



E.ON UK plc
Westwood Way
Westwood Business Park
Coventry
CV4 8LG

www.eon-uk.com

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David Hall
Deputy Director, Financial Resilience and Controls
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

By email only: RetailFinancialResilience@ofgem.gov.uk

Dear David,

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

Thank you for the opportunity to comment on Ofgem’s latest proposals about strengthening supplier financial resilience. We welcome the further detail on capital adequacy following the high-level points included as part of the November consultation.

Over the past 12-18 months, Ofgem has made a series of changes to help improve financial resilience in the sector and we welcome its most recent decision to ringfence RO payments from later this year. We remain of the view however, that the package of measures is not sufficiently robust and should be implemented more swiftly to reduce the moral hazard. We are concerned that the measures proposed and implemented to date do not go far enough to drive any material change in the behaviours of unscrupulous suppliers and would not lead to a significant reduction in the costs at risk of mutualisation. Consumers and financially stable suppliers will be left to pick up the pieces as a result.

Whilst we understand the concept of Ofgem’s capital adequacy proposals, we are concerned about the level of discretion it has when agreeing to the steps a supplier who doesn’t meet the Capital Target would need to take to improve financial performance. Any supplier Capitalisation Plan should be based on a strong framework set up to motivate suppliers to improve their financial health and needs to ensure the Target is met within a short period. Until the Target is met in full there should be consequences that are clear, meaningful and consistent across suppliers.

E.ON UK plc
Registered in
England and Wales
No 02366970
Registered Office:
Westwood Way
Westwood Business Park
Coventry CV4 8LG

As Ofgem will be aware, we have always supported ringfencing of credit balances for all suppliers. In setting the triggers for ringfencing, careful thought is required to ensure they target the suppliers who need to improve their financial position. It would be perverse if an arbitrary trigger was met by a financially stable supplier, who was then required to ringfence, while a less financially stable supplier was not.

Ofgem recognises that capital requirements drive costs for suppliers and notes that the proposed measures will require a profitable and investable sector which will be taken into account in decisions on the EBIT allowance in the price cap. Currently, in the EBIT review, Ofgem is attempting to review supplier profitability by reviewing the EBIT allowance in isolation. In doing so Ofgem assumes that an efficient supplier is able to earn whatever EBIT allowance it sets; however, individual supplier costs are not the same and not all price cap allowances enable suppliers to cover their costs. The reality, as Ofgem's data shows, is that few if any suppliers have been able to earn a 1.9% EBIT whilst the price cap has been in place (with most making a loss). Whilst we accept no EBIT decision has been published, based on our current understanding of the approach Ofgem is taking, an assumption that capital adequacy measures can be introduced because the EBIT review will result in a profitable and investable sector is flawed and creates real risks for market stability and could make it difficult for suppliers to meet proposed capital adequacy targets as a direct consequence.

Should this situation occur, and the sector remains unprofitable and uninvestable post the EBIT review, Ofgem is likely to be confronted with the challenge of needing to increase a supplier's financial resilience whilst being unable to enforce its own requirements due to the risk of it causing a supplier to fail. This may even be the reason why Ofgem proposes significant discretion in its approach to enforcement for suppliers who fail to meet the Capital Target. A weakened enforcement regime driven by this situation risks continued weak financial resilience in the sector which could ultimately lead to a repeat of 2021, with supplier failures and mutualisation of costs, in the not-too-distant future.

Appendix 1 provides our responses to Ofgem's consultation questions and incorporates our feedback on the associated draft guidance and draft licence conditions.

Should you have any questions, please do not hesitate to contact us.

Yours sincerely,

Steve Davies

Head of Regulation

Appendix 1

Minimum capital requirement - Compliance Framework

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

We understand the rationale behind Ofgem's approach of the Capital Floor and Target and the aim to provide a level of financial flexibility to suppliers in times of stress. We do, however, have reservations about the strength of the compliance framework and its ability to ensure suppliers' compliance with the proposals and whether it will be able to deliver improved financial resilience in the market.

As mentioned in our response to the financial resilience consultation issued by Ofgem in November, we are concerned about Ofgem's reliance on suppliers to notify them (self-report) if they fall below the Capital Target or Floor. Many suppliers experiencing financial stress may be reluctant to alert Ofgem to this or may feel they can take action to rectify an increasingly risky situation before notifying Ofgem, ultimately leading to a detrimental outcome for customers. An unscrupulous supplier facing significant financial challenges could easily decide not to self-report issues to Ofgem in line with proposed requirements or be dishonest in reports they make (noting they may well have nothing to lose), we suspect this has happened in the past. Other suppliers may simply be overly optimistic about their situation and reflect this optimism in their reports to Ofgem. Although Ofgem would still be in receipt of monthly FRP and stress testing data, it will only be of use if it contains the data Ofgem requires to identify when a supplier is experiencing financial challenges. At present it is very possible for a supplier to fail before Ofgem is able to take any action which will help reduce the costs of mutualisation.

Ofgem states in its draft guidance,

"We accept that suppliers may need to be in the Intermediate Position in times of stress or use it as a transition period when the requirement is introduced for the first time on 31 March 2025. However, Ofgem expects that suppliers are only in the Intermediate Position temporarily as it is our policy intention that all suppliers will achieve the Capital Target"

We agree. However, it is difficult to determine from the consultation what Ofgem's view of "temporary" is and what would be an acceptable maximum period that a supplier could find itself in the Intermediate Position for. We are concerned that Ofgem's proposals for monitoring the Capitalisation Plan could lead to suppliers being below the Target for significant periods of time with little or no consequence and lead to a supplier experiencing a market shock that they are not sufficiently capitalised to withstand. The ultimate result being supplier failure and the consequential detrimental impacts faced by both consumers and suppliers as seen in the recent past.

To avoid such instances occurring, the trajectory to meet the Capital Target should be a swift one and Ofgem should establish some parameters that any supplier would need to adhere to if it was to find itself in the Intermediate Position both before and as part of any agreed Capitalisation Plan. We urge Ofgem to extend its proposed Transition Controls so that they are in place until the Target is met. This places a much stronger incentive on the supplier to meet the target quickly. Current proposals indicate a high level of discretion for Ofgem in determining the measures a supplier needs to meet as part of their Capitalisation

Plan. However, Ofgem should be mindful of previous supplier activity and the fact that some suppliers may not ever intend to meet the Capital Target.

Indeed, there are already licence conditions in place which require suppliers to keep the costs at risk of being mutualised to a minimum and have “adequate financial arrangements in place to meet its costs at risk of being Mutualised”. It is important that suppliers take the Capitalisation Plan seriously and have sufficient motivation to reach the Target as soon as possible.

Ofgem needs to be more transparent about the direct consequences of not meeting the Target to ensure consistency in approach and drive required improvements across suppliers effectively. Current proposals acknowledge there may not be a one size fits all approach however, there must be some minimum requirements that all suppliers should meet when they find themselves in the Intermediate Position.

Furthermore, we expect Ofgem to take a firm stance on requirements for new entrants to the market, after the implementation of capital adequacy measures. We see no reason why these suppliers shouldn't meet the Capital Target from day 1 of trading. To avoid making the mistakes of the past, which led to the failure of numerous suppliers of 2021, and ensure a timely transition to net zero, only well-capitalised suppliers should be able to enter the market to support its future success. Any supplier with a robust business plan should be able to demonstrate that it meets the Capital Target for 50,000 customers, in line with the initial milestone assessment threshold introduced in 2022 (SLC 28C). This should be included as part of the initial self-assessment which new entrants should complete before being granted a licence to show how they will comply with licence conditions, particularly 4B.1-4B.6 over the next 12 months. Drafted licence conditions suggest that a supplier could enter the market without meeting the Capital Target however, this appears to be at odds with the guidance. Ofgem must take a firmer stance on new entrants to ensure past mistakes are not repeated.

Finally, we agree with Ofgem's position on the Capital Floor and any supplier not meeting it is directly in breach of licence. However, as explained earlier in the response, Ofgem should not rely on a supplier to self-report when they hit this trigger.

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

We do not agree. Given Ofgem's decision last year not to take full ringfencing of customer credit balances forward, it should be looking to implement alternative measures as soon as possible. We acknowledge that Ofgem is still proposing to introduce a level of credit balance ringfencing if certain triggers are met and we address these proposals in our responses to questions 12-15.

Currently it remains too easy for suppliers to exit the market leaving costs to be mutualised, which our customers ultimately pay for. We have highlighted our thoughts on implementation timescales through several consultation responses however, we continue to await meaningful action. We acknowledge that some changes have been made in an attempt to improve stability in the market, but we are sceptical as to whether these changes will impact the types of activities they are aiming to eliminate. Discussions have

been ongoing since at least 2018 and we have been expecting the implementation of robust financial resilience measures for some time. It is not acceptable that consumers continue to be left to pay for supplier failures when action could have been taken sooner.

If suppliers are meeting existing licence conditions, there should be no reason why they would be unable to meet these proposals much sooner. Current market conditions, where the majority of consumers are on tariffs where price cap applies, are unusual and expected to change later this year with an anticipated decrease in wholesale prices. Such conditions are attractive to new entrants, or those suppliers aiming to rapidly increase their customer base and could lead to an influx of cheaper deals with little regard for the longer-term impact on their financial position. In the absence of robust financial resilience requirements, it is possible that some suppliers will meet the same fate as others. Therefore, measures should be brought in as soon as possible perhaps taking into consideration how the Intermediate Position could be applied.

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

Overall, we agree with the process and agree that a more robust approach should be taken with suppliers not meeting the Capital Floor. The concept of a Capitalisation Plan is sensible however, we question whether it will provide Ofgem with the desired outcome of increasing the financial resilience of a supplier on the Plan.

Minimum Capital Requirement – Definition of Capital

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?

Yes.

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

We agree with Ofgem's views that a 12-month tenor is reasonable. Ofgem has suggested a two-year tenor that extends every year is preferable to an evergreen 12-month tenor to ensure there is always a minimum of 12 months remaining. An alternative could be to update the facility quarterly to achieve the same outcome.

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?

No, Ofgem should not consider other debt instruments. Capital should be standardised across the market, and we agree with Ofgem's proposed position.

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



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

Yes, including all intangible assets under the definition of Assets comes with risks.

Some intangible assets can be more difficult than others to put a value on. Consequently, suppliers can take different approaches to valuing them and what useful life they are amortised over. This means Ofgem would not receive a consistent view of assets across suppliers and, in the event of supplier failure, assets Ofgem thinks are available to cover costs of failure are not.

Furthermore, suppliers could take advantage of intangible assets like this, such as goodwill, over the relative short-term to improve the view of their balance sheet and give a false impression of their own financial health. It would also be possible for some suppliers to artificially increase intangibles by moving them between balance sheets of different companies to artificially inflate them. Without a longer-term plan, this approach could lead to supplier failure and higher costs to be mutualised than expected.

We agree with Ofgem's statement, in paragraph 2.10 of the consultation, and we agree it's right to consider whether at least some intangible assets should be excluded from the definition of Assets. We encourage Ofgem to explore this in more detail with a view to exclude intangibles that risk becoming worthless (like goodwill and cost to acquire). If Ofgem concludes this is not feasible due to the complexities involved, the risk of including worthless assets is too high, so Ofgem should look to exclude intangibles.

✂. A well-capitalised supplier will be able to make use of one Ofgem's proposed alternative sources of capital to meet the Target. Where a supplier is not able to do so, this approach will ensure that suppliers commence their journey to improved resilience through the Capitalisation Plan sooner and are better prepared for any instances of market shocks that may occur in future (subject to some tightening up of current proposals about the Plan).

Minimum Capital Requirement - Level of capital

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.

We agree with the Capital Target equivalent to £130 Adjusted Net Assets. We have provided views on the implementation date in our response to question 2.

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

We agree. We remain of the view that any approach should be a simple to apply and any consideration for future changes should be subject to consultation.

Q11. 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.

Yes, we agree in line with recent price cap typical values, but Ofgem should keep this under review in case the situation changes in future.

Customer Credit Balance Ringfencing

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

No, we do not agree.

In its consultation, Ofgem explains that the triggers are in place to “address concerns about the reliance on CCBs as a source of working capital”. In reality, where this a real concern, we question whether it would be feasible to require a supplier to ringfence their CCBs without it causing them significant challenges. Suppliers who are truly using CCBs as working capital and are unable to cover the Capital through Net Assets or the proposed alternative sources of capital are highly unlikely to be able to provide any meaningful level of CCB ringfencing that would protect customers.

Ofgem should be mindful that a financially stable supplier may be able to meet the Capital Target but may hit the Cash Coverage Trigger. ✂

Furthermore, and similar to our comments made about the capital adequacy targets, where Ofgem has a level of discretion in determining the percentage of CCBs to be ringfenced based on supplier representations, suppliers in this position are likely to put strong cases forward for the reasons why they shouldn't ringfence any CCBs. The longer these suppliers are able to use CCBs to fund their business the more opportunity they will have to get into financial difficulties before action is taken and consumers and well-run suppliers will be the ones who suffer as a result.

Considering the experiences of the past, there must be a motivation for suppliers with poor financial health to make improvements. If Ofgem addresses and strengthens some of the shortcomings we have highlighted in its capital adequacy proposals, these measures on

their own should be sufficient to drive up supplier standards. Focus on implementing the capital adequacy measures sooner rather than later would also take away the need to implement one of the CCB ringfencing triggers before capital adequacy measures kick in at a later date.

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

As indicated in our previous response, it's likely that those suppliers with weaker financial stability and an overreliance on CCBs are more likely to be the suppliers who are directed to either ringfence a low proportion of CCBs or not be required to ringfence at all. The balance of these issues would mean that a well-capitalised supplier could be more likely to be required to ringfence their CCBs which is at odds with Ofgem's intentions.

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

We have already indicated our preference for capital adequacy measures to be implemented much sooner. Ofgem's focus should be to implement a robust capital adequacy regime that takes away the need for additional protections.

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

No, our responses to the other questions in this section address the reasons why.