers and industry, as they have higher consumer credit balances, and impose roll off risk at times of market volatility and rising wholesale prices whereas predominantly prepay, SVT, fully hedged suppliers will carry much lower risks as they have minimal credit balances, no roll off risk and the energy consumed is (mostly) paid for in advance of use.

In addition, the calculation approach appears to lack the necessary rigour. Using company returns over a few short years - spanning such a period of profound change as the introduction of the price cap, a pandemic, extreme energy market instability and a deep cost-of-living crisis, without suitable adjustment - is a completely inadequate way of assessing risk exposure.

We note the methodology includes a simple estimation of retail price, but Ofgem does not propose to vary the capital requirement in line with retail prices. Crucially, Ofgem does not consider – or cost - the increased exposure to wholesale market volatility of fixed rate contracts compared with variable rate contracts (and SVTs).

Customers on variable rate contracts pose much less volume risk to the supplier and there is no uncertainty relating to the probability of renewal following the expiry of a fixed rate period. Ofgem ought to assess, in a more sophisticated and reliable fashion, the difference between the potential losses at a given level of confidence for variable and fixed tariff customers. This assessment should be carried out under a range of hedging scenarios.

Further, we believe that Ofgem is not reflecting the diverse nature of a supply business and its customers. Ofgem is proposing a set model that all suppliers must fit into in order to satisfy the Capital Target and Floor requirements (even where the supplier may not pose a material level of risk) and where they do not meet the requirements, the penalties require the supplier to stop growth until they are back within tolerances. By definition, such a regime would impose unfair burdens on smaller, lower risk and prudent suppliers.

In addition, there is a profound difference from the financial services sector approach in that the regime is not attempting – in any way - to protect the suppliers from risks posed by their customers or counterparties (as is the case, e.g., in relation to risk-based capital requirements which relate to losses on a loan book).

Instead of devising a more sophisticated, but robustly calibrated system, based on exposures to the wholesale energy markets and the price cap, Ofgem has taken a much cruder measure. The approach seems to be derived from taking a plausible loss that a notional supplier might make in a time of market stress (9%) and applying that to the average customer's energy bill (£2000) = £145.

While we understand the calculation, it is a very crude, blunt instrument. Ofgem also refers to the "notional supplier" they have considered to calibrate the calculation, as being "well hedged". However, this approach doesn't appear to take account of the hedging that a prudent supplier would do and then allow that to be recognised and valued in the capital requirements. In fact, Ofgem appears somewhat dismissive about hedging and attributing value to it being associated with reduced risk, even though presumably a well hedged supplier would be less likely to suffer losses.

We believe that if the requirements took into account hedging activities, valuing appropriately a prudent approach by way of a reduction in capital requirements, this would have the potential to act as a very powerful incentive to drive the desired protective behaviours which Ofgem seeks to achieve in strengthening financial resilience.

10. 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.

We disagree with the over-simplified approach of dividing by two. We believe that a Capital Target, if applied, should be assessed separately by supply point. There is no justifiable rationale for simply dividing a number, which has been estimated inadequately using an oversimplified calculation for a dual fuel customer, equally between gas and electricity and then assuming that to reflect the relevant range of risks for either fuel.

The Capital Target should be assessed on a supply point basis and then further split by payment method and then overlaid by a grid incorporating the scale of the customer requirements (contract type, proportion hedged etc...). This more adaptable approach can then be used to form a matrix to calculate the portfolio requirement using standard values e.g., Ofgem medium, credit, electricity; Ofgem low, prepay, E7; etc. which in turn would allow the supplier to calculate their portfolio level Capital Target requirement. In this way, suppliers can follow some standardisation, but this would also reflect fair and efficient amounts of cover being held rather than the one-size-fits-all approach. This approach would also lend itself to an appropriate level of audit to provide Ofgem with reasonable confidence in the requirement figures submitted by suppliers.

This approach is also consistent with Ofgem's approach to price protection. By not segmenting capital in the same way Ofgem is failing to properly protect current and future vulnerable customers. As commented above, by burdening SVT customers with the risk premium of fixed price roll-off, costs are being inequitably apportioned.

We therefore disagree with the proposed licence drafting within the definitions of Capital Target and Capital Floor which gives a "per Domestic Customer" definition rather than supply point.

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

No. As stated elsewhere in this submission, the Target should be segmented and based on risk. The capital requirement relates to risk, but not the level of the price cap. While retail prices will be correlated to risk, gas and electricity are subject to different risks, with greater volume risk on gas (which will vary over the year for a direct debit but not change for prepay) and greater market price risk on electricity. Ordinarily, stochastic process modelling would be used to generate a probabilistic assessment.

12. 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?

We disagree with the proposed reporting triggers. There is no difference between ringfencing RO related cash and credit balances, and the only reason why the Impact Assessment considered ringfencing credit balances to be less valuable is because of the level of credit balances assumed in the Impact Assessment, which may not be typical of the future.

In an event of supplier failure, a supplier would be no more able to cover its customer credit balances than its RO, and there is no logical basis for ringfencing one but not the other. The trigger should, therefore, be direct debit customer credit balances greater than zero.

13. 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.

We strongly believe that ringfencing Customer Credit Balances is preferable to Capital Targets, and more proportionate and beneficial. It will be more cost efficient and less distortionary across the range of suppliers according to their size and business models. Ofgem's proven flawed approach to the Market Compliance Reviews is clearly a case in point. Any exemption to the ringfencing of credit balances in the consumer interest should apply equally to the RO.

The above approach is undoubtedly distortionary. Where suppliers can meet their Capital Target, they can continue to use consumer credit balances.

14. 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.

The capital target trigger mechanism should not be brought in until well after the price cap operating cost allowance has been reviewed so as to first allow an efficient supplier to generate an economic and normal profit, and thereby be able to raise capital.

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

Where all Renewable Obligation expenditure is to be ringfenced then Customer Credit Balances must also be ringfenced.

Appendix 2: Comments on the proposed Guidance, the Revised Impact Assessment and the proposed Licence Drafting.

The Revised Impact Assessment:

As we have set out in the covering letter, we consider that the approach in the Revised Impact Assessment (RIA) may, in itself, be problematic and is an unintended consequence of Ofgem's decision to split the Enhanced Financial Responsibility Principle (EFRP) Decision and the common Minimum Capital Requirement (MCR) re-consultation process. This approach has led, in our view, to a failure to correctly assess the 'do nothing' counterfactual which should be used for the MCR.

This failure has led to flaws in the Impact Assessment that mean that Ofgem's assessment of the MCR being in the interests of consumers is very likely to be incorrect. We believe that there could be several such flaws that could impact the conclusion. We highlight a number below.

We observe assumptions around the historical differences between supplier segments in their SVT and FTC offered prices not changing (para 4.69) and a reversion to a historical proportion of SVTs (para 4.74).

Ofgem appears to ignore the impact of competition on prices prior to the price cap, which seems flawed, and only looks ahead 6 years at the effect on competition. As we have set out above, in light of the scale of industry change in recent years, this analysis is unlikely to be correct.

Ofgem has disregarded the innovations that Utilita has brought to the prepayment meter sector – the experience of PPM customers is now very different from the position during the years of data used by the CMA. These advances have been so important that Ofgem has, in fact, enshrined many of them in the Standard Licence Conditions which apply to all Suppliers.

The mistaken assumption (para 4.64) that the MCR will not require an increase in the price cap is, we believe, clearly incorrect. We have requested Ofgem to bring forward evidence underpinning its assumption on this key point elsewhere in this submission.

More generally, Ofgem seems to assume that competition from existing challenger brands is sufficient – but this ignores the fact that all challengers were once small suppliers and without new entrants coming in to challenge them in turn, the result could well be a return to the oligopoly of the past and a reduction in innovation. While Utilita is aware of the flaws in the CMA's Energy Market Investigation, Ofgem has completely ignored the CMA's findings with regard to the benefits of competition/customer engagement in reducing inefficiency.

In addition to the above, we have some more specific observations to make on the RIA, which may also need to be reconsidered when Ofgem reviews the RIA for the MCR against a corrected counterfactual.

Under the Impact Assessment, in paragraph 4.5, Ofgem considers a weighted average cost of capital among all supplier types as appropriate. However, Ofgem has a duty to ensure suppliers can recover their efficient costs under the price cap, which is particularly important for those suppliers whose cost of capital cannot be artificially reduced by membership of a group in which less risky activities are carried out. Ofgem should therefore use the cost of capital of an *independent* supplier rather than all suppliers, as this most accurately reflects the cost of the supply business, rather than the cost of capital of a group of companies where less risky activities than energy supply depresses the overall cost of capital.

In paragraph 4.37, the Impact Assessment assumes there is less value in protecting customer credit balances than in protecting the RO based on historical credit balances. The IA does not consider how suppliers might respond to reduced working capital from RO and the free working capital that can be generated by retaining larger credit balances than have been the case historically; while RO is fixed and a supplier cannot benefit from any cost of capital in excess of the cost of the renewable obligation, a

supplier is not limited in the amount of credit balances it can hold. The IA has failed to consider how restricting working capital in relation to the RO and in increasing the capital requirement generally may encourage suppliers to increase customer credit balances.

Paragraph 5.49 uses wholesale prices that are well out of date and now much lower. This assumption on wholesale pricing very much affects the calculated benefits of the proposal. This creates significant uncertainty in the accuracy of the benefits calculated.

The Draft Guidance on the Operational Capability and Financial Responsibility Principles

Our comments on the Draft Guidance must be considered in conjunction with the Statutory Consultation responses in Appendix 1.

We firmly believe that protecting Consumer Credit Balances and ringfencing RO remains a priority. However, the guidance has made each of these areas distinctly separate, with their own unique measures for compliance. This approach adds a layer of complexity that is not required. We believe Ofgem should create one simple measure, for both the CCB and RO protections to reduce overly burdensome and bureaucratic procedures, which would be expected to drive unnecessary costs.

While we understand the concept of guidance is generally intended to assist suppliers in their understanding and interpretation of the relevant Supplier Licence Conditions, we believe this Guidance as now proposed goes far beyond this point. The Licence Conditions certainly require the supplier to have regard to the Guidance, and equally it is clear that the Licence Conditions take precedence. However, the licence conditions also cross refer to the Guidance, while the consultation reflects that the Guidance may be expected to change.

This would not normally be expected to create a significant issue, but in this case, we believe it does. This Guidance sets out material intended to help suppliers construe critical areas of the Licence, and, so understand where suppliers may as a result be non-compliant, leading to subsequent intervention by Ofgem. As these actions may include a requirement to stop selling and taking on new customers and indeed operate to restrict trade, it is inappropriate that this Guidance does not have formal Governance procedures.

Proper Governance should ensure that all suppliers are consulted on changes within defined timelines, a certain quality of consultation process, a full Impact Assessment, a formal decision process and an implementation period. This has simply not been provided here. Given Ofgem has recently demonstrated, with concerning frequency, its tendency to use letters rather than consultations, and the provision of extremely short consultation periods regardless of supplier concerns, this does not allow proper consideration or informed response. We believe for guidance of this importance and significance it should follow defined Governance procedures.

Our strong preference is for the Governance (of the Guidance) itself to be set out in the Supplier Licence Condition to ensure that not only are the rules clear for how the Guidance will be updated, but that those rules in turn are subject to protections.

The current proposals are to create a Capital Floor set at £0, which we broadly support, for the reasons set out above. However, please also note our point that the actual amount (£0) should remain set out in Licence. This would ensure that if Ofgem were minded to change this value, it would do so following statutory licence modification processes, and not through arbitrary changes to the Guidance. This approach would ensure such values are not changed without proper planning and implementation arrangements, including transition if necessary.

Without prejudice to Utilita's position as to the inappropriateness of the Capital Target of £130 Adjusted Net Assets for the reasons set out above, proper Governance should apply equally to the £130 Capital Target (Net Assets of £65 per domestic customer) which Ofgem has claimed in the Guidance "could be reviewed subsequently".

For the avoidance of doubt, and moving on from Governance specifically, we disagree with the Capital Target of £130 Adjusted Net Assets that is proposed at £65 per domestic gas customer and domestic electricity customer. As per our response to the consultation questions, this should be set at supply point level. We also request that Ofgem share the methodology that sets out how the £65 may be reviewed and recalculated.

Ofgem state that they will consider whether to approve a Capitalisation Plan provided by a supplier. As noted above, we question whether Ofgem have the skills and experience to be able to make such assessments. We also note that Ofgem will “review the Capitalisation Plan in a reasonable timeframe” but that it does not commit to a specific timeframe which, in turn, provides for potential inconsistency as between suppliers, and uncertainty for suppliers in being able to move forward with their Plan while waiting on approval.

In paragraph 3.44, Ofgem expect suppliers to provide Ofgem with information about their capital position at any point. This is entirely inappropriate and burdensome because it implies 24/7 monitoring and does not take into account seasonal profitability.

With regard to Section 4, under 4.2(a) we believe that ALL Direct Debit Credit Balances should be ringfenced.

The Draft Licence Conditions

Our comments on the Draft Licence Conditions must be considered in conjunction with the Statutory Consultation responses in Appendix 1 and the remainder of this submission.

Our principal concern with the Licence drafting is the failure to provide Governance arrangements for the Guidance. We consider there are two viable approaches to this issue: either incorporate Governance for changing and updating the relevant Guidance into the Licence Conditions; or incorporate relevant parts of the Guidance itself within the Licence Conditions.

Of the two approaches, we suggest the former. We understand and even support the additional flexibility use of guidance can bring. However, in this case, the Guidance itself has the potential to critically restrict business and therefore we consider that it is only reasonable to provide formalised rules for how the Guidance can be changed. We further suggest that the Governance for the Guidance prescribe how Suppliers can seek changes or derogations from the Licence Condition if required.

In addition, we note that in relation to the definition for Alternative Sources of Capital, there is a proposed requirement that Drawn Parent /Group Company Working Capital Facilities should have a minimum of a Baa3/BBB- or equivalent rating. We would like clarity on how “an equivalent” of this credit rating would be assessed. We consider that a small supplier or new entrant will almost certainly not be able to obtain a credit rating from a ratings agency, so it is essential to clarify how Ofgem considers an ‘equivalent’ test will be met. If this is not addressed, it may have the effect of inhibiting competition.