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5th May 2023

Sent by email to: RetailFinancialResilience@ofgem.gov.uk

Dear David,

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

Centrica welcomes the opportunity to respond to this further statutory consultation.

A resilient energy market remains critical to protect consumers from the mutualisation of costs when suppliers exit the market. In its review setting out the facts of the recent exit of energy suppliers; the National Audit Office highlighted that:

- 29 energy suppliers have failed since July 2021
- This meant 2.4 million customers moving to a new supplier
- Ofgem's best estimate of the cost of transferring these customers was £2.7bn or around £94 for every energy customer – not just those customers whose supplier had failed.
- This meant that a typical customer on the price cap paid had an annualised bill of £1,971 in the Summer of 2022, of which £66 were due to approved claims from transferring customers of failed suppliers.¹

Of the £2.7bn cost, £217m relates to the cost of honouring customers' credit balances; nearly 10% of the total.² Given this, there is an urgent need for Ofgem to act on protecting customer credit balances and broader financial resilience. Centrica first identified the mutualisation of costs risks, specifically customers' credit balances being used to fund unsustainably low tariffs, to Ofgem in December 2016.³ Whilst we welcome the decisions Ofgem has taken, we believe it has still not adequately addressed these risks. We make the following recommendations to Ofgem to make these proposals work sooner and better for energy consumers:

¹ Report by the Comptroller and Auditor General, The energy supplier market: The Department for Business, Energy & Industrial Strategy and Ofgem, 22 JUNE 2022, Key facts, and Figure 8.

² Ibid, Paragraph 2.8.

³ Letter to Rob Salter-Church after the failure of GB Energy.

- The proposed Capital Floor⁴ is too low and should be brought in as planned on 31st March 2024;
- Ofgem should have in place a robust framework to review the Capital Target whilst not delaying the current proposals;
- Ofgem must begin its consumer credit balance ringfencing framework without delay and not dilute its effectiveness;
- The definition of regulatory capital should address liquidity risks; and
- Ofgem should reduce discretion in its compliance framework setting out clear boundaries for suppliers.

We explain each of these points below and go on to answer each of the consultation questions in the Appendix. Annex 1 sets out a full summary of our recommendations.

The Capital Floor is too low and should be brought in on 31st March 2024.

We urge Ofgem to maintain its original proposal for suppliers to reach zero net assets by 31st March 2024. Where suppliers cannot do this Ofgem should use the compliance framework to move suppliers to the intermediate position⁵ by 31st March 2025. Moving back the date for compliance with the Capital Floor to 31st March 2025 would reduce benefits to consumers and is not consistent with the Enhanced Financial Responsibility Principle (hereafter the EFRP) which is effective from 31st May 2023 and requires suppliers to be able to maintain:

‘Capital and Liquidity of sufficient amount and Quality that it is able to meet its reasonably anticipated financial liabilities as they fall due on an ongoing basis.’⁶

In addition, from 31st March 2025 Ofgem should increase the Capital Floor to reflect its intention that suppliers do not rely on customer credit balances for working capital in the intermediate position.⁷ Ofgem might do this by setting the Capital Floor in line with its estimate of working capital of £40 per dual fuel customer.

Ofgem should have in place a robust framework to set the Capital Target whilst not delaying its proposals.

The Capital Target is an important indicator of the level of resilience that Ofgem believes the energy supply market should have. Whilst we support the immediate introduction of the Capital Target, as a staging post, we urge Ofgem to develop a robust framework to determine the level of Capital required including a full impact assessment which considers a meaningful set of options.

The appended PA Consulting report also notes that Ofgem should make changes to its definition of regulatory capital (as set out below). And that, if it does this,

⁴ Capitalised terms have the meaning given to them in [Statutory Consultation Notice SLC 4B](#) where applicable, 5th April 2023.

⁵ [Proposed SLC 4B](#) notes that ‘Suppliers which are below the Capital Target but above the Capital Floor are in the Intermediate Position and are subject to Transition Controls until they have a Capitalisation Plan accepted by the Authority.’

⁶ SLC4B.1.

⁷ Ofgem will be required to direct the ringfencing of customer credit balances when suppliers are in the Intermediate Position under the proposed Capital Target trigger.

- It should also carry out detailed modelling and sensitivity analysis for both types of Capital before proposing an appropriate target for Equity Capital and Liquidity Capital.
- 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.

If Ofgem proceeds with a 'staging post' or 'indicative' Capital Target our view is that the proposed £130 Capital Target should not be reduced. We have analysed the EBIT margins of suppliers who exited the market and found that 5 out of 6 suppliers would have incurred losses above Ofgem's proposed Capital Target of £130 per customer. This analysis indicates that Ofgem's proposed Target is only appropriate where wider financial resilience controls mean that the market does not return to that which prevailed in 2019, where highly risky suppliers were incurring significant losses. Ofgem should therefore keep this under review.

Ofgem must begin its consumer credit balance ringfencing framework without delay and not dilute its effectiveness

Our view is that Ofgem has failed to provide an assessment of the consumer impact of its proposed approach to consumer credit balance ringfencing and that its proposals will leave consumers at risk of mutualised costs when a supplier exits. Furthermore, we continue to be concerned that Ofgem has failed to include an option including ringfencing of CCBs, ROs and Capital Adequacy in its impact assessment. Ofgem's admission that including this option would create the most benefits for consumers using a 10-year NPV⁸ is significant and calls into question the validity of the Impact Assessment.

However, if Ofgem delays the introduction of credit balance ringfencing, consumers will continue to bear the risks of supplier failures. There is therefore an urgent need for Ofgem to act on protecting customer credit balances, without which there is a material gap in the regulatory framework. Whilst we believe that these proposals won't provide adequate protection for consumers, they are better than inaction.

Without leading to further delay, we propose that Ofgem amends the triggers and timetable for implementing them as follows:

- The Capital Target trigger should begin on 31st March 2024 (as should the Capital Target); and
- Ofgem should reinstate the SLC4B.1 Trigger (hereafter the EFRP trigger) and make it effective alongside the Cash Coverage Trigger i.e. immediately.

In our response to the November Statutory Consultation, we asked that if Ofgem did not proceed with CCB ringfencing, it should require suppliers to disclose whether their credit balances would be fully protected.⁹ Ofgem has not done this and continues to signal to suppliers that it is acceptable to use customer credit balances as working capital.

⁸ Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, Appendix B, A2.1

⁹ Centrica response to Statutory Consultation on Strengthening Financial Resilience, 3rd January 2023.

We are disappointed that Ofgem has not addressed our proposal in this consultation. We continue to urge Ofgem to address the lack of transparency for customers by requiring suppliers to disclose whether their credit balances would be fully protected prominently in all communications - particularly at point of sale and tariff renewal.

Ofgem should reduce discretion in its compliance framework setting out clear boundaries for suppliers.

The compliance framework is a clear signal to suppliers of the consequences of not holding sufficient regulatory capital and enables Ofgem to proceed to enforcement action swiftly. However, there is a degree of discretion built into the process and we urge Ofgem to minimise this. We suggest that:

- Ofgem introduces a time limit for Capitalisation plans to prevent their being used to circumvent the requirements; and
- Whilst a Capitalisation Plan is in effect, Ofgem should retain Transition Controls, as a minimum setting out an explicit requirement that they would not be removed unless Ofgem is confident that the supplier is fully compliant with SLC 4B.1 – SLC 4B.5.

We also suggest that Ofgem considers risks managed under the Enhanced Financial Responsibility Principle (hereafter EFRP) within the enforcement framework. Specifically, when a supplier is required to submit a Capitalisation Plan it should be required to include significant risks which are identified under the EFRP in its Capital Target.

The definition of Regulatory Capital should address liquidity risks

The definition of capital is an important component of Ofgem's capital adequacy regime and we are pleased to see that Ofgem is consulting further on the details of the proposed Net Assets approach. We have commissioned an independent report by PA Consulting to review this approach and Ofgem's proposals relating to Alternative Sources of Capital. The report finds that Capital should be considered in relation to two objectives: one short-term liquidity and the other long-term skin in the game. We agree with this finding which builds on our view, as previously set out, that Ofgem should consider short-term liquidity alongside its broader financial resilience.

Yours sincerely,

Tim Dewhurst
Director of Regulatory Affairs and Policy

Appendix 1 – Responses to Consultation Questions

Minimum capital requirement - Compliance Framework

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

We agree with the process of setting a Capital Target and Floor but suggest changes to the level of the Floor and to the process for a Capitalisation Plan.

The formulation of the proposed capital adequacy regime is more complex than that set out in the November proposals, where a simple Minimum Capital Requirement was proposed. This new formulation sets out a process for Ofgem to take enforcement action where a supplier does not hold the Capital Target. We support this formalisation of the enforcement process because it sends clear signals to suppliers about the impact of not holding sufficient regulatory capital and enables Ofgem to proceed to enforcement action swiftly.

However, there is a degree of discretion built into the process and we urge Ofgem to minimise this. We suggest that Ofgem introduces a time limit for Capitalisation plans to prevent their being used to circumvent the requirements and we set this out in our response to question 3 below.

On the Capital Floor

As part of this new formulation Ofgem has created a concept of the Capital Floor. The Capital Floor is the level below which suppliers would be in breach of their licence.

Ofgem has set out that the Capital Floor should equal zero Adjusted Net Assets and sets out that this is based on a need for a supplier to have ‘some loss-absorbing capital, alongside other risk management tools, to withstand shocks.’ They add that ‘A supplier in a negative net asset position and therefore unable to pay its debts as they fall due is technically insolvent and is in a vulnerable position should there be further shocks.’¹⁰

We do not think this logic justifies Ofgem’s choice of zero Adjusted Net Assets for the Capital Floor.

- The impact assessment published alongside these proposals clearly shows that if suppliers do not comply with the Capital Target net benefits of the capital adequacy proposals (Option 3) are reduced. (If compliance with the Capital Target is reduced to 50% net benefits of capital adequacy will fall to £58m in 2028 – a reduction from £90m for full compliance.)¹¹
- Ofgem’s argument that that a supplier above the Capital Floor would not be in a negative net asset position – and therefore technically insolvent – is incorrect. The Capital Floor is based on Adjusted Net Assets. Therefore, a supplier could have negative net assets but hold Alternative Sources of Capital and continue to meet the Capital Floor.

We therefore propose that Ofgem should increase the Capital Floor to a level of Adjusted Net Assets above zero. One option would be for this to be set at a level commensurate with Ofgem’s estimates for working capital; making it clear that suppliers cannot rely on customer

¹⁰ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraph 3.10.

¹¹ Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, Figure 18.

balances for working capital. This would be consistent with Ofgem's proposed Capital Target trigger which requires Ofgem to ringfence credit balances where a supplier falls below the Capital Target (but remains above the Capital Floor).

Ofgem estimate working capital to be £-20-40 and appear to use a value of £40 in reconciling the Capital Target to capital elements.¹² We therefore suggest that £40 of Adjusted Net Assets be used to set the Capital Floor.

On the interaction with the Enhanced Financial Responsibility Principle

The Capital Target will be in place within the framework of the Enhanced Financial Responsibility Principle (EFRP). Under this framework Ofgem set out that some risks will be managed by suppliers under the EFRP and therefore are not included in the Capital Target. One such area is wholesale trading collateral which is excluded from the Capital Target but where Ofgem set out that 'the enhanced FRP requires that each supplier has adequate capital and liquidity to manage these risks, which may in some instances include access to funds for collateral.'¹³

Under the EFRP it will be up to individual suppliers to evaluate and report on their business specific risks and mitigations. We recommend that Ofgem considers standardising this process for significant risks and where the evaluation of risks would benefit from a consistent approach across suppliers. Collateral capital is one such area. In this case Ofgem could require suppliers who are posting collateral capital to either use a standardised template or model to report on this risk. Ofgem has already observed that where suppliers post collateral this is typically about £10 per dual fuel customer.¹⁴

If Ofgem introduces such an approach, we recommend that this be considered in the Capital Floor and Target formulation. A supplier in the intermediate position should be required to include significant risks which are identified under the EFRP in its Capitalisation plan.

¹² Ofgem propose a Capital Target of £130. They break this down according to the capital elements which include fixed assets of £90 per domestic dual fuel customer and working capital per dual fuel customer of £-20 to £40. Based on the proposed Capital Target of £130 we consider that £40 of working capital is implied. [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), paragraph 3.25 – 3.27.

¹³ Ibid, Paragraph 3.26.

¹⁴ Ibid.

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

No, we don't agree. Ofgem should not delay the proposal it made in November 2022 to require suppliers to hold zero net assets on 31 March 2024.

Ofgem's proposals on capital adequacy as part of a broader move towards prudential regulation are an essential step in the right direction and should not be delayed until March 2025. Ofgem has deliberately delayed implementation to support suppliers who cannot raise enough capital to finance the risks to their business. Ofgem hopes that the end of the energy crisis along with implementation of the government's new retail strategy will help these suppliers raise capital at lower costs. Even if this turns out to be true – which is by no means guaranteed - there is a material gap in the regulatory framework during which consumers will continue to bear the risks of supplier failures.

To justify the delay to 2025, Ofgem pointed to the balance between increasing resilience while still maintaining a competitive market¹⁵. It indicated that the risks to competition are short term and that the transition period addresses this issue¹⁶. Centrica's view is that Ofgem has failed to appreciate that the competition provided from firms that are not able to move more quickly to deliver the capital adequacy requirements will act as an entirely illusory and short-term source of competition.

In mitigating the impact on competition from these suppliers, Ofgem must consider the impact this has on sustainable competition and consider any impact of distorting competition on lower risk business models in making its decision. Delaying implementation might perpetuate unsustainable suppliers and distort competition. Furthermore, Ofgem has not set out how delaying the implementation of capital adequacy will allow suppliers, who are currently unable to raise capital without a significant cost uplift, to become sustainable.

[On the April 2023 proposal](#)

Ofgem published a set of draft guidance in December 2023 which set out that suppliers must submit a Capitalisation plan to explain how they will reach the March 31, 2025 Minimum Capital Requirement. The guidance said that:

'For that plan to be credible, we consider that the supplier should illustrate how they will achieve at least an above-zero net asset position about a year ahead of the minimum requirement going live.'¹⁷

This requirement was also referenced in the Statutory Consultation which set out that to credibly be on route to the requirement 'we would expect suppliers to illustrate how they will be above zero net assets within about a year'.¹⁸

¹⁵ [Statutory Consultation - Strengthening Financial Resilience | Ofgem](#), Forward

¹⁶ Ibid, Paragraph 1.26.

¹⁷ [Statutory Consultation - Strengthening Financial Resilience | Ofgem](#), Proposed FRP Guidance, Paragraph 3.45.

¹⁸ [Statutory Consultation - Strengthening Financial Resilience | Ofgem](#), Statutory Consultation, Page 39.

Ofgem's current proposal represents a delay to this timetable because suppliers are no longer required to reach a zero net assets position a year ahead of the requirement going live. When the requirement does go live, they are not required to meet the Capital Target straight away. If the transition period thus far is an indication of the time Ofgem might give suppliers to meet the Capital Target through a Capitalisation Plan, some may not do so until 2026 or 2027.

In the revised impact assessment Ofgem sets out a sensitivity analysis which shows that if only half of suppliers meet the Capital Target by 2025 the consumer benefits of Option 3 (Capital Adequacy only) are £58m in 2028, the final year of Ofgem's analysis. Full compliance with the Capital Target would increase this benefit to £90m in 2028, increasing annual customer benefits by more than 50%.¹⁹

Furthermore, by comparing Ofgem's updated impact assessment (the Current IA) with the impact assessment for the November proposals (the November IA) the impact of delaying the proposals can be observed directly.

- In the November IA the benefits of Option 3 (Capital Adequacy only) were a net present value of £423m socially weighted over a 6-year period. These benefits began to accrue in 2023 as capital requirements took effect, reaching £110 per customer by 2025.
- In the Current IA the benefits of Option 3 are £289m on the same basis. In this case benefits do not begin to accrue until 2025 when they are assumed to reach £130 per equivalent dual fuel customer straight away.²⁰

These findings do not support Ofgem's decision to delay the implementation of Capital Adequacy requirements; they indicate that delaying the capital adequacy requirements reduces benefits to consumers.

Ofgem's delay to the requirement for suppliers to reach zero net assets is a clear signal that it does not expect all suppliers to meet the Capital Target in 2025. Creating the concept of the Capital Floor will have the effect that some suppliers will delay improvements to their capital position in favour of doing the minimum. These suppliers will therefore remain uncapped until such a time that they agree a Capitalisation Plan with Ofgem and implement this, potentially well after the 2025 deadline.

But Ofgem has not set out any reasons for this approach or provided any assessment of the consumer benefits of delay. We assume that is because there are no benefits to delay and urge Ofgem to maintain its original proposal for suppliers to reach zero net assets by 31st March 2024.

We set out below four key reasons for which we expect that Ofgem would find there are no benefits to delaying the 31st March 2024 requirement:

1. This date (31st March 2024) has already been signalled in the November Consultation giving suppliers over 1 year to prepare for the requirement.

¹⁹ Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, Sensitivity 6, Figure 18.

²⁰ In a response to a query sent by Centrica asking why the benefits of the Capital Adequacy option are lower in the Current IA, Ofgem set out that high prices in 2024 and move to a single fuel target also influenced these modelling results. Ofgem, Response to Centrica queries, April 2023.

- Furthermore, Ofgem is already proposing that suppliers report on their Capital position in the first Annual Adequacy self-assessment due by 31st March 2024.²¹
2. The Capital Floor is a lower requirement than the November proposals because it is based on 'Adjusted Net Assets' and therefore includes 'Alternative Sources of Funding'.
 3. In Ofgem's summary of consultation responses those suppliers that argued for a delay did so because:

*'given the current financial position of some suppliers in the sector, reaching a net zero and the subsequent 2025 target would not be achievable.'*²²

- Our strong view is that this is not a reason to delay implementation but should cause Ofgem to put requirements in sooner to manage the risks that suppliers in a poor financial position pose to the energy supply market.
4. Where suppliers are unable to meet the Capital Floor by 31st March 2024, Ofgem could use the proposed mechanisms for the Capital Target to allow suppliers to work towards the Capital Floor with regulatory oversight.

We also believe that delaying the Capital Floor is inconsistent with SLC4B.1 which requires that from 31st May 2023 suppliers maintain 'Capital and Liquidity of sufficient amount and Quality that it is able to meet its reasonably anticipated financial liabilities as they fall due on an ongoing basis.'²³ As Ofgem note in the Statutory Consultation, 'A supplier in a negative net asset position and therefore unable to pay its debts as they fall due is technically insolvent'.²⁴

In contrast there are clear benefits to maintaining the 31st March 2024 requirement as it would increase the likelihood of full compliance by 31st March 2025 which, in turn, would increase consumer benefits by 50% in 2028.²⁵

We urge Ofgem to maintain its proposals from the November Statutory Consultation and require suppliers to reach zero Adjusted Net Assets by 31st March 2024, where they do not Transition Controls should be applied until a Capitalisation Plan is approved by Ofgem in the same way as is currently proposed from 31st March 2025. This could be achieved by adjusting the proposed licence conditions and we have set out a proposed amendment in Annex 2: Proposed adjustment to licence condition 4B.18 and 4B.19.

We also note that Ofgem has already set out in the Statutory Consultation that by 31 March 2024 'as part of this first Self-Assessment, suppliers will be required to set out how they plan to meet the Capital Floor by 31 March 2025 and how they plan to meet the Capital Target from 31 March 2025 or be on a path to meeting it.'²⁶ However, Ofgem has not formalised this requirement either in the guidance or the licence condition – Ofgem should formalise this requirement in line with its clear intention.

²¹ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), paragraph 1.28.

²² [Ibid](#), Paragraph 3.7.

²³ SLC4B.1

²⁴ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), paragraph 3.10.

²⁵ Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, figure 18.

²⁶ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraph 1.28

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

Yes, we agree with the process but Ofgem should set out a time limit for the operation of Capitalisation plans to prevent them being used by suppliers to indefinitely circumvent the requirements.

Ofgem should also set out clearly whether Transition Controls would be removed under a Capitalisation plan and what its reasons for removing these controls would be. Where Ofgem removes a 'sales ban' the effect would be to increase a suppliers Capital Target but it would also increase the costs at risk of mutualisation should a supplier fail. Likewise, removing the 'non-essential payments ban' will increase the risk of non-essential payments reducing a suppliers capital position and potentially increase mutualised costs should a supplier fail and enter a Special Administration Regime. We urge Ofgem to commit to retain Transition Controls during a Capitalisation Plan and set out an explicit requirement that they would not be removed unless Ofgem is confident that the supplier is fully compliant with proposed SLC 4B.1- 4B.5.

We also propose that a supplier in the intermediate position should be required to include significant risks which are identified under the EFRP in its Capitalisation plan.

Minimum Capital Requirement – Definition of Capital

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

We refer to an independent report produced by PA Consulting appended to our response.

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

Ofgem proposes a residual 12-month tenor meaning that in practice Parent Company Guarantees are required to have a two-year tenor that extends every year rather than evergreen 12-month facilities (with the effect that the tenor is always longer than 12 months). Ofgem argues that this would infer that a parent company has a ‘true stake in the long-term future of the company’.²⁷

We agree that it is important that a parent company is committed to any energy supplier for whom they supply a guarantee. Our view, as previously noted with respect to the ringfencing of renewables obligation, is that parent company guarantees should be dependent on public commitment and an investment grade credit rating²⁸ and in a form prescribed by the regulator. Ofgem should also consider whether the tenor of a parent company guarantee covers any period where they could be exposed to a loss.

Furthermore, in order to make this requirement effective Ofgem should clarify its process for monitoring Alternative Sources of Capital (ASC) in addition to the Annual Adequacy Self-Assessment and the notification requirement for ASC.

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

We refer to an independent report produced by PA Consulting appended to our response.

²⁷ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraphs 2.16-2.20.

²⁸ By investment grade credit rating we mean at least investment credit rating of BBB- by S&P or Baa3 by Moody's as this is the threshold for the definition of investment grade counterparties.

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

We refer to an independent report produced by PA Consulting appended to our response which reviews Ofgem's proposed accounting basis for net assets and considers how the proposed assurance basis could be improved.

BGTL sets out its accounting policies in full in its Statutory Accounts which were last published for year ending 31 December 2021. In those accounts we set out that:

'The Company financial statements have been prepared in accordance with Financial Reporting Standard 101 Reduced Disclosure Framework ('FRS 101'). In preparing these financial statements the Company applies the recognition, measurement and disclosure requirements of UK adopted International Financial Reporting Standards ('Adopted IFRSs'), but makes amendments where necessary in order to comply with the Companies Act 2006 and has set out below where advantage of the FRS 101 disclosure exemptions has been taken.'²⁹

We note that there is an option to prepare the accounts using FRS 102 which other suppliers may apply. However, our accounts are prepared under FRS 101 to align to our listed Group consolidated financial statements, which aids comparability and is more closely aligned to full IFRS. Some of the key differences in approach with applying FRS 102 would be to amortise all intangibles (including goodwill), an option to expense borrowing costs, and differences in pensions accounting. These may have an impact on reported net assets, although the impact would be minimised if some of the proposed adjustments to the definition of capital within the PA Consulting independent report were to be considered. The other key difference with FRS 102 is the impact on derivatives accounting although this is more likely to impact the P&L/OCI, so may not impact reported net assets but may need consideration. We also note that the recognition of derivative balances may not be consistent across suppliers even where IFRS/FRS 101 is applied.

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

We refer to an independent report produced by PA Consulting appended to our response.

²⁹ British Gas Trading Limited, Annual Report and Financial Statements for the Year Ended 31 December 2021.

Minimum Capital Requirement - Level of capital

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.

The appended PA Consulting report finds that Ofgem should make changes to its definition of Regulatory Capital. It proposes 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.

Linked to this, PA also find that if Ofgem change the definition of Regulatory Capital as proposed:

- It should also carry out detailed modelling and sensitivity analysis for both types of Capital before proposing an appropriate target for Equity Capital and Liquidity Capital.
- 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.

We agree with these proposals.

The Capital Target is an important indicator of the level of resilience that Ofgem believes the energy supply market should have. Whilst we support the immediate introduction of the Capital Target as a staging post, we urge Ofgem to develop a robust framework to determine the level of Capital required including a full impact assessment which considers a meaningful set of options.

In addition, we comment on the analysis that Ofgem has carried out below. Our comments are intended to provide Ofgem with our views on the approach it has taken to estimating the Capital Target, notwithstanding the further points made by PA Consulting referred to above.

Ofgem's estimate of the Capital required is based on the current market structure

To calculate the Capital Target Ofgem has used historic earnings of the bottom 5th percentile of 16 current suppliers over a 6-year period from 2016 - 2022. These suppliers sustained a 9% loss over the period which Ofgem translates to about a £145 loss per domestic dual fuel customer based on a £2,000 (inc. VAT) annual bill which they note is the approximate level implied by recent wholesale prices. Ofgem uses this as a proxy for the possible impact on retained earnings of shocks like the COVID pandemic and energy crisis.

Ofgem should consider a larger sample of suppliers to validate the analysis it has published in the consultation. In June 2018 there were a peak of 70 electricity and gas suppliers operating in the Great Britain,³⁰ meaning that Ofgem's sample is 23% of the maximum. Furthermore, Ofgem's sample appears to be based on current suppliers as Ofgem states that:

³⁰ [Retail market indicators | Ofgem](#), Number of active gas and electricity suppliers in GB.

‘the capital required by **current suppliers** during the recent shocks aids our understanding of the business models employed and how they differ from our notional supplier.’³¹ (emphasis added)

By looking at the capital required by current suppliers Ofgem is tying the Capital Target into the current market structure. Ofgem should at least consider alternative market structures such as the one that prevailed at the time of the energy supplier exits. This will help Ofgem to validate that its Capital Target will be robust to a range of outcomes.

To understand how Ofgem’s estimate compared to failed suppliers we analysed EBIT margins of six suppliers who exited the market over the period September 2021 to November 2021. We picked suppliers of a range of sizes for which at least one set of statutory accounts was available.

Figure 1: Centrica Analysis of EBIT margins of a sample of failed suppliers

Centrica Analysis			
Number of customers	Sample of suppliers	Weighted average EBIT Margin over period	Estimated loss per customer (based on £2000 bill)
over 500k	1	-15%	-251
	2	-6%	-99
100 - 500k	3	-11%	-189
	4	-13%	-213
under 100k	5	-23%	-383
	6	-10%	-174
Ofgem estimate			
16 current suppliers		-9%	-145

Source: Statutory Accounts, Companies House.

Our analysis shows that 5 out of 6 of these suppliers had a weighted average EBIT margin below Ofgem’s estimated -9% over the period for which accounts were available. This means that, based on the information available, 5 out of 6 suppliers would have incurred losses well above Ofgem’s proposed Capital Target of £130 per customer based on £2000 bill.

Our view is that Ofgem’s proposed Capital Target of £130 per equivalent dual fuel customer should not be reduced. Furthermore, based on the analysis above, we believe the target is only appropriate where wider financial resilience controls mean that the market does not return to that which prevailed in 2019, where highly risky suppliers were incurring significant losses. Given Ofgem intends the Capital Target to be static it would be important that Ofgem reviews this target regularly and particularly if the market structure changes or the risks that all suppliers face increase.

Ofgem has not considered other options for the Capital Target in the Impact Assessment

³¹ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraph 3.18.

Ofgem has updated the Impact Assessment (the Current IA) so that option 3 and option 4 assess a Capital Target equivalent to £130 Adjusted Net Assets per domestic dual fuel customer (i.e. £65 per gas customer and £65 per electricity customer). In the previous impact assessment³² (the November IA) Ofgem, assessed the benefits of the same options based on a capital requirement in a range of £110 and £220 per domestic customer.

The Current IA finds socially weighted benefits of £289m over the next six years for the proposed £130 requirement. Ofgem has also included a sensitivity whereby only 50% of suppliers comply with the Capital Target. In this sensitivity benefits fall to £190m over the same 6-year period.

This shows that consumers will benefit from the Capital Target and that those benefits reduce if some suppliers don't reach the target. As Ofgem acknowledges, this is because the Impact Assessment shows greater benefits if the capital requirement is increased:

'The current model would suggest that there would be higher or lower benefits from increasing or decreasing the level of capital that suppliers are allowed to hold.'³³

Our view is that Ofgem should have considered a wider range of options for the Capital Target in addition to the £130 proposed (Option 3). Instead, the Impact Assessment only considers:

- Option 1: an option that Ofgem is no longer actively considering;³⁴
- Option 2: an option that is has already implemented; and
- Option 4: combining the Option 3 and Option 2.

This approach means that the policy option being appraised (the Capital Target) has not been compared against other relevant options. The Green Book sets out guidance for assembling a 'rational viable set of shortlist options' which can then be subject to a Social Cost Benefit Analysis. It recommends that these include:

- 'Do minimum option (that just meets the business needs required by the SMART objectives)
- Preferred Way Forward (that may or may not be the Do Minimum)
- A more ambitious preferred way forward (this may be more expensive, deliver more value, but at higher costs with increased risks "
- A less ambitious preferred way forward – unless the preferred option is a do minimum (this option may take longer, deliver less value but cost less and / or carry less risk)³⁵

Whilst we support the immediate introduction of the Capital Target, as a staging post, we urge Ofgem to develop a robust framework to determine the level of Capital required including a full impact assessment which considers a meaningful set of options.

³² Revised impact assessment of Strengthening Financial Resilience Proposals Publication date: 25 November 2022.

³³ Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, Paragraph 3.14.

³⁴ Ibid, Paragraph 3.11.

³⁵ [The Green Book](#), HM Treasury, 2022, Paragraph 4.40.

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

It is our understanding that the previous proposal was based on total domestic customers including single fuel and dual fuel customers, not 'per dual fuel customer' as the question implies. We answer on that basis.

We agree with Ofgem that setting a separate target per electricity and gas customer is more appropriate than an average requirement on a per customer basis. This will allow the Capital Target to reflect better the customer base of individual suppliers and therefore the level of risks that they need to manage.

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

We agree with Ofgem's approach to apply an even split between gas and electricity customers and that it will be reviewed in the future.

Customer Credit Balances Ringfencing

Our view is that Ofgem's proposed approach to Customer Credit Balance (CCB) ringfencing:

- Has not been subject to an assessment of its consumer impact and will leave consumers at risk of mutualised costs when suppliers exit.
- Is not consistent with Ofgem's proposals on Renewables Obligation (RO) ringfencing and capital adequacy which are justified by the premise that using customer funds to capitalise suppliers creates dis-benefits which are paid for by customers.³⁶
- Is not supported by Ofgem's impact assessment which shows that including market wide ringfencing of customer credit balances alongside RO ringfencing and capital adequacy would create the highest benefits for consumers over a 10-year period.

However, there is an urgent need for Ofgem to act on protecting customer credit balances and we believe that whilst these proposals won't provide adequate protection for consumers; they are better than inaction. We urge Ofgem to move forward with the ringfencing of customer credit balances. However, we also propose that Ofgem commits to a mandatory 12-month evaluation of bespoke ringfencing. If this evaluation finds that bespoke ringfencing is not effective in protecting customer balances Ofgem should commit to introducing market wide ringfencing at the earliest opportunity.

Ofgem's proposals are not a substitute for market wide ringfencing

Ofgem has argued that existing and proposed requirements will mitigate the need for market wide ringfencing:

'We continue to believe that concerns relating to reliance on CCBs can be addressed by building on existing and associated new requirements, such as our work on capital adequacy and strengthened rules around how suppliers set Direct Debits.'

There is no support for this assertion in Ofgem's impact assessment which only assesses the benefits of market wide ringfencing and finds that these are lower than other policies (capital adequacy and RO ringfencing). It does not assess the points on which it relies:

- **That strengthened rules on Direct Debits will reduce reliance on CCBs:** An analysis of the proposed policy might have found that, even where suppliers meet Ofgem's strengthened rules on Direct Debits, they are still likely to hold significant amounts in CCBs at certain times of the year due to seasonality of energy use³⁷. Furthermore, Direct Debit requirements will need to be continually enforced by Ofgem in order to ensure that suppliers continue to meet the requirements.
- **That capital adequacy requirements will reduce reliance on CCBs for working capital:** An analysis of the impact of capital adequacy requirements on working capital would be needed to validate this. Ofgem's current proposals mean that the Capital Target could be met with intangible assets or Alternative Sources of Capital – in fact Ofgem points out in its consultation (Figure 1) that a number of suppliers have high levels of intangible assets. In these cases, it is not clear that capital adequacy requirements would reduce the incentive for suppliers to use CCBs as working capital. In addition, suppliers may potentially continue to have zero Adjusted Net

³⁶ For example, in paragraph 4.17 of the [Revised Impact Assessment](#) Ofgem note that 'Any capital that is at risk of being mutualised if a supplier fails is effectively insured by customers because they will bear the cost in the long-term.'

³⁷ As noted by Ofgem in paragraph 4.29 of the [April Statutory Consultation](#).

Assets until 2025 and beyond under Ofgem's proposals. This means a supplier could continue to rely on CCBs for working capital for two years or more.

Even where Ofgem has carried out an impact assessment, its findings continue to ignore comments made by Centrica in response to the previous consultation which would invalidate Ofgem's conclusions. Our previous comments included that:

- a. Market wide ringfencing would not require an increase in the default tariff cap (DTC). If Ofgem had taken this into account, its analysis that market wide ringfencing has lower benefits than other policies, would not hold true.
- b. Ofgem should include an option assessing a combination of CCB and RO ringfencing and capital adequacy in its impact assessment. Ofgem do not do this but say that:

*'a combination of capital adequacy and market-wide ringfencing of both RO receipts and CCBs is not included as this would come at a high cost to suppliers and customers while producing less benefits than other combinations at a 6-year NPV.'*³⁸

However, in the same Impact Assessment, Ofgem acknowledges that 'a combination of market wide CCB and RO ringfencing with capital Adequacy would create greater benefits at the 10-year NPV.'³⁹ This should have led to such an option being included in their short list.

As noted above we propose that Ofgem commits to a mandatory 12-month evaluation of bespoke ringfencing which should include evaluation of an option for mandatory market wide ringfencing of CCBs.

³⁸ Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, Paragraph 3.6.

³⁹ Ibid, 5 April 2023, Appendix B, A2.1

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

No, we think the proposed triggers are insufficient and the EFRP triggers should be reinstated.

Ofgem should bring back the EFRP triggers

Ofgem's proposals on customer credit balance ringfencing reduce its ability to direct the ringfencing of customer credit balances by reducing the six conditions under which the November proposals allowed Ofgem to make a Direction to two conditions. This means that suppliers may continue to use customer credit balances for working capital even if they are in breach of the Enhanced Financial Responsibility principles including that:

- 4B.1: The licensee must ensure that it maintains Capital and Liquidity of sufficient amount and Quality that it is able to meet its reasonably anticipated financial liabilities as they fall due on an ongoing basis.

And

- 4B.3: The licensee shall at all times manage responsibly costs that could be Mutualised and take appropriate action to minimise such costs.

And

- 4B.4: The licensee shall at all times have adequate financial arrangements in place to meet its costs at risk of being Mutualised.

Ofgem argues that it has removed these triggers in response to stakeholder input. Ofgem notes:

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

We believe that triggers based on the FRP conditions are clear and unambiguous and urge Ofgem not to exclude them from its potential CCB triggers. Ofgem needs to have a broad scope to ringfence CCBs to ensure that unanticipated events or risks can trigger ringfencing. By only providing the ability to ringfence if specific events occur Ofgem risks a too narrow approach to oversight.

We are also concerned that Ofgem thinks the EFRP licence conditions are not clear or are ambiguous. SLC 4B.1 is the cornerstone of Ofgem's new Enhanced Financial Responsibility Principle, is supported by a 27-page guidance document and requires all suppliers to submit an annual assessment of compliance to Ofgem. The EFRP is a crucial element of Ofgem's capital adequacy regime and means that suppliers who face risks not covered by the Capital Target are required to hold additional capital. If Ofgem considers the licence condition it has drafted is not clear enough that a breach can be identified unambiguously we have serious concerns about Ofgem's ability to enforce this crucial licence condition.

On Ofgem's proposed triggers

Ofgem has proposed two new triggers that would require it to direct customer credit balance ringfencing. We consider each in turn.

The Capital Target Trigger

The Capital Target Trigger is set at a value of £130 per dual fuel customer in Adjusted Net Assets. Ofgem set out that 'By maintaining sufficient capital levels, we would expect to see a decreased reliance on CCBs as working capital and so this trigger can be seen to directly support our policy intent'.⁴⁰

We agree with the principle that a supplier in breach of its Capital Target should be required to ringfence customer credit balances.

This is particularly important because Ofgem's framework would allow a supplier to breach its target for, potentially, a long period of time. During this period there is clearly a risk that a supplier would be relying on customer credit balances for working capital.

However, the Capital Target may be too low a threshold for this trigger for the following reasons:

- The Capital Target is a minimum capital requirement. Suppliers with a higher risk business model may require additional capital to meet the EFRP and therefore continue to rely on customer credit balances even when they are above the Capital Target.
- Based on Ofgem's proposed definition of Net Assets, a supplier may meet the Capital Target using intangible net assets and continue to rely on customer credit balances for working capital.

To address these points we propose that Ofgem re-introduce a trigger for ringfencing CCBs based on SLC4B.1 in addition to the Capital Target trigger. An SLC4B.1 trigger would cover a broader range of financial risks including liquidity risks, business specific risks and risks around collateral requirements. It is essential that Ofgem is able to react to this broad set of risks to ensure that it can take swift action where supplier financial resilience is under threat.

The Cash Balance Trigger

Ofgem has set out that the Cash Balance Trigger is designed to 'ensure suppliers have sufficient capital to fulfil their obligations to their customers with respect to their CCBs.' Ofgem has set out the reasons for this approach⁴¹. They say:

- '... this threshold will give a more direct and meaningful indication of sustainable business practices in relation to CCBs than the alternative proposals we have considered (such as total assets and current assets thresholds)'.⁴²

⁴⁰ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraph 4.21.

⁴¹ Ofgem also note that 'A further benefit of this approach is that it applies consistently across varying business models regardless of supplier size.' Ofgem should further explain this statement with reference to examples and stakeholder comments – if relevant. The current drafting does not provide enough explanation for us to comment.

⁴² Ibid, Paragraph 4.24 – 4.25.

An indicator of 'sustainable business practices'

We agree that suppliers should be able to repay customer credit balances on demand. The ability to repay balances would be in line with the requirement for suppliers to have clear Direct Debit and Credit Balance Refund policies which was underlined in the recent Market Compliance Review⁴³. And by the requirement in Standard Licence Condition 27.16 that customers should be able to ask for a refund at any time and suppliers must do so promptly unless they have reasonable grounds not to.

We also consider that the ability to repay customer credit balances on demand would be implied by new licence condition SLC 4B.2 which will require each supplier to ensure that:

‘were it to exit the supply market (due to insolvency, licence revocation or in any other circumstances), its operational and financial arrangements are such that any Supplier of Last Resort or special administrator appointed would be able to efficiently and effectively serve its customers and that the exit would result in minimised Mutualised costs.’

Centrica has already stated, that as a responsible, sustainable supplier, we protect customer deposits which are held in a separate bank account.⁴⁴

We are concerned at Ofgem’s proposal to require suppliers to be able to repay only 20% of customer credit balances on demand. By setting this trigger point Ofgem is once again⁴⁵ signalling to suppliers that it is acceptable to use 80% of customer credit balances as working capital.

We are also concerned that Ofgem has not presented any evidence that 20% is an upper bound for customer churn in a given period. Ofgem does set out the basis of its calculation which is based on the potential for ‘several million’ customers to switch over a six-month period, with roughly half of these switches being to external suppliers and hence requiring a CCB refund. However, whilst Ofgem says it has considered a number of scenarios, Ofgem does not set these out. One such scenario could be that individual suppliers face much higher switching rates.

Ofgem also does not appear to have considered other potential demands on suppliers cash balances during a switching event which may affect suppliers ability to repay CCBs.

Given the lack of evidence presented by Ofgem to support its proposals our view continues to be that to best protect current and future consumers, Ofgem should require suppliers to ringfence 100% of gross CCBs net of unbilled consumption and that the Cash Coverage trigger should therefore be set at 100% of CCBs.

In our response to the November Statutory Consultation, we asked that if Ofgem did not proceed with CCB ringfencing, it should require suppliers to disclose whether their credit balances would be fully protected prominently in all communications - particularly at point of

⁴³ [Direct Debit Market Compliance Review: Progress Update | Ofgem](#)

⁴⁴ [Centrica announces it will protect customers' credit balances | Centrica plc](#)

⁴⁵ We previously made this point in relation to Ofgem’s proposed trigger of CCBs at 50% of total assets in our response to [Ofgem’s November 2022 Consultation](#).

sale and tariff renewal.⁴⁶ Ofgem has not done this and continues to signal to suppliers that it is acceptable to use customer credit balances as working capital.

We are disappointed that Ofgem has not addressed our proposal in this consultation. We continue to urge Ofgem to address the lack of transparency for customers by requiring suppliers to disclose whether their credit balances would be fully protected prominently in all communications - particularly at point of sale and tariff renewal.

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

Yes, we agree a Consumer Interest test is appropriate but propose amendments to the Consumer Interest test.

Reducing Ofgem's discretion

Proposed licence condition sets out that Ofgem **will** direct the suppliers to ringfence a proportion of CCBs where one of the two triggers has been breached and the supplier does not satisfy the Authority that ringfencing of CCBs would not be in the Consumer Interest.

We welcome this clarification from Ofgem that the issuance of a Direction following breach of a trigger is not discretionary and will take place subject to the Consumer Interest test. In the Statutory Consultation, Ofgem note that following a supplier breaching a trigger:

*'We will engage with the supplier to further analyse the circumstances of the trigger event and the overall resilience picture. We will consider the wider sector environment such as the normal fluctuations of CCBs, for example, going into a winter period or coming out of a winter period.'*⁴⁷

This statement does not appear to be in line with the licence condition which sets out that Ofgem will direct ringfencing unless it receives a representation from the supplier within 7 working days. We ask that Ofgem clarifies this point in the final decision. Our view is that a clear signal of regulatory intent is needed to reduce the moral hazard that has been identified. Ofgem should therefore make clear that a trigger breach will lead to ringfencing unless a valid representation is made.

Defining the Consumer Interest

The current proposal is for any representation to be on the grounds of Consumer Interest which is defined as:

*'Consumer Interest Means the likely impact of any adjustments on Resilience, Prices, Quality and Standards and Low-Cost Transition to Net Zero.'*⁴⁸

⁴⁶ Centrica response to Statutory Consultation on Strengthening Financial Resilience, 3rd January 2023.

⁴⁷ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraph 4.42.

⁴⁸ Statutory Consultation Notice, SLC 4B, 5th April 2023.

This definition includes the four ‘key components of an energy system working in consumers interests’ identified by Ofgem in the framework for consumer interests which they set out in July 2022 (hereafter ‘the original framework’).⁴⁹ When setting out the original framework for consumer interests Ofgem explicitly noted that the framework could help Ofgem to answer challenging trade-offs.

We agree with Ofgem that an assessment of consumer interest would need to not only consider the likely impact on the key components but also the trade-offs between them. To ensure that Ofgem can consider these trade-offs we suggest that Ofgem should explicitly require suppliers to consider the likely impact on each of the key components. For example:

*‘the likely impact of any adjustments on **each of** Resilience, Prices, Quality and Standards and Low-Cost Transition to Net Zero’.*

Whilst we support Ofgem in setting out its framework for consumer interests we consider that, particularly in this case, the proposed definitions of consumer interests should be reviewed. Both the definition of prices and resilience are different from those set out in Ofgem’s original framework and may reflect consumer outcomes that are not consistent with effective competition.

There are two areas where we ask Ofgem to consider this point.

1. First, Ofgem propose to define Prices simply as ‘Charges for the Supply of Electricity’. This definition would imply that lower prices are better for consumers. Recent experience tells us that this is not necessarily the case where competition through low prices is not sustainable and leads to mutualised costs. Ofgem could resolve this by defining prices as ‘Delivers fair prices for consumers’ as it proposed in the original framework. Alternatively, Ofgem could explicitly include mutualised costs in its consideration of prices amending the definition to ‘Charges for the Supply of Electricity taking into account future Mutualised costs.’
2. Ofgem defines resilience as ‘Means the proportion of the Market at Risk of Failure and the likely Mutualised cost that would result in the event of that failure occurring.’ This definition does not reflect the meaning of resilience which is generally defined as the ability to recover from a shock. This is reflected in Ofgem’s original definition which describes resilience as an energy system which is ‘Is resilient to volatile wholesale prices, attractive for long-term investment and ensures reliable supply for consumers.’ Ofgem’s proposed definition appears to reflect concern that ringfencing of consumer credit balances could lead to market exit. However, Ofgem should be clear that inducing failure may be in the consumer interests if a supplier is not sustainable and that resilience is not defined by preventing failure where this is the case.⁵⁰ We would suggest that Ofgem retains its original definition of resilience and (as noted above) accounts for any impact on mutualised costs through the direct impact on prices.

Finally, we note that ‘the extent of competition’ would not normally be considered as defining ‘Quality and standards’ although it may have an impact on outcomes. Whilst we encourage Ofgem to consider the interactions between consumer interest and effective competition, in

⁴⁹ Net Zero Britain: developing an energy system fit for the future Publication date: 8 July 2022.

⁵⁰ We note that Ofgem also has a duty to have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations on them but that this should not form part of the consumer interest test.

this case we ask Ofgem to review this definition to ensure that it is focused on delivering quality for consumers.

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

Yes, we think the Capital Target trigger should be brought in earlier and the EFRP trigger reinstated and brought in immediately.

Ofgem proposes that the Cash Coverage Trigger will take effect at the same time as the power for Ofgem to issue a direction under SLC 4B. However, it intends to delay the Capital Target Trigger until the Capital Target requirements become effective on 31 March 2025. As set out in our response to question 2 we believe that Ofgem should begin the transition to the Capital Target on 31st March 2024 as originally proposed in the November Statutory Consultation. We believe that the Capital Target trigger should also begin on 31st March 2024 and that Ofgem should reinstate the SLC4B.1 Trigger (hereafter the EFRP trigger) alongside the Cash Coverage Trigger i.e. immediately.

Whilst Ofgem delays the introduction of the Capital Target, and the Capital Target trigger, consumers will continue to bear the risks of supplier failures. During the recent spate of energy supplier failures, no less than 29 suppliers exited the market in a single year (2021). Over a period of two years (the time that Ofgem suggest is required to transition to Capital Adequacy requirements) from 2020 - 2021, a total of 37 suppliers failed representing more than half of the 58 suppliers active at the start of 2020. This recent example of a stress event in the energy supply market should have led to urgent action by Ofgem to mitigate the risks of future events. It has not. As a result, there has been a material gap in the regulatory framework for two years, for which there is no apparent mitigation advanced by Ofgem, leaving the energy supply market vulnerable to another stress event.

To bring forward the Capital Target trigger, Ofgem should also bring forward the Capital Target by introducing a transition phase as proposed in our response to question 2. By reverting to its previous position⁵¹ Ofgem could increase the number of suppliers that meet the Capital Target by 2025 by using the Transition controls and Capitalisation Plan process to move suppliers to be in a position of compliance by 31st March 2025. An increase in compliance would benefit consumers as evidenced by Ofgem's own sensitivity analysis⁵².

However, this still means that undercapitalised suppliers would not need to ring fence customer credit balances until 2024, leaving customers balances at risk of mutualisation. We recognise that it would be difficult for Ofgem to bring forward the Capital Target trigger ahead of the Capital Target. We therefore propose that Ofgem brings in the EFRP trigger immediately as we set out in response to question 12. The EFRP Trigger is required to address risks not mitigated by the Capital Target Trigger and can be implemented immediately. An EFRP trigger would require Ofgem to direct ringfencing of customer credit balances where a supplier does not meet SLC 4B.1 which requires it to maintain Capital and Liquidity of sufficient amount and Quality that it is able to meet its reasonably anticipated financial liabilities as they fall due on an ongoing basis.

⁵¹ [Statutory Consultation - Strengthening Financial Resilience | Ofgem](#)

⁵² Revised impact assessment of Strengthening Financial Resilience proposals, 5 April 2023, Figure 18.

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

Ofgem has amended its approach to setting the level of ringfencing that would be required. Proposed SLC 4B.24 sets out that a direction would require a supplier to ringfence 100% of customer credit balances unless the requirement would have 'a Material adverse effect on the licensee's ability to finance its activities'. Where Ofgem does expect a material adverse effect it will ensure that:

*'the licensee has sufficient Working Capital to pay its employees and those suppliers whose goods or services are essential to the continued operation of its supply business and other essential monetary obligations (such as, but not limited to, meeting its tax liabilities).'*⁵³

Ofgem also notes that 'Where the Capital Target Trigger has been reached, the supplier will also be expected to provide a Capitalisation Plan.'⁵⁴

We understand that Ofgem must have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations⁵⁵. However, Ofgem should be clear that ringfencing consumer credit balances may be in the consumer interest even if it induces supplier failure if a supplier is not sustainable. In this case Ofgem's principal objective to protect the interests of existing and future consumers should take precedence and this should be reflected in the text of the proposed licence condition.

⁵³ Proposed SLC 4B.24.

⁵⁴ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), 4.48.

⁵⁵ [Our powers and duties | Ofgem](#)

Annex 1: Summary of proposals

This table summarises the proposals that we make throughout our response. Full explanation of each proposal is set out in the response to individual questions in appendix 1.

Minimum Capital Requirement – Compliance framework			
Question and Topic	Proposals		
Question 1: On the level of the Capital Floor, we propose that:	Ofgem increases the Capital Floor in line with its estimate of working capital of £40 per dual fuel customer.		
Question 2: On the transition period we propose that:	Suppliers be required to reach zero adjusted net assets by 31 st March 2024.	Ofgem use the compliance framework to move suppliers with below zero adjusted net assets to the intermediate position by 31 st March 2025.	
Question 3: On Capitalisation Plans we propose that:	Ofgem should introduce a time limit for Capitalisation plans.	Whilst a Capitalisation Plan is in effect, Ofgem should retain Transition Controls, as a minimum setting out an explicit requirement that they would not be removed unless Ofgem is confident that the supplier is fully compliant with SLC 4B.1 – SLC 4B.5.	Ofgem has already set out in the Statutory Consultation that by 31 March 2024 ‘as part of this first Self-Assessment, suppliers will be required to set out how they plan to meet the Capital Floor by 31 March 2025 and how they plan to meet the Capital Target from 31 March 2025 or be on a path to meeting it.’ ⁵⁶ Ofgem should formalise the requirement in line with its clear intention.
Question 3: On the interaction between the compliance framework and the EFRP:	When a supplier is required to submit a Capitalisation Plan it should be required to include significant risks which are identified under the EFRP in the Capital Target.	To support the inclusion of EFRP risks in the Capital Target. We recommend that Ofgem considers standardising the EFRP process for significant risks and where the evaluation of risks would benefit from a consistent approach across suppliers.	

⁵⁶ [Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem](#), Paragraph 1.28

Questions 4-8: On Regulatory Capital we have submitted a report by PA consulting which proposes that:	Capital should be considered in relation to two objectives: one short-term liquidity and the other long-term skin in the game.	Certain components of Net Assets be excluded from Equity and/or Liquidity Capital.	Alternative Sources of Capital are also considered separately depending on whether the purpose is Equity of Liquidity Capital.
Minimum Capital Requirement – Level of Capital			
Question and Topic	Proposals		
Question 9 - On the level of Capital we propose that:	Ofgem does not delay introduction of the proposed Capital Target as a staging post.	Ofgem develops a robust framework to determine the level of Capital required including a full impact assessment which considers a meaningful set of options.	
Customer Credit Balance Ringfencing			
Question and Topic	Proposals		
Question 12: On the CCB triggers we propose that:	The Capital Target trigger should begin on 31 st March 2024.	Ofgem should reinstate the EFRP triggers including the SLC4B.1 Trigger making it effective alongside the Cash Coverage Trigger i.e. immediately.	Ofgem should clarify its requirement to issue a Direction when a trigger is breached in its decision document providing a clear signal of regulatory intent.
Question 13: On the Consumer Interest test	Ofgem should explicitly require suppliers to consider the likely impact on each of the key components of Consumer Interest in the Consumer Interest test.	Ofgem should review the proposed definitions of the components of Consumer Interest.	Proposed SLC4B.24 should account for Ofgem's principal objective to protect the interests of existing and future consumers.
On regulatory transparency we propose that:	Ofgem should require suppliers to disclose whether their credit balances would be fully protected prominently in relevant communications - particularly at point of sale and tariff renewal.		
On evaluation:	Ofgem should commit to a mandatory 12-month evaluation of bespoke ringfencing. If this evaluation finds that bespoke ringfencing is not effective in protecting customer balances Ofgem should commit to introducing market wide ringfencing		

	at the earliest opportunity.		
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Annex 2: Proposed adjustment to licence condition 4B.18 and 4B.19

We propose that Ofgem further amend their draft proposed modifications to proposed licence conditions 4B.18 and 4B.19 to bring forward the date at which suppliers must meet the Capital Floor to 31st March 2024 and apply Transition Controls and submit a Capitalisation Plan where it does not. We have added text, underlined, to the proposed draft licence conditions to indicate how our proposals may be incorporated. Our reasons for why this change are necessary is set out in our response to Question 2.

4B.18 If the licensee supplies to Domestic Premises,

- a) with effect from 31 March 2024 until 31st March 2025 where the licensee's Adjusted Net Assets are below the Capital Floor (the "Transition Position"); or
- b) with effect from 31 March 2025, where the licensee's Adjusted Net Assets exceed the Capital Floor but are below the Capital Target (the "Intermediate Position"),
- c) it must:
 - i) Notify the Authority, as soon as reasonably practicable, and at most within 7 days, of being in either the Transition Position or the Intermediate Position, that it is in the Transition or Intermediate Position;
 - ii) Notify the Authority at least 28 days before making any payment, providing any loan or transferring any asset to any third party unless that payment, loan or transfer is one that it is essential to the licensee's operation as a supplier of electricity to consumers (with such payments and transactions together hereinafter referred to as "Non-essential Payments");
 - iii) Adhere to Transition Controls until the Capitalisation Plan has been approved by the Authority in accordance with standard condition 4B.19 ("Approved Capitalisation Plan"); and
 - iv) Once the Capitalisation Plan has been so approved, adhere to the Approved Capitalisation Plan.

4B.19 Where the licensee is in the Transition Position or the Intermediate Position:

- i) It must submit to the Authority a credible proposed Capitalisation Plan (the "Proposed Capitalisation Plan").
- ii) The Authority will consider the Proposed Capitalisation plan and confirm in writing to the licensee whether it is has been approved or rejected.
- iii) Where the Authority approves the Proposed Capitalisation Plan the licensee must adhere to the Approved Capitalisation Plan in accordance with 4B.18(iv). iv) Where the Authority rejects the Proposed Capitalisation Plan, it will provide the licensee with reasons for its rejection. In those circumstances, the licensee must submit to the Authority a further Proposed Capitalisation Plan which the Authority will consider and either approve or reject with reasons.