



Ofgem's proposed minimum capital requirement for energy retailers

PA Consulting Report for Centrica plc

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01

Executive Summary



Executive Summary – Context and our scope

Context

Autumn and winter 2021/22 saw 31 energy suppliers enter insolvency, affecting over 10% of UK households whose electricity and gas accounts were transferred to the remaining suppliers. The substantial costs of these failures (estimated at £2.7bn) were mutualised and recovered from GB households adding £96 per household bill.

Starting in June 2002, Ofgem conducted a series of consultations focused on Strengthening Supplier Resilience. Most recently - 5 April 2023 - Ofgem issued a statutory consultation to clarify proposals, refine the policy and the licence drafting regarding a common minimum capital requirement (as a subset of the Financial Resilience Principle) and powers to direct suppliers to ringfence customer credit balances to strengthen the financial resilience of the energy supply market. This latest consultation is the focus of this report. An important component of Ofgem's consultation is the proposal to introduce a Capital Floor and Target, and the associated definition of Capital.

Our Scope

In this context, PA has been commissioned in late April 2023 by Centrica plc to advise it in relation to a selection of consultation questions raised by Ofgem pertaining to its proposals on a Capital Target and definition of Capital. In particular, PA has been asked to advise on the following five Ofgem consultation questions (quoted from Ofgem's consultation paper):

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



Executive Summary – Questions 4 and 6

Question 4 – credit facilities and ratings

Ofgem proposes to include drawn PCGs or group WCFs within the definition of Capital, and also to include undrawn PCGs and group WCFs if there is a binding commitment to lend and support the energy retailer from the parent or group company. Ofgem also proposes that the parent or group entity providing the PCG or WCF has an investment-grade credit rating in order for Ofgem to include the PCG or WCF in Capital.

We agree with most aspects of Ofgem's proposal. However, in relation to the facilities proposed, we recommend Ofgem to further consider whether the parent company made a legally binding commitment to provide these funds if required. If it has only provided a letter of intent or some other conditional indication of support, then there is less confidence that these funds will be available

Regarding the investment-grade requirement, we broadly agree with Ofgem. Our own analysis shows that there is a very significant difference in the probability of default of entities with investment grade and sub-investment grade credit ratings and therefore the dependability of the availability of the PCG or group WCF is stronger if it is provided by a parent or group entity with an investment grade credit rating.

Question 6 – definition of Capital

Ofgem proposes to define Capital equal to Adjusted Net Assets, derived from the financial statements of energy retailers. It further proposes that Adjusted Net Assets would be set equal to Net Assets, with some specific adjustments to include some other items from the financial statements. Ofgem does not propose to exclude any items from Net Assets from its definition of Capital.

Based on our analysis, we consider that two separate definitions of Capital (and associated Capital Targets) are needed to better measure whether Ofgem's intended objectives for Energy Suppliers to have loss absorbing capital and 'skin in the game'. Ofgem should consider two different definitions of Capital for two different purposes.

The need for two different definitions, one for Liquid Capital and one for Equity Capital, arises from (a) some assets not being capable of conversion to cash in the short term and so, while they are still representative of skin in the game for equity investors, they are not Liquid Capital; and (b) differences between the accounting values and treatment of some assets and the future stream of economic benefits those assets create for equity investors.

Some specific examples of assets falling into (b) are Intangibles, and Retirement benefits, where either the future stream of economic benefits is difficult to measure, the assets are not for the benefit of shareholders. Deferred tax assets is an example of (a), because these assets only become valuable when offset against future taxable profits (and cannot be transferred or sold to another entity).



Executive Summary – Questions 7, 8 and 9

Question 7 – Accounting requirements

In order for the Capital Target and Floor to be robustly implemented, preserving both a level playing field among energy retailers and protecting consumers, it is important that Ofgem is able to monitor energy retailers' capital based on audited and comparable data.

However, IFRS and UK GAAP accounting rules allow energy retailers a degree of discretion about how to interpret certain specific rules. There may also be situations where energy retailers which are part of larger groups of companies account for certain assets and liabilities differently from other energy retailers. Thus, to ensure the robustness and comparability of the data Ofgem should provide guidance to energy retailers about how to complete the existing financial templates (with the guidance particularly focused on areas of potential divergence between energy retailers, such as those described in this report).

Question 8 – Intangible assets

Intangible assets includes a number of different types of assets. Our assessment is that some of these assets may not meet the criteria for either Liquid Capital or Equity Capital (as defined in this report).

Customer relations and brand, and application software do provide 'skin in the game' as they create future economic benefits for shareholders, therefore these should be included in Equity Capital, but not in Liquid Capital as neither can normally be converted to cash in the short-term.

Other intangible assets such as goodwill, in our view, should not be included in either definition of Capital as there may be uncertainty about what proportion of goodwill relates to future economic benefits e.g. goodwill may arise as a matter of accounting treatment if an energy retailer is acquired for a value higher than its net assets, but on the other hand such higher value might relate to potential synergies with other companies owned by the acquirer.

Our proposal to exclude selected intangibles from the definition of Capital is consistent with the approach taken in the banking sector.

Question 9 – Capital target

Our analysis of a sample of retail suppliers shows that the exclusion of some items from the definition of Capital has the potential to move some suppliers from above the Capital Floor or Target to below.

Considering that in combination with our qualitative assessment of whether certain balance sheet line items meet the tests to be classed as Capital or not, we recommend Ofgem to assess an appropriate Capital Target and Capital Floor for each of Equity Capital and Liquid Capital.

To do this Ofgem would need to carry out detailed modelling and sensitivity analysis for both types of Capital before proposing an appropriate target for Equity Capital and Liquidity Capital. It would, however, not be in customer interests to delay the introduction of Capital targets further and so we suggest to Ofgem that, if further analysis is required then Ofgem should consider setting indicative Capital Targets and Floors that energy retailers could start to prepare for (e.g. take steps to increase Capital on their balance sheets) in parallel to the further work that Ofgem decides to undertake.



02

Introduction



Context

Autumn and winter 2021/22 saw 31 energy suppliers enter insolvency, affecting over 10% of UK households whose electricity and gas accounts were transferred to the remaining suppliers. The substantial costs of these failures (estimated at £2.7bn) were mutualised and recovered from GB households adding £96 per household bill. It was widely reported that the unprecedented increases in wholesale energy prices due to the war in Ukraine were the trigger for these exits, with many energy retailers not having hedged wholesale energy prices and not having sufficient capital to withstand the resulting shock from higher wholesale energy prices that they could not pass on to end consumers.

Ofgem commissioned Oxera to report on the lessons to be learned. Delivered in May 2022, the report identified that the failed suppliers shared many of the following financial and operational characteristics which limited suppliers' ability to absorb shocks including (i) negative equity balances in the years leading up to their failure; (ii) poor liquidity (current ratios and low levels of working capital); (iii) over-reliance on their customer credit balances to finance their operations; and (iv) insufficient hedging of wholesale gas and electricity prices.

The BEIS Select Committee also investigated and was highly critical of Ofgem: “..suppliers [were allowed] to enter the market without ensuring they had access to sufficient capital, acceptable business plans, and were run by individuals with relevant expertise. The regulator enabled poorly capitalised suppliers to be overly reliant on customer credit balances and operate with inadequate hedging, leaving the market ill-equipped to absorb wholesale price increases. The rules that were in place were not enforced and Ofgem did not understand the business models of the suppliers it is mandated to supervise.”

Context

In response to the supplier failures, and building on the Oxera work, starting in June 2002, Ofgem conducted a series of consultations focused on Strengthening Supplier Resilience. Since then, it has modified suppliers' licences to include two measures:

Measure	Content	Coverage and Status
Enhanced Financial Responsibility Principle (FRP)	What suppliers must do to ensure that they are sufficiently financially resilient to survive market shocks and minimise costs at risk of being Mutualised where they do fail. Circumstances where a supplier must notify the Authority if certain financial events have occurred or are likely to occur.	Applies to domestic and non-domestic suppliers, existing and new entrants Effective in licenses from 31st May 2023
Ringfencing of Renewables Obligation (RO) receipts	Suppliers will be required to ringfence their Renewables Obligation (RO) receipts attributable to domestic supply.	Domestic supply only. Effective in licences with 1st compliance milestone in November 2023 covering Q1/Q2 2023/24 scheme

Ofgem also have introduced additional licence conditions relating to supplier resilience including; minimum requirements for staff in significant leadership and appropriate board governance, the need for suppliers to have ownership or sufficient control over all material assets required to run their business and rules on fixed direct debits.

Most recently - 5 April 2023 - Ofgem issued a statutory consultation to clarify proposals, refine the policy and the licence drafting regarding a common minimum capital requirement (as a subset of the FRP) and powers to direct suppliers to ringfence customer credit balances to strengthen the financial resilience of the energy supply market. Ofgem is proposing new regulations with regards to Capital whereby suppliers should have access to financial reserves that can be deployed in times of stress (e.g., relatively liquid assets) and have something material to lose ("skin in the game") which would incentivize the owners to maintain a capability to withstand shocks rather than being a "free bet".

This latest consultation is the focus of this document.

Our scope of work

In order to deliver the best outcome for energy customers the definition of Capital, and the setting of Capital Targets, Ofgem has to balance the benefits of strengthening the financial resilience and shareholder governance of energy retailers against the current and future costs to consumers that result from increasing the Capital requirements. There are also a wide variety of different financial instruments that are used and available to energy retailers. This means that the definition of Capital and the setting of the Capital Target needs to be carefully calibrated. There may also be differences in the accounting policies and procedures of energy retailers which could impact on the comparability of financial statements and, by extension, the Capital, of different retailers. Accordingly, these issues also need to be carefully considered.

In this context, PA has been commissioned in late April 2023 by Centrica plc to advise it in relation to these matters and to provide our independent views on a selection of consultation questions raised by Ofgem. The specific questions are listed on the following slide.

To form our view, we have been asked to review Ofgem's consultation, supporting documents (e.g., investor presentation) and wider existing evidence (e.g., company accounts, credit rating agency criteria). We have also discussed Ofgem's proposed approach, and associated accounting and financial arrangements, with Centrica. We have also reviewed relevant past Ofgem consultations and decisions. For example, the consultation has been considered in parallel to Ofgem's Decision on Strengthening Financial Resilience² and an earlier consultation³ on similar issues which was published in November 2022.

¹Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement. Consultation can be found here: [link](#)

² Decision on Strengthening Financial Resilience. Decision can be found here: [link](#)

³ 2022 Statutory Consultation on Strengthening Financial Resilience. Consultation document can be found here: [link](#)

Selected questions we have been asked to consider

The selection of Ofgem's consultation questions which PA has been requested to assist Centrica assess and reply to are set out below. PA has not been asked to comment on any other consultation questions or matters raised in the consultation paper.

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?

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?

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

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.

Structure of this report

To address the scope of work described on previous slides, and to set out our assessment of Ofgem's definition of Capital and the Capital Target, this report is structured as follows.

Q4: Credit Facilities	<ul style="list-style-type: none">• We consider the degree of confidence in parent company financing of energy retailers that is required for its inclusion in Capital• We discuss appropriate measures of the strength of commitment by, and financial strength of, parent companies
Q6: Definition of Capital	<ul style="list-style-type: none">• We provide an alternative definition for Capital, and assess Energy Suppliers balance sheet items against our proposed test criteria• We examine case study in Banking and alternative financial instruments that could count towards Capital
Q7: Accounting Methods	<ul style="list-style-type: none">• We consider the key differences between UK GAAP and IFRS accounting standards, and the choices available to energy retailers which may impact on the comparability of financial statements• We consider the appropriate assurance and audit activities relating to the preparation of financial statements by energy retailers
Q8: Intangibles and Capital	<ul style="list-style-type: none">• We discuss whether intangibles satisfies the tests we specify for inclusion in Equity under Q6• We consider how intangibles are treated in banking sector Capital calculations
Q9: Capital Target	<ul style="list-style-type: none">• We analyse a sample of balance sheets of energy suppliers covering new entrants, challengers and major ones• We adjust Net Assets for items that we do not consider should count towards Capital, and opine whether £130 is appropriate measure for the Capital Target and timing of it

Q4

Credit ratings for PCGs / parent working capital facilities

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?



Inclusion of PCGs and WCFs within Capital

Ofgem proposes to include drawn PCGs or group WCFs within the definition of Capital, and also to include undrawn PCGs and group WCFs if there is a binding commitment to lend and support the supplier from the group company (assuming an energy retailer has a parent entity and/or is part of a group structure). We consider this in more detail under Q6, but in summary we agree with this proposal. It is appropriate to include drawn facilities (e.g., credit facilities where money was already taken out), because this represents capital which the parent company would lose if the energy retailer is not managed well. The energy retailer therefore is incentivized to preserve this capital and consequently has skin in the game.

With respect to undrawn PCGs and group WCFs, given Ofgem's objectives, it is important that there can be a high degree of confidence in the availability of PCGs and group WCFs to support energy retailers before these items should be included within the definition of Capital. If a PCG, for example, cannot be drawn upon by the energy retailer when it requires capital, then the PCG does not provide any protection to customers and therefore including these in Ofgem's Capital target would not be in consumer interest. Further, there needs to be a high degree of confidence that the parent company would actually commit the funds to the energy retailer, otherwise it does not represent "skin in the game".

To assess the confidence that the PCG and/or group WCF will be available to the energy retailer, we suggest that Ofgem considers:

1. Has the parent company made a legally binding commitment to provide these funds if required. If it has only provided a letter of intent or some other conditional indication of support, then there is less confidence that these funds will be available. We also note that a parent company could also make a public statement about its commitment to supporting the energy retailer and this would create a reputational incentive for the parent company to support the energy retailer if called upon, so while we consider that a legally binding commitment would be even stronger, a public commitment of support could also be valuable.
2. The financial strength of the parent company, which influences the likelihood that the parent company would actually be in a position to provide the funds if required. Even a legally binding commitment from the parent company will not be a dependable source of funds for the energy retailer if the parent company does not have the funds available to commit to the energy retailer.

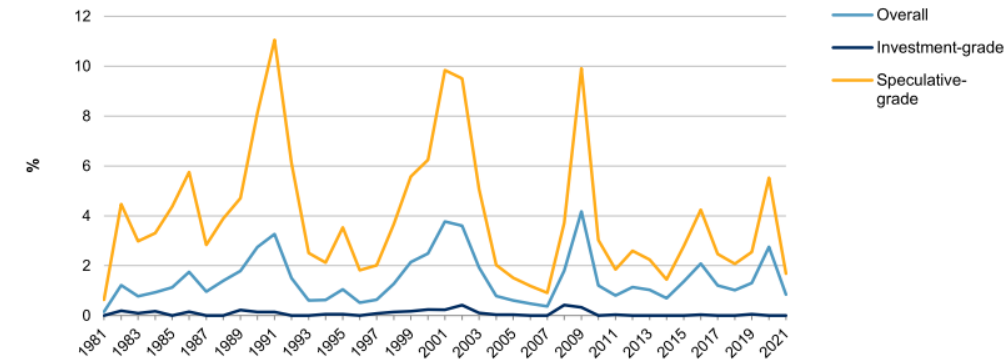
Minimum Credit Rating for PCGs and WCFs

As an independent objective measure of the financial strength of the parent company, a credit rating is a useful measure to consider. Accordingly, we agree with Ofgem's proposal to consider credit ratings. We also note, as the chart illustrates, that there is a very significant difference in the probability of default – and by extension the dependability of the availability of the PCG or group WCF – of investment grade and sub-investment grade credit ratings.

We also note that the use of investment grade credit ratings to distinguish between companies with high financial strength and those without such strength has an extensive set of precedents in economic regulation: Ofgem has required energy networks to have an investment grade credit rating in order to pay dividends to shareholders and Ofwat and other economic regulators have done similarly.

The above discussion indicates that requiring providers of PCGs and WCFs to have an investment grade credit rating would be in consumer interest. If typical industry commercial practice was, however, for energy retailers to obtain PCGs and WCFs from sub investment grade rated parties then requiring them to now obtain those PCGs and WCFs from entities with an investment grade rating would impose additional costs upon energy retailers and by extension customers. This would be undesirable, unless it is also the case that energy retailers are underestimating the risks associated with sub-investment grade PCGs and WCFs. However, we think the requirement that the parent or group entity has an investment grade credit rating is consistent with standard industry commercial practices since we also expect that energy retailers would obtain PCGs/WCFs from entities with an investment grade credit rating as parties would seek support/ backing from entities with a strong financial position. This is likely to be because a PCG or WCF from a sub investment grade rated entity would not provide investors in energy retailers with the financial support that they would be seeking and, as such, it would not be typical commercial practice to obtain such PCG or WCF from an entity without an investment grade credit rating. Accordingly, the customer interest is aligned with standard commercial practices in this case.

Global Default Rates: Investment-Grade Versus Speculative-Grade



Sources: S&P Global Ratings Research and S&P Global Market Intelligence's CreditPro®.
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Q6

Definition of Capital

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?



Ofgem's definition of capital

Ofgem proposes to define Capital equal to Adjusted Net Assets, derived from the financial statements of energy retailers. Ofgem further proposes that Adjusted Net Assets would be set equal to Net Assets, with some specific adjustments to include some other items from the financial statements. Ofgem does not propose to exclude any items from Net Assets.

Net Assets would be taken from financial statements prepared according to normal Balance Sheet reporting arrangements using suppliers' standard accounting practices. That is, Net Assets would be defined as:

$$\text{Net assets} = (\text{fixed assets} + \text{current assets}) - (\text{current liabilities} + \text{non-current liabilities})$$

Such definition is consistent with standard accounting practices, such as IASB and FASB where net assets and capital are equal, and the difference between net assets and equity relates to the value of debt capital.

To this they propose to add eligible alternative sources of capital that are provided by counterparties *“that can drive the right behaviours in the company, through control of risk policies and the risk management in the company”*².

¹Paragraph 2.12 of the Further Statutory Consultation: Strengthening Financial Resilience – introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction consultation.

²Paragraph 2.14 of the Further Statutory Consultation: Strengthening Financial Resilience – introducing a Minimum Capital Requirement and Ringfencing CCBs by Direction consultation.

Views on definition of capital based on Ofgem's objectives

Ofgem's approach to Capital is based on accounting data. However, it's been long recognized in the financial literature that book value of a business derived following accounting principles/rules is an imperfect measure of economic value.¹

There are various examples of differences between the economic and accounting value of assets and liabilities. For example, under conventional accounting rules, both assets and liabilities are being recorded on a historical cost basis, and not the present value. That is, Net Assets merely reflect a snapshot in history of a company. However, this may not reflect the economic value which incorporates a forward-look concept (based on future benefits which accrue to investors) and combine financial and non-financial information. Along similar lines, we note that a study conducted within the Banking Sector concluded that *"valuations derived from market prices can be more accurate and timely than those derived from standard accounting sources"*¹.

On the following slides we discuss in more detail the potential differences between economic and accounting values and what this means for the use of Net Assets, and some specific individual line items within Net Assets, for the definition of Capital. On the following slide, we use the insight from this slide and define specific characteristics of Equity and Liquid Capital that each financial statement item needs to satisfy in order to qualify as Equity or Liquid Capital. We then discuss this issue in relation to the two purposes that Ofgem has specified for Capital, as outlined on earlier slides i.e., liquidity and "skin the game" (which we refer to as Equity Capital).

¹See, for example, paper in Managerial Finance on Market value, book value and earning considering banking sector located here: [link](#)

Criteria for Capital

In this slide we set out our definitions of Equity and Liquid Capital based on the discussions of the differences between these two types of Capital set out in the previous slide. In the following slides we use the definitions derived here to assess which line items from the balance sheet should be included as part of Equity and/or Liquid Capital. Given the differences between the two concepts, while there is overlap between the line items which qualify for each, Equity and Liquid Capital will have different constituent parts and are not necessarily a subset of one another.

Equity Value can be seen as present and future cashflows available to equity shareholders. We consider that for Equity to truly represent “skin in the game”, financial items being considered need to:

- **Create future benefits** - they need to create future stream of economic benefits
- **Accrue to shareholders** – future cash flows need to be targeted to shareholders (as opposed to other stakeholders)

As Equity has value to shareholders in the short, medium and long term it influences their behaviour – they will act to preserve and increase that value, and are incentivised to do so. This creates and fulfils “skin in the game” assumption.

Liquidity Capital for resilience purposes

- **Liquid:** to improve the liquidity as it is required we consider that an asset and/or financial instrument have to be readily convertible to cash i.e. within a sufficiently short period of time to address the types of risks which could emerge. This period of time is likely to be 6-12 months at most.
- **Certain:** in order for Ofgem and other stakeholders to have confidence that the Capital is available when required, there has to be certainty around their value in both good and bad times so they can be called upon/liquidated as and when required. Assets which could diminish in value during a period of distress, or which there is insufficient confidence about the dependability of access to that Capital (such as Capital which is only available on a conditional or contingent basis), may not have sufficient certainty attached to it to be included in Capital for Ofgem’s purposes.

Assets and liabilities present in retail energy suppliers' balance sheets

To investigate the types of items that might or might not be included within Capital, we have analysed the most recent financial statements for a sample of companies in the retail market. Our analysis focused on heterogeneous sample, noting that there are a significant number of retailers in the market of various sizes, shapes and histories. Accordingly, we divided the market into the conventional energy retailers segments with:

- large supplier – suppliers that were spun out of RECs and with a large share of the market at that time
- challengers – suppliers that have entered the market and gained more than 1 million customers
- small suppliers – suppliers that have less than 1 million customers.

We then selected at least two suppliers per group, adding an additional one in the small suppliers category given the further heterogeneity present within this group.

The assets and liabilities found in the balance sheets examined are as follows:¹

- | | | |
|--|---|---|
| • Intangible assets | • Deferred tax asset | • Deferred tax liabilities |
| • Tangible assets | • Inventories | • Trade and other payables |
| • Right-of-use assets | • Current derivative financial instruments | • Derivative financial instruments |
| • Investments | • Cash at bank and in hand | • Provisions for other liabilities and charges |
| • Non-current trade and other receivables | • Creditors: Amounts falling due within one year (Trade and other payables) | • Creditors: Amounts falling due after more than one year |
| • Retirement benefit assets | • Derivative financial instruments | • Provisions for liabilities |
| • Non-current derivative financial instruments | • Provisions for other liabilities and charges | |
| • Current debtors, trade and other receivables | • Borrowings | |
| | • Lease liabilities | |

¹Please note that only the retail entity financial statements were examined for the suppliers that are part of groups also engaged in other markets such as wholesale and distribution. The financial statements used were the most recent ones available on Companies House for each one of the retail suppliers analysed which were either for financial year 2021-2022 or calendar year 2021 depending on the supplier's reporting practices.

Balance sheet items against the definition of Equity Capital

The table below assesses which line items from the balance sheet should be included based on our definition of Equity Capital derived on slide 20.

Balance sheet line	Equity Capital		Include in Capital Y/N?
	Create future benefit	Accrue to shareholders	
Intangible assets	—	—	Different categories of intangibles may need to be treated in different ways, see our response to Q8
Tangible assets	✓	✓	Y
Right-of-use assets	✓	✓	Y
Investments	✓	✓	Y
Non-current trade and other receivables	✓	✓	Y
Retirement benefit assets	✗	✗	N – do not accrue to shareholders
Non-current derivative financial instruments	✓	✓	Y
Current debtors, trade and other receivables	✓	✓	Y
Deferred tax asset	—	✓	Y, though there may be some uncertainty about future benefits created as depends on there being future profits.
Inventories	✓	✓	Y
Current derivative financial instruments	✓	✓	Y
Cash at bank and in hand	✓	✓	Y

Based on the analysis above, we consider that retirement assets **do not meet our detailed criteria outlined**. For Equity purposes we advise Ofgem excluding these from its calculations. Intangible assets are discussed in more detail under Q8.

** In the case where Ofgem was to adopt two definitions of Capital (one for “skin in the game” and one for liquidity then Intangible assets should be included in the former*

✓	Meets the criteria
✗	Doesn't meet the criteria
—	Ambiguous to classify

Balance sheet items against the definition of Liquid Capital

The table below assesses which line items from the balance sheet should be included based on our definition of Liquid Capital derived on slide 20.

Balance sheet line	Liquid Capital		Include in Capital Y/N?
	Liquid	Certain	
Intangible assets	✗	✗	N – insufficiently liquid and certain, more details on slide 35
Tangible assets	—	✓	Y – risk with duration to liquidate
Right-of-use assets	✓	✓	Y
Investments	—	✓	Y
Non-current trade and other receivables	✓	✓	Y
Retirement benefit assets	—	✓	N – Cannot be accessed
Non-current derivative financial instruments	✓	✓	Y
Current debtors, trade and other receivables	✓	✓	Y
Deferred tax asset	✗	✓	N – is not liquid
Inventories	✓	✓	Y
Current derivative financial instruments	✓	✓	Y
Cash at bank and in hand	✓	✓	Y

Based on the analysis above, we consider that intangible, retirement and deferred tax assets **do not meet our detailed criteria outlined**. For Liquid Capital purposes we advise Ofgem excluding these from its calculations. Intangibles is discussed in more detail in Q8.

✓	Meets the criteria
✗	Doesn't meet the criteria
—	Ambiguous to classify

Additional debt instruments

Ofgem also discusses whether there are other debt instruments which should be included in its definition of Capital. As outlined in the table below, which assess the alternative sources of Capital against the criteria set in the previous slides, we do not fully agree with Ofgem's assessment. We do not think that unsecured shareholder loans and drawn parent/group WCFs should be considered part of Liquid Capital because these items would be either (a) already counted as part of other assets if the funds have been used to purchase or invest in other assets; or (b) undrawn facilities, if they have not been drawn upon. These items do qualify as Equity Capital in our assessment because they represent capital which the shareholders or parent company would stand to lose if the energy retailer is not well managed.

Additional sources of Capital – Table 1 in the Consultation paper	Equity Capital		Liquid Capital		Include in Capital Y/N?
	Create future benefit	Accrue to shareholders	Liquid	Certain	
Unsecured shareholder loans	✓	✓	✗	✗	Y for Equity, N for Liquid
Drawn Parent / Group Company Working Capital Facilities	✓	✓	✗	✗	Y for Equity, N for Liquid
Undrawn Parent / Group Company Working Capital Facilities	✓	✓	—	—	Y - if there is a binding commitment to lend and support the supplier from the group company as proposed by Ofgem
Unconditional, quantifiable general guarantee from parent or group company	✓	✓	✓	✓	Y (subject to credit rating of parent company, see Q4)

- ✓ Meets the criteria
- ✗ Doesn't meet the criteria
- Ambiguous to classify

Additional debt instruments (continued)

We also note that there are additional forms of debt instruments such as hybrid debt and contingent convertibles (CoCos), a specific type of hybrid debt, which have risen in popularity in the banking industry following the Basel III capital requirements.

- **Hybrid debt** are securities which, by being given specific parameters, possess elements of both debt securities as well as those characteristic of equity. Most commonly these are bonds which have a right or an obligation to exchange the bond for a predetermined number of shares in the issuing company at certain times of a bond's lifetime.¹ This type of debt is currently being used by some of the parent companies of some of the retail suppliers, but none of the retail suppliers themselves.
- **Contingent convertibles** (CoCos) are a type of hybrid capital securities that absorb losses when the capital of the issuing bank falls below a certain level,² have grown in popularity to address the capital requirements following the Basel III directives. Similar instruments could be used by bond issuing companies to boost their capital positions in other sectors, such as the energy one, and provide a buffer in times of financial distress.

Both of the above present advantages to the issuer in terms of lower cost of capital, flexibility of terms, enhanced credit rating and maintaining control compared to equity or bond financing. From a regulatory requirements perspective, they provide an additional buffer and in fact do fall under the definition of AT1 and Tier 2 Capital in the banking sector under Basel III, therefore being a loss absorption instrument in case of insolvency.

Given that they create both future benefits and that they accrue to shareholders if converted into equity at maturity, hybrid debt should be included in the Equity Capital definition. On the other hand, given they are relatively illiquid, and there is uncertainty whether they will be converted into equity or not, and that they are excluded the CET1 Capital in the banking sector (more information on this in the following slides) we advise Ofgem not to include hybrid debt in the definition of Liquid Capital.

¹Issuance of hybrid debt instruments and so-called contingent convertible bonds (CoCo): [link](#)

²CoCos: a primer: [link](#)

Case study: Banking regulation approach to the definition of Capital

To benchmark Ofgem’s and our views on the definition of Capital, we have also considered international regulations in the banking sector as a case study.

In the banking sector, the minimum capital adequacy requirements for financial resilience are set under Basel III amongst other requirements which were first published in 2010. Basel III objective is to “strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector. The objective of the reforms is to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill over from the financial sector to the real economy.”¹

Basel III considers both Tier 1 and Tier 2 Capital. Broadly, Tier 1 capital tends to be high quality capital that can absorb immediately losses when they occur, while Tier 2 capital ‘gone-concern’ capital which is used when a bank fails to absorb losses before depositors and general creditors do.² The following instruments are included in the capital definition under Basel III and are divided into the three following groups:

Tier 1	Common Equity Tier 1 (CET1)	Sum of common shares and stock surplus, retained earnings, other comprehensive income, qualifying minority interest and regulatory adjustments
	Additional Tier 1 (AT1)	Sum of capital instruments meeting the criteria for AT1 and related surplus, additional qualifying minority interest and regulatory adjustments
Tier 2		Sum of capital instruments meeting the criteria for Tier 2 and related surplus, additional qualifying minority interest, qualifying loan loss provisions and regulatory adjustments

¹Basel III, paragraph 1: [link](#)
²Definition of capital in Basel III – Executive Summary: [link](#)

Case study: Banking regulation approach to the definition of Capital (continued)

The definition of Capital used in the banking sector therefore aims at ensuring that banks are well capitalised and have enough reserves to absorb losses immediately with equity (CET1), also ensuring 'skin in the game'. AT1 capital provides further loss absorption but does not meet all the criteria for CET1 (for example contingent convertibles fall in this section), while Tier 2 capital is used as a buffer if a bank fails to absorb losses before depositors and general creditors do. Thus, the purpose of CET1 closely resembles the financial resilience and 'skin in the game' objectives set by Ofgem in this consultation.

On a first read, CET1 may also appear to be similar in definition to the minimum capital requirement of net assets proposed by Ofgem as part of this Consultation. However, the last item included in CET1 called 'regulatory adjustments' provides a key difference, this term reflects the deductions of certain items from CET1, including the following (not all items have been included as some are less relevant for the discussions of this Consultation):¹

- **Goodwill and other intangibles** are deducted because they are highly unlikely to meet the requirement of Common Equity Tier 1 Capital of unrestricted and immediate use to cover risks or absorb losses as soon as they occur. In addition, some software assets are deemed to present a high level of volatility in terms of value, due to the fast pace of technological change, which results in rapid obsolescence.²
- **Deferred tax assets** that rely on the future profitability of the bank are deducted in the calculation of CET1 because, especially in the event of a bank's financial distress or insolvency, the ability to realize deferred tax assets may be uncertain, particularly if the bank does not generate sufficient taxable income in future to utilise the tax credit.
- **Defined benefit pension fund assets and liabilities** should be deducted as these assets may not be capable of being withdrawn and used for the protection of depositors and other creditors of a bank due to their nature

¹Basel III, paragraphs 66-90: [link](#)

²EBA Draft Regulatory Technical Standards on the prudential treatment of software assets under Article 36 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR): [link](#)

Case study: Banking regulation approach to the definition of Capital (continued)

There are some important differences between the banking and energy retail sectors risks, such as exposure to wholesale costs, weather conditions, systemic risks and contagion, but nevertheless based on the evidence provided in the previous two slides about the regulatory capital requirements in the banking sector under Basel III, there are likely to be some useful lessons to learn from the banking sector since the capital requirements in that sector have been introduced with similar objectives to what Ofgem is trying to achieve with this Consultation for the energy retail market of financial resilience and 'skin in the game'.

In this regard, we note that Ofgem is not proposing any type of Capital similar to AT1 and Tier 2 Capital in the banking industry, but this is because the role that those two types of capital play in the banking sector are addressed by other arrangements in the energy retail sector. In particular, the role of AT1 and Tier 2 Capital is to protect the wider banking system against the risks and costs of contagion i.e. one bank's financial difficulties leading to financial difficulties for other banks. In the energy retail sector, the limits on the amount of customer credit balances a retailer may hold and ring fencing of Renewable Obligation funding mean that the costs of an energy retailer failure to other energy retailers should be low: unlike in the banking sector where all banks have a wide range of transactions between each other, such that if one bank gets into financial difficulties it can leave other banks with irrecoverable assets, if an energy retailer gets into financial difficulties this should have a more limited effect on the wider sector so long as the SOLR process works effectively (as it largely has in the past) and there are no mutualisation or other costs imposed on the wider sector because the energy retailer (which has gotten into financial difficulty) still has the funds to cover those costs (and is prevented from using those funds for other purposes by ring fencing in the case of the RO) or because limited amounts of customer money has to be repaid (due to the limits on customer credit balances retailers are allowed to hold).

Accordingly, since the definition of Capital differs from what Ofgem has set as some items including intangible assets, deferred tax assets and defined benefit pension fund assets and liabilities are deducted from Net Assets to what is defined as Common Equity Tier 1 in the banking sector (due to the uncertainty and unlikelihood of absorbing losses that they bring) it is useful to note that these deductions from net assets align with the proposed adjustments to net assets that we recommended as part of our assessment of the definition of Liquid Capital on earlier slides. This provides further evidence to suggest that Ofgem may wish to reconsider its inclusion of all aspects of Net Assets within Capital.

Q7

Accounting requirements

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?



Accounting standards

In order to set a Capital Target, and to measure whether that Capital Target or the Capital Floor is met, Ofgem needs a robust way of measuring Capital. Aside from defining Capital appropriately, as discussed under Q6 but also taking into account the answers to other questions which discuss the appropriate items to include/exclude within Capital, it is important that Ofgem has access to financial data that is comparable. To this end, it is important that the financial statements of the energy retailers are prepared following the same rules and that there is appropriate assurance around the quality of the data submitted.

Standards

International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Principles (GAAP) are the most common accounting standards used in the UK. The first is used for larger international groups which have securities traded on regulated markets, while the second one is for UK based entities.

All the balance sheets of the seven suppliers examined in this report used UK GAAP and its reporting financial standards, but it is possible that other energy retailers used IFRS. Noting this possibility, it is relevant to note that IFRS and UK GAAP do not have significant differences between each other as they are both widely accepted standards and aim to achieve the same purpose. Broadly, IFRS tends to require more disclosures compared to UK GAAP, which will only impact the details of the accounts. However, from an accounting perspective, there are a few small differences which will only result in minor changes to the accounts and won't impact much to the purposes of this consultation. More details are provided on the following slide.

¹Institute of Chartered Accountants in England and Wales (ICAEW), Key differences between UK GAAP and IFRS: [link](#)

Accounting standards (continued)

Item	UK GAAP	IFRS
Intangible Assets	Considered to have a finite useful life.	Entity's choice to declare them as finite or indefinite, if indefinite (i.e. goodwill), then the intangible asset should not be amortised. However, assets do need to be reviewed for impairment from time to time.
Leases	Operating leases are recognised straight line through the profit and loss.	All leases are capitalised and depreciated over its useful economic life.
Development Costs	Choice between capitalising and expensing such costs.	Requires entities to capitalise development costs.
Financial Instruments	More detailed two chapters for basic and complex financial instruments.	Uses expected losses rather than incurred losses.
Deferred Taxes	Timing concept (i.e. all deferred taxes are recognised in respect of timing differences at the reporting date)	Temporary concept based on the balance sheet.
Revenue	Revenue is recognised when it is probable that an economic benefit will flow to the entity (risk-rewards approach).	Revenue is recognised over time (control approach).
Borrowing Costs	May capitalise borrowing costs for a qualifying asset.	Have to capitalise borrowing costs for a qualifying asset.

The accounting standards may leave the choice to treat certain items based on the entities' preference. This may potentially have some impact on the Net Assets position, depending on how certain items are valued. It may also mean certain items may appear in different lines within the balance sheets based on the entity's choice, limiting comparability of certain line items and potentially distorting incentives for energy retailers if certain items are included within the definition of Capital or not. For example, Renewable obligation certificates (ROCs) might be accounted as part of the inventories or as part of the intangible assets. Furthermore, Ofgem must note that some items may be recorded in separate entities within the group, therefore Ofgem should look at accounts holistically rather than at a single subsidiary to ensure that items, such as financial derivatives and hedges, are tracked appropriately.

Accounting methodology and assurance

Methodologies

Two methodologies can be used for accounting purposes, cash accounting and accrual accounting. The former accounts for revenues and expenses when they occur, the latter focuses on anticipated revenue and expenses, therefore taking into account future planned ones. Given the nature of the energy supplier industry, with sizeable receivables and payables on retail accounts and hedging, and that cash accounting isn't permitted under IFRS or UK GAAP, the accrual methodology should be used by retail suppliers.

Assurance

As noted earlier, appropriate assurance of financial statements is important to ensure that the information reported is high quality and the calculation of Capital according to Ofgem's definition is robust. Audit of the accounts is one way of providing assurance. According to the UK Government all private limited companies which satisfy at least two of the following criteria must legally get their accounts audited by an external party:

- an annual turnover of more than £10.2 million
- assets worth more than £5.1 million
- 50 or more employees on average.¹

Please note that all of the seven suppliers examined did satisfy the requirements above, even when examining some of the smallest ones in the market. If we take Ofgem's assumption of a typical annual bill being £2000,² then we could safely assume that any supplier with more than 10,000 customers should tick the first criteria. With regards to the other criteria, based on the balance sheets examined, suppliers have at least £120 of assets per customer (NB not the same as net assets per customer), therefore a supplier that has at least 50,000 customers will likely have more than £5.1 million in assets. Therefore, most, if not all, of the suppliers in the retail energy market fall within these categories and will have their accounts audited.

¹Audit exemption for private limited companies: [link](#)

²Paragraph 3.19: [link](#)

Accounting methodology and assurance (continued)

Audit of the energy retailers accounts will help to ensure the information is robust. However, audit will not necessarily ensure full comparability of the data as the remit of an auditor would not include dictating particular interpretations of IFRS or UK GAAP rules and policies, such as in those areas where there is discretion and/or different interpretations possible under the different accounting standards as described on the earlier slides. Furthermore, a supplier may fail to pass an audit, if that is the case, Ofgem should implement appropriate measures to ensure the information is reliable for the purposes of the Capital requirements set out.

It might, therefore, be appropriate for Ofgem to require all energy retailers to prepare a set of “regulatory accounts” based on a common set of accounting guidelines and these separate regulatory accounts could also be subjected to audit or independent external assurance to ensure compliance with Ofgem guidelines.

In this respect, we note that Ofgem already requires energy retailers to prepare a pro forma set of financial information. However, Ofgem has not provided detailed guidance about exactly how these accounts should be completed, nor has Ofgem set out the levels of assurance and audit of these accounts that it expects. To ensure comparability of data, both in aggregate and for individual line items, these matters may warrant further consideration, with any guidance issued by Ofgem particularly focused on those areas of financial statements that have the potential to differ between energy retailers (such as those we have discussed in this section of our report).

Q8

Intangibles in Capital

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



Intangible assets assessment

Based on the balance sheets of the energy retailers we have analysed, we note the following intangible assets tend to be included by energy suppliers under the intangible assets in their accounts. Please find below the assessment of these sources of Capital against the criteria set out under Q6.

Intangible Assets	Further details	Equity Capital		Liquid Capital		Include in Capital Y/N?
		Create future benefit	Accrue to shareholders	Liquid	Certain	
Customer relationships and brands	Value of being able to retain/attract customers based on relationship and brand for example	✓	✓	✗	✗	Y for Equity, N for Liquid
Application software	For smart grid and customer services purposes for example	✓	—	✗	✗	Y for Equity, N for Liquid
Goodwill	An intangible asset created when a company purchases another company for a price higher than the fair market value of the target company's net assets.	—	—	✗	✗	N

Rationale for the 'Liquid' column as follows:

- Customer relationships and brands – not readily convertible to cash as it would require customers to be bought or the supplier itself
- Application software – may be highly supplier specialized with little to no resale value and not an immediate sales process
- Goodwill – illiquid as it would only be realised if the company is sold

✓	Meets the criteria
✗	Doesn't meet the criteria
—	Ambiguous to classify

Intangible assets assessment (continued)

Our assessment of the different categories of intangible assets shown on the previous slide suggests including some items but excluding others from the definitions of Equity Capital and Liquid Capital. In our view, customer relationships and brands, and application software, do create future economic benefits for shareholders, so should be included in Equity Capital, but because neither can be converted to cash in the short term they do not meet the requirements for Liquid Capital. There may also be some uncertainty around the valuation of brand, which might also make it a less appropriate item to include in Liquid Capital, where Ofgem should require a higher degree of confidence about that valuation when conducting tests of energy retailer robustness to short term shocks.

Goodwill, in our view, should not be included in the definition of Liquid Capital because it is unlikely to be convertible to cash in a short period of time. The position with respect to Equity Capital is not clear cut. The reason for this is that goodwill, as recorded in financial statements, often reflects the difference between the value which has been paid to acquire a business and that business's fair market valuation, so goodwill can only be measured with a degree of uncertainty and it is difficult to ascribe a stream of future economic benefits to it e.g. if it related to brand then it might appear as "brand" on the financial statements, but if it does not relate to brand then it is not certain what it does relate to. On the other hand, goodwill might arise on financial statements because the new owner thinks it can grow the business faster than before or it has synergies with another business owned by the new owner. However, the challenge is that there's no easy way to figure out how much of goodwill relates to robust views about future economic benefits accruing to shareholders and how much of it doesn't, especially in light of literature on the winners' curse. Further, because a shareholder cannot influence the value of goodwill - it's driven by accounting rules - after it has acquired the business, the value of goodwill doesn't necessarily incentivise good management/stewardship/governance of the energy retail business.

Intangible assets assessment (continued)

We note that some of our recommendations are consistent with precedent from the banking sector. For example, in the banking sector, for capital adequacy requirements purposes set under Basel III, goodwill and other intangible assets must be deducted when calculating the capital adequacy ratio.¹ This is because intangible assets are highly unlikely to meet the requirement of Common Equity Tier 1 Capital of unrestricted and immediate use to cover risks or absorb losses as soon as they occur. In addition, some software assets are deemed to present a high level of volatility in terms of value, due to the fast pace of technological change, which results in rapid obsolescence.² We note that the Basel III regulations are more focused on short term liquidity and therefore more closely correspond to Liquid Capital in our analysis and here our views align with banking regulations i.e. we exclude the same items as Basel III requires to exclude.

¹Definition of capital in Basel III: [link](#)

²Draft Regulatory Technical Standards on the prudential treatment of software assets under Article 36 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR): [link](#)

Q9

Capital Target of £130

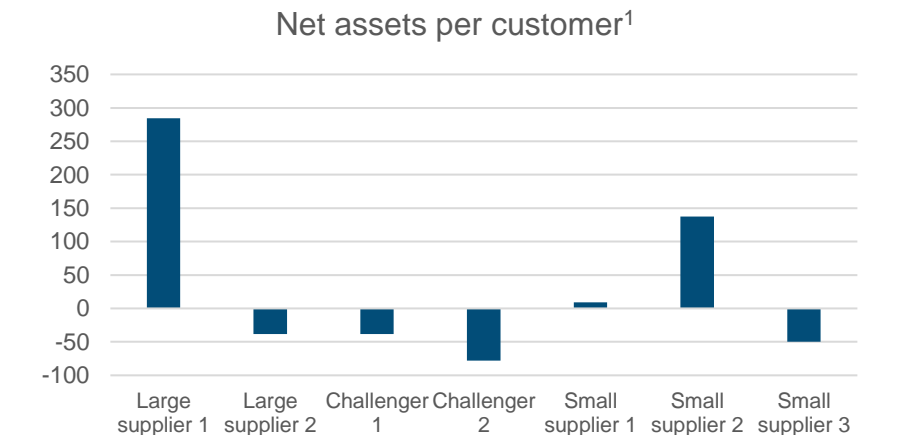
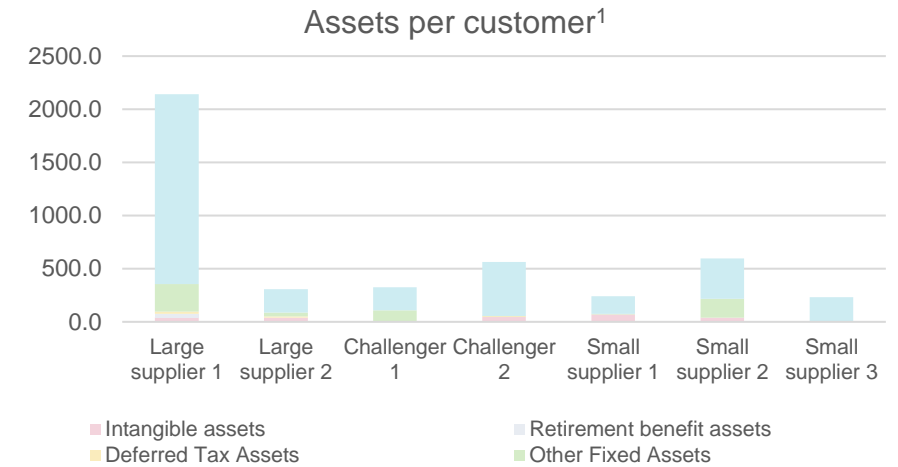
Do you agree with a Capital Target equivalent to £130 Adjusted Net Assets per domestic dual fuel customer by March 2025? If you disagree, please provide justification and supporting evidence.



Ofgem rationale and analysis supporting £130 Capital Target

Ofgem proposes to set the Capital Target at £130 per dual fuel customer and £65 per single fuel customer. Ofgem provides its analysis and how it reached the proposed £130 Capital Target in paragraphs 3.18 to 3.22 in the Consultation. In summary, the analysis shows that, when reviewing the domestic retail suppliers operating profits/losses incurred over the last seven years, “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.” Then taking into account 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.” and “that other changes we (Ofgem) are making to improve supplier financial resilience should reduce the level of risk taken by suppliers.” the Capital Target was adjusted to £130 per dual fuel customer.

Further details of the scenario and impact analysis that Ofgem has based its proposed £130 per dual fuel customer Capital Target on were not published or shared by Ofgem, so it is difficult to review the robustness of this analysis. However, we note that in the investor relations call Ofgem has stated that “1/3 of the market is already above the target, 1/3 of the market is between the floor and the target and 1/3 of the market is below the target.” This is broadly in line with the seven retailers that we have analysed and suggests that many energy retailers might not meet the Capital Target or even the Capital Floor.



¹Please note that only the retail entity financial statements were examined for the suppliers that are also engaged in other markets such as wholesale and distribution. The financial statements used were the most recent ones available on Companies House for each one of the retail suppliers analysed which were either for financial year 2021-2022 or calendar year 2021 depending on the supplier's reporting practices.

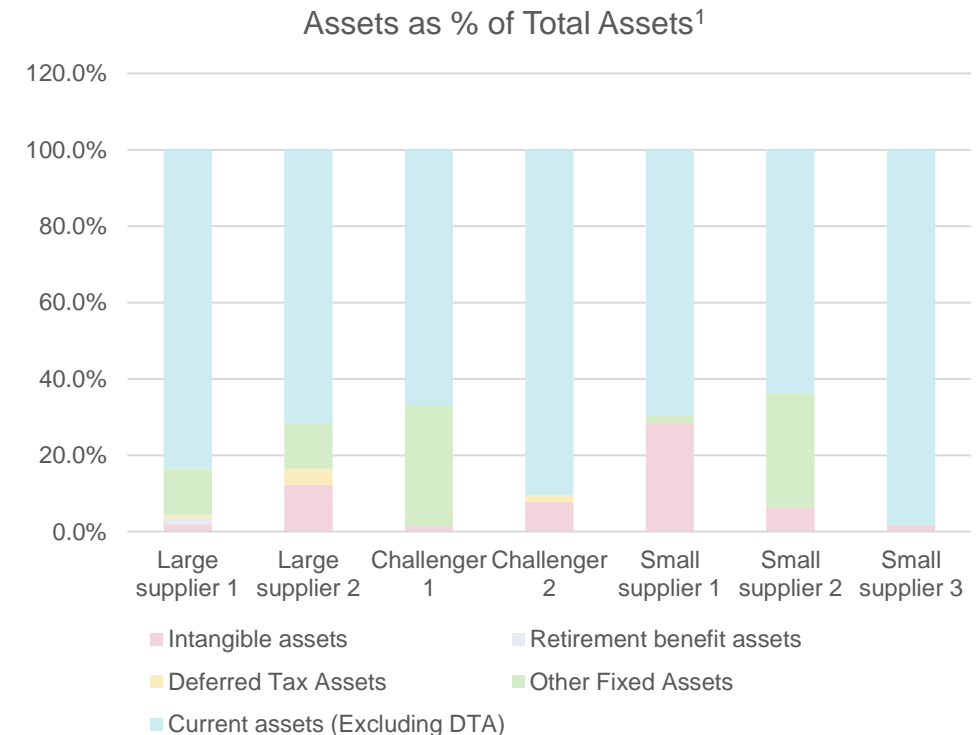
Energy suppliers' balance sheet analysis

Based on a review of the energy retailers financial statements, current assets are the dominant assets for all the companies given the nature of the market they operate in and high level of debtors and receivables (as well as creditors and payables for current liabilities).

With regards to fixed assets, these vary greatly in how they are composed, depending on the supplier with some having up to 28.4% of their total assets as intangible assets, while others with only 1.4%. These differences might prove to be key depending on the definition of Capital adopted by Ofgem for the purposes of this consultation which are discussed as part of this report.

The composition of Capital is shown in the chart on the right. Capital has been grouped into five different groups, as shown in the legend on the graph on the bottom right, to simplify visually and conceptually some of the results.

As shown, intangibles, deferred tax assets and retirement benefit assets are categories of assets within Capital. We consider on following slides the impact of including/excluding these items within the definition of Capital following the reasoning and evidence provided in Q6.



¹Please note that only the retail entity financial statements were examined for the suppliers examined that are also engaged in other markets such as wholesale and distribution. The financial statements used were the most recent ones available on Companies House for each one of the retail suppliers analysed which were either for financial year 2021-2022 or calendar year 2021 depending on the supplier's reporting practices.

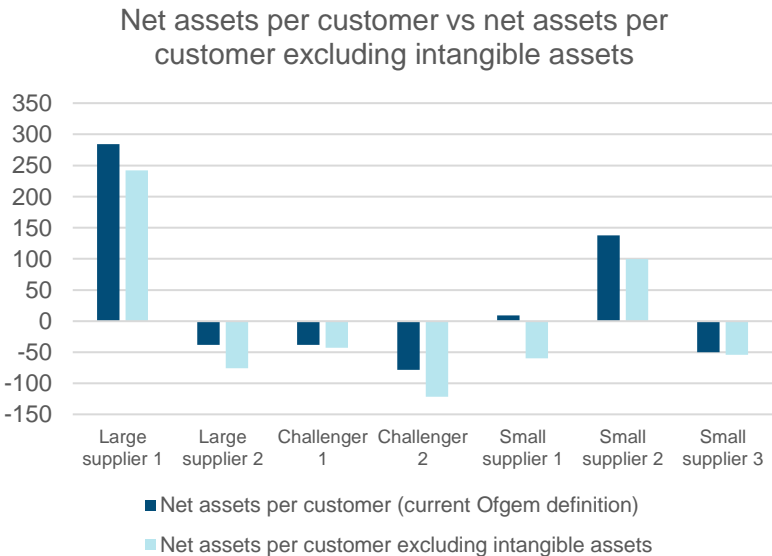
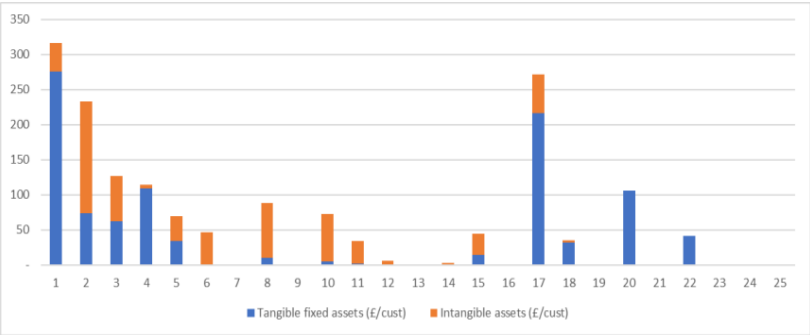
Impact of excluding intangible assets from the definition of Capital

As discussed within this report and Ofgem’s Main Consultation paper under paragraph 2.11, “Including these intangibles in the definition of Net Assets may increase the risk that there is insufficient loss absorbing capital when it is required”. We have therefore tested the impact on the current Capital Floor and Targets of excluding such assets from the definition of Net Assets. Figure 1 from the Consultation shows that intangible assets make up the majority of fixed assets for the 16 anonymised suppliers analysed by Ofgem, hence the importance of testing this. The second graph, compiled based on the seven suppliers examined as part of this report, shows the impact of removing intangible assets from the Net Assets definition. Two out of seven suppliers would move from above either the Capital Floor or Target, to beneath them if intangible assets are excluded.

Therefore, if Ofgem wishes to ensure that the Capital Target can withstand a 5th percentile operating loss, based on data from the past seven years, purely from an accounting perspective, then the Capital Target does cover for that as explained in the Consultation (paragraph 3.19)¹. However, if a business posts an operating loss, there is a possibility that it could become insolvent. If that is the case, following the evidence provided above and under Q6 in this report when examining intangible assets’ effectiveness in times of distress, intangible assets would not provide the established level of protection to customers in a 5th percentile operating loss scenario. Thus, we advise Ofgem to exclude intangible assets from the Liquid Capital definition, and part of it from Equity Capital.

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



Impact of excluding retirement benefits and deferred tax assets from the definition of Capital

Retirement benefits

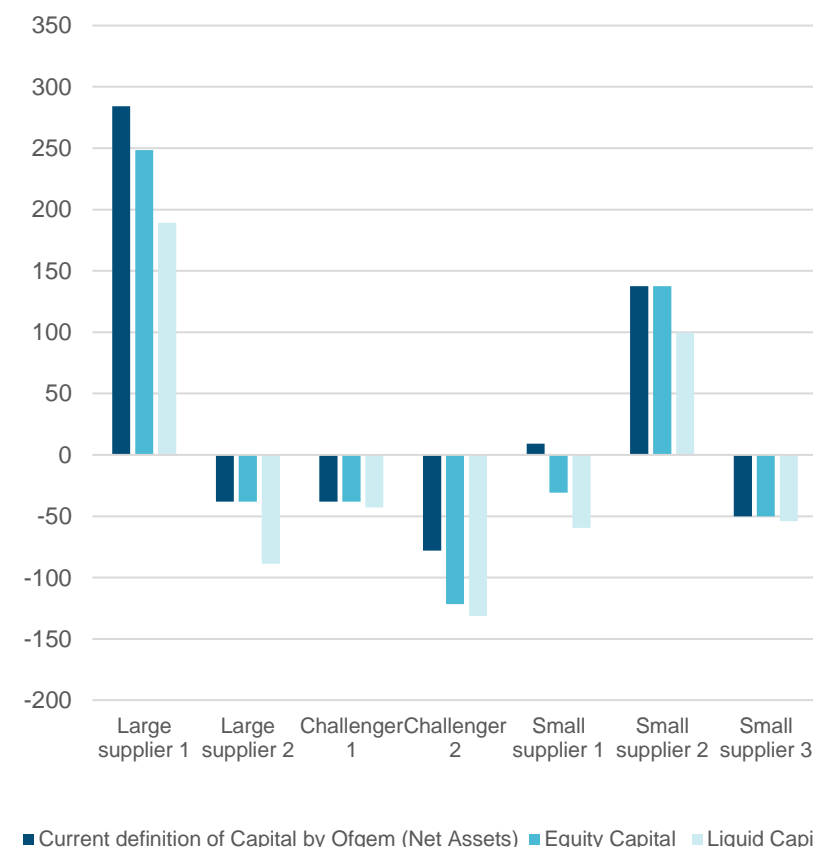
Retirement benefits do not provide financial resilience or 'skin in the game' for shareholders given they have to be legally distributed to employees once retired, we do not believe these should be included as part of the Net Assets definition, and as showcased from the banking case study under Q6, other industries exclude this asset from the regulatory capital requirements too. Retirement benefits were only included in one of the suppliers' accounts examined and they only constituted 1.4% of the total assets in that case, therefore excluding them from the Net Assets definition is not expected to have a considerable impact.

Deferred Tax Assets

Deferred tax assets cannot be used to meet short term capital requirements. Furthermore, it can only be realised if the supplier is profitable in future years. Hence, if a supplier faces times of distress leading to an insolvency for example, this type of asset is not going to be realised and therefore won't be used to absorb losses. Deferred tax assets were included in three out of the seven retail suppliers examined, ranging from 1% to 4.2% of total assets. When excluding them from the definition of Net Assets, there was only a small impact. Nevertheless, while the impact is small in these cases, the impact could be larger in other cases and scenarios, so in our view Ofgem should consider excluding deferred tax assets from Liquid Capital.

Overall, excluding intangible assets, retirement benefits and deferred tax assets from the definition of Liquid Capital, as advised in this report, will have a significant impact on suppliers' position relative to the values set by Ofgem.

Current definition of Capital by Ofgem (Net Assets) vs proposed Equity Capital and Liquid Capital



Overall assessment

Conclusion

In our view, in order to best achieve its stated objectives, Ofgem should consider Capital in two ways: short term liquidity and the other long term skin in the game. Our analysis and assessment (see Q6 and Q8) has shown that there are some balance sheet items which should be excluded from these two measures of Capital and, further, that the precise items to exclude differs between the two measures of Capital.

Our recommendation to Ofgem is, therefore, to assess an appropriate Capital Target and Capital Floor for each of these two different definitions of Capital. Our scope of work has not included a detailed review and analysis of Ofgem's work on scenarios and sensitivity analyses to determine the appropriate Capital Target or Floor, so we cannot definitively conclude that Ofgem's proposed £130 per dual fuel customer is inappropriate, but since in our view the definitions of these two types of Capital will differ, it seems likely to us that the appropriate Capital Target will be different in each case, reflecting the different purposes of these two measures of Capital. For example, a target for Liquid Capital might need to be targeted on the ability of energy retailers to withstand short term shocks, possibly from economic conditions, changes in wholesale gas/electricity prices or from weather conditions. The Liquid Capital Target might also need to consider other measures Ofgem has proposed to introduce like the Cash Coverage Trigger.

Further, the chart shown on the previous slide illustrates that Liquid and Equity Capital, based on our proposed definitions, could be quite different in £/customer terms based on the financial statements of a sample of energy retailers. This tends to reinforce that the Capital Target may differ in these two cases, though the target should not necessarily be set by reference to the actual capital levels of energy retailers (e.g. the target should not be set as an average of the current capital levels of energy retailers if many of those energy retailers do not have enough capital to meet Ofgem's requirements).

Overall assessment (continued)

Based on the foregoing discussion we consider it appropriate for Ofgem to consider two different definitions of Capital for two different purposes. However, it is not possible for us to propose an appropriate Capital Target and Floor for the Equity Capital and Liquid Capital measures that we have proposed because:

- our analysis is only based on a selection of energy retailers and these energy retailers may also be among some of the more robustly capitalised energy retailers noting that most of them have survived the recent market conditions that led to numerous energy retailer exits; and
- we do not have access to all the same data and models as Ofgem has used in its stress testing to calculate the Capital Target and Floor.

Consequently, we recommend that Ofgem undertakes such analysis and proposes appropriate Capital Targets and Floors for the two definitions of Capital we propose. In this respect, throughout the report we assumed that Ofgem may come up with two separate targets for Equity and Liquid Capital expressed in £/customer, but we note the targets for Liquidity Capital could be expressed as a percentage or ratio of the targets for Equity Capital.

Timetable for implementation

Ofgem has proposed that energy retailers have until March 2025 to comply with the Capital Target that it has proposed. We recognise that some energy retailers may need to raise new capital, while others may need to fundamentally overhaul their operations and business models, in order to meet Ofgem's Capital Target. This tends to suggest that energy retailers should be afforded some time to transition to the new targets. On the other hand, until such time as energy retailers have met Ofgem's Capital Target then energy customers are not appropriately protected against risk (though it should be recognised that even if an energy retailer achieves the Capital Target there is no guarantee that the retailer would be resilient to all shocks). In this regard, we note that energy retailers with Capital below the target but above the floor, would be classified as in the Intermediate Position and subject to the Transition Controls; the controls may prevent an energy retailer from acquiring new customers and from making non-essential payments, these measures may not offer protection to the energy retailer's existing customers from an unexpected shock. This absence of strong protection for customers in the absence of Capital Targets being specified suggests that energy retailers should be required to comply with the Capital Target sooner than Ofgem has proposed (all else equal). A more rapid requirement to meet the Capital Target would also be consistent with Ofgem's statutory duty to protect consumers now and in the future by working to deliver a greener, fairer energy system. Weighing both of these factors, while it may be desirable for Ofgem to achieve industry compliance with the Capital Target faster, it may be challenging for all energy retailers to comply with Ofgem's proposed Capital Target by March 2024, so Ofgem may wish to consider setting an interim or milestone Capital Target for energy retailers to achieve by March 2024 (on a trajectory towards compliance with the Capital Target by March 2025).

Timetable for implementation (continued)

The statements on the previous slide relate to Ofgem's consultation proposals for the Capital Target. With respect to our recommendation to consider two different definitions of Capital and to set two separate Capital Targets, we note that in the absence of Ofgem having shared or published the models and analysis that underpin its proposed Capital Target, it is not possible for us to undertake the equivalent analysis for our two proposed measures of Liquid Capital and Equity Capital. If Ofgem needs to undertake this analysis or consult upon any revised proposals, we note that this may delay implementation of the capital adequacy framework Ofgem is consulting on. For the reasons stated above, any such delay may not be in customer interest. Consequently, recognising the need to implement these targets rapidly, Ofgem could set an indicative target for March 2024 that energy retailers could start to work towards in parallel to any further consultation or refinements of the targets that Ofgem carries out over the remainder of 2023. An indicative target for March 2024 could be aligned with the interim or milestone Capital Target that we have referred to in the paragraph on the previous slide.

Contact details

Anthony Legg

Partner

Email: anthony.legg@paconsulting.com

Telephone: +447753300520

Matteo Chiarelli

Consultant Analyst

Email: matteo.chiarelli@paconsulting.com

Telephone: +447929872107

Mantas Aleksa

Principal Consultant

Email: mantas.aleksa@paconsulting.com

Telephone: +447814067004

**Bringing
Ingenuity
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Corporate Headquarters

10 Bressenden Place
London
SW1E 5DN
+44 20 7730 9000

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