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Dear David,

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

EDF is the UK's largest producer of low carbon electricity. EDF operates low carbon nuclear power stations and is building the first of a new generation of nuclear plants. EDF also has a large and growing portfolio of renewable generation, including onshore, offshore wind and solar generation, and energy storage. We have around six million electricity and gas customer accounts, including residential and business users. EDF aims to help Britain achieve net zero by building a smarter energy future that will support delivery of net zero carbon emissions, including through digital innovations and new customer offerings that encourage the transition to low carbon electric transport and heating.

EDF remains supportive of Ofgem taking measures to improve the financial resilience of the retail market, which will lead to more sustainable competition in the long-term, to the benefit of consumers. We, therefore, support the direction of travel reflected in Ofgem's work programme in this area. However, it is important that Ofgem adopts a sensible balance between minimising additional costs on consumers and financially responsible suppliers and ensuring Ofgem has powers it needs to act where it has concerns around individual suppliers' activities.

**Minimum Capital Requirements**

EDF is supportive of Ofgem taking measures to address the failings of the past where many retail businesses held insufficient capital to manage the risks involved in retail energy supply and as such left consumers facing high mutualisation costs when they exited the market. We agree that suppliers should not be allowed to operate with minimal capital, investors must have '*skin in the game*' and share any risk of liquidation with consumers and the wider industry. The current arrangements have led to significant risk of 'moral hazard' where any profits are owed to the directors/investors, but with any losses managed through mutualisation processes.

**With this challenge in mind, Ofgem continuing to pursue using accounting 'Net Assets' as a foundation metric for liquidity/solvency is flawed,** especially if any net assets are to be included which are unable to be used to offset losses in a stress position by a supplier or administrator.

Such an approach will not deliver the desired regulatory benefits of reducing any mutualisation risk, despite imposing a considerable cost on consumers and financially responsible suppliers.

#### A Share Capital approach

We have, in both our response to the previous statutory consultation and subsequent bilateral meetings with Ofgem, proposed a more detailed alternative approach as to how Ofgem should implement capital adequacy arrangements in the energy retail market which would better achieve Ofgem's stated aims. **We continue to consider that such an approach - based around share capital and other alternative shareholder funding (PCGs, long term loans) - is more appropriate.**

For completeness, we repeat the summary of our preferred alternative approach. We would urge Ofgem to further consider the benefits of an approach based around shareholder funding where:

- A new requirement is introduced for all suppliers to demonstrate directly to Ofgem that they are a going concern, potentially via the annual resilience assessment.
- A Minimum Capital Adequacy arrangement is set for all suppliers, based on share capital and other alternative shareholder funding. For established and stable suppliers this should be no more than £100 per domestic customer (or £50 per fuel); and
- Ofgem should take powers, as it has for CCBs, to be able to increase this level of Minimum Capital Adequacy for new entrants or where financial reporting data (e.g. rapid growth) raises material concerns around individual supplier's financial resilience.

Fundamentally, there is not a direct link between a shareholder's net residual interest in a company on dissolution and a pure net assets measure. Ofgem acknowledge this on page 8 of the current consultation document:

*"Setting a minimum capital requirement on its own also does not guarantee a level of capital adequacy, or an organisation's ability to withstand shocks. For example, a company may appear to be well-capitalised but the capital may be largely invested in highly illiquid fixed assets and operate with a very low level or negative liquidity. In such a scenario, even a modest shock may force the organisation out of business".*

#### An Adjusted Net Assets approach

However, we do note that such concerns with a net asset measure could be addressed through an adjusted net assets approach that only includes those assets that can be used to limit mutualisation costs in the event of a supplier failure. In other words, those net assets that have an intrinsic value which can actually be realised (even at the point of dissolution).

If Ofgem is, therefore, to continue with a net assets-based approach, we would support Ofgem adopting an adjusted net assets measure in line with the comments and rationale set out below:

- Some entities will have assets which are illiquid – IT systems, office leases, Goodwill - or which are required to run the business. These should, therefore, be excluded.
- Hedge books do have an intrinsic value and can be monetised, however, Ofgem should be aware in the case of suppliers trading through difficulty that disposal of the hedges could further worsen a liquidity issue at a supplier (derivative net assets related to hedge books in a rising market) and, therefore, for this reason fair value derivatives should be excluded from the adjusted net asset measure.
- No value should be attributed to customers, as if there was an intrinsic value to customers, then a trade sale could be realised, rather than a SoLR which results in a mutualisation cost. For this reason, capitalised acquisition costs should be excluded from the adjusted net asset measure.
- Accounting is not perfect. For example, acquired two-year fixed tariff customers may appear as a capitalised acquisition cost asset on the balance sheet - yet legacy default tariff customers are not recognised with a value on the balance sheet because they joined the supplier in an earlier time period, therefore, incumbents are disadvantaged as a result.
- Accounting judgements can be reasonable within a range, these judgements of themselves do nothing to improve or worsen the liquidity of a supplier. Therefore, introducing significant operational impacts (halt on sales, essential payments only etc.) that are dependent on accounting outcomes could incentivise judgements to be made which over-state net assets – and potentially unnecessarily punish those that make more prudent estimates. Furthermore, were a shock to cause an unexpected drop below the Target this could lead to inappropriate pressure on, and scrutiny of, accounting judgements that may not ultimately be impacting shareholder net residual value. Ofgem should consider these marginal and tail-risk cases to ensure that they do not incentivise inappropriate accounting or create significant ethical issues.

#### Level of Capital Target and Floor

It is also important if Ofgem is to proceed with a net-asset based approach that it does not impose disproportionate costs on financially responsible suppliers. It should be recognised that all retail suppliers still operating in the market have proven their financial robustness over an extremely challenging period and so placing disproportionately high costs on existing suppliers will only add to costs with little market benefit. **On this basis, while there is logically an argument that the Capital Floor should be higher, both the level of the Floor and Target are acceptable as conservative introductory levels. However, Ofgem should keep both levels under review to ensure that the protections are meeting Ofgem's policy aims.**

#### New Suppliers

This track record of resilience, will not, however, be true of any new entrants once the market moves to a more competitive environment. As part of its work implementing proposals to strengthening financial resilience, we would, therefore, encourage Ofgem to have a particular focus on ensuring that new entrants are robustly financed and have sufficient capital when entering the market. There is no acceptable reason why new entrants should not have a positive

adjusted net assets position at the point of market entry, as they have no operating history to point at for incurring losses. At inception they must not be relying on forecasts of future profits in order to meet a Capital Target or Capitalisation Plan. We recommend that **Ofgem place explicit measures on new entrants for their first three years**, including a higher capital floor requirement, measured by adjusted net assets, equal to the Capital Target. This explicit requirement could be gradually decreased over time in line with a risk-based approach. **We also see no reason why this could not be introduced as soon as possible** and form part of Ofgem's assessment of new licence applicants.

#### Electricity / Gas split

The Capital Target split between electricity and gas should be based on a single tariff ratio using the cost of annual consumption per fuel. This would better reflect the mutualisation cost risk per fuel and would future proof the split where forward prices of each fuel evolve over time. This split should be updated at regular intervals to ensure it takes account of such forward price movements.

#### **Protection of Customer Credit Balances (CCBs)**

We remain supportive of Ofgem adopting a risk-based approach to the protection of CCBs as opposed to adopting measures on a market-wide basis. Providing Ofgem with the powers to issue directions to suppliers' where they have concerns around supplier actions or financial risks is a proportionate approach to the regulation of such risks.

However, in terms of Ofgem's revised proposals around the triggers that would lead up to the issuing of any Direction, it is important that there are not any unintended consequences for financially responsible suppliers. For instance, in terms of the Cash Coverage Trigger and the requirement to maintain monthly cash (in the bank) balances at a level equal to or greater than 20% of gross CCBs (net of unbilled consumption), it is important to consider that within any particular month a supplier's cash balance will fluctuate significantly and may lead to a supplier for normal business reasons being under and over the trigger at times within a particular month. Furthermore, calculating gross advances net of unbilled debt is typically only performed periodically for financial reporting. To address this issue, we would suggest that any measurement point is taken using a supplier's month end financial reporting in order to ensure consistency across suppliers and reduce the administrative impact on suppliers.

Should you wish to discuss any of the issues raised in our response or have any queries, please contact Steven Eyre or myself. Please note that this response is not confidential and may be published.

Yours sincerely

A handwritten signature in black ink, appearing to read "J. Mason", enclosed within a thin black rectangular border.

John Mason  
**Senior Manager (Price Regulation & Market Dynamics)**

## **Appendix**

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

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

Please refer to our comments above and under Question 8 regarding the appropriateness of the proposed Capital Floor and Target and the use of net assets as a foundation metric where this is not robustly detailed to ensure only liquid assets with an intrinsic value can be included.

Please also note our views above on our preferred approach for new entrants, that should be implemented as soon as possible. Specifically, new entrants should have a requirement to address moral hazard they create and as such we see no reason why they should not have a positive adjusted net assets position at the point of entry. Therefore, for the first three years we would support new entrants having a Capital Floor (measured by net assets) equal to the Capital Target. This amount should not be able to be met with alternative sources of capital, it must be met with shareholder equity funding to ensure that investors have 'skin in the game'. This should prevent a new entrant making a year one loss causing an immediate licence condition breach.

#### **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?**

Yes, we support this timeframe. However, we see no reason why appropriate capital requirements for new entrants cannot be implemented much sooner and ideally as soon as possible.

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

How non-essential payments is defined is important. For example, employee incentives could be necessary to retain and grow the business and attract talent so that you hit the capital target in future – so we would suggest a narrow definition is used (i.e. Director bonuses, dividends etc.). In addition, while some payments to parent companies should be prevented (i.e., dividends), it is important that payments required where a parent company is providing support in return should be able to continue.

What credible steps will be accepted by Ofgem in any supplier Capitalisation Plan in order for a supplier to recover and meet the Capital Target also needs careful further consideration. For instance, efforts to increase net assets may not be sufficient. What may need to be addressed is solvency and funding, so measures should also consider addressing operating cashflow (margins, cost reductions etc.) or financing like new sources of debt, parental support or equity.

**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?**

We fully support the adoption of a minimum credit rating for parent/group working capital facilities or guarantees of Baa3/BBB-. We strongly advocated and provided robust justification for the adoption of such a rating level in our previous consultation responses and via bilateral meetings with Ofgem. On that basis we welcome Ofgem's proposals in this respect. However, we would welcome additional clarity on Ofgem's approach to dealing with instances where a Guarantor's credit rating is downgraded below the minimum required. For instance, would suppliers be given a grace period to put in alternative arrangements when such a downgrade was unexpected?

In addition, Ofgem should provide clarity and a clear timeline on how to submit a Capitalisation Plan and how quickly Ofgem will agree any Plan where an otherwise financially sound supplier temporarily breaches the Capital Target for unexpected reasons. This will provide more certainty for suppliers and ensure there are not any unexpected consequences of this regulatory requirement.

**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 consider that a minimum residual 12 months remaining on unsecured, committed, unconditional loans or working capital facilities to be treated as long-term is reasonable.

In terms of the option of using Parent Company Guarantees (PCG), we would also like clarity on the following matters:

- Who the beneficiary for a PCG would be i.e., would it be the licensed entity (as would be the case with a shareholder loan, for example), or would it be Ofgem?
- That a PCG from a non-UK (EU) entity is acceptable, as in the case of the RO protections measure that Ofgem are introducing; and
- Will the PCG need to follow similar wording as for the RO first demand guarantee format, or is discretion allowed provided that the guarantee is legally robust?

**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?**

It is appropriate that energy suppliers should be able to include alternative investor funding sources (PCGs etc.), so long as those instruments do practically mitigate the risk of mutualisation, for example being of sufficient timing, credit rating and without conditions - as set out by Ofgem.

**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.**

UK GAAP and IFRS are materially aligned for accounting valuation purposes. It should, however, be recognised that there are various accounting judgements (bad debt provision rates for example) that can materially impact the net assets of a company under both accounting frameworks. A risk of the net asset approach (i.e. a regulatory requirement that is a straight read across from accounting definitions) is that it may incentivise poor practice, for example not recognising provisions appropriately or over-stating assets useful lives. This has a read across to a Capitalisation Plan in that these must, to be effective, be focused on obtaining cash and lines of credit, not changing accounting policies to boost net assets.

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

We are assuming that the relevant accounts are single entity accounts and not consolidated accounts. However, if this is not the case then Goodwill should be excluded. We also believe other non-current assets that have no ability to absorb unexpected losses should be excluded, such as the capitalised cost of lease assets, IT systems, licenses etc.

Derivatives should be excluded as though hedge books do have an intrinsic value and can be monetised, Ofgem should be aware in the case of suppliers trading through difficulty that disposal of the hedges could further worsen a liquidity issue at a supplier (derivative assets related to hedge books in a rising market). Therefore, fair value derivatives should be excluded from the adjusted net asset measure.

Finally, no value should be attributed to customers, as if there was an intrinsic value to customers, then a trade sale could be realised, rather than a SoLR which results in a mutualisation cost. Furthermore, a customer sale cannot in practice be made quickly enough to absorb unexpected losses, so customers do not represent a form of risk capital held to absorb such unexpected losses. For this reason, capitalised acquisition costs should also be excluded from the adjusted net asset measure.

**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.**

Yes, as an introductory level. However, this should be kept under review to ensure that the protections are meeting Ofgem's policy aims.



Additionally, we would call for Ofgem in setting any target to ensure that it applies this consistently with the risk capital allowed under the EBIT default price cap allowance. **It is essential that Ofgem ensure sensible suppliers are fairly reimbursed for the costs of this policy places on them.**

**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 that this is a sensible approach.

**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**

No. The Capital Target split between electricity and gas should be based on a single tariff ratio using the cost of annual consumption per fuel. This would better reflect the mutualisation cost risk per fuel and would future proof the split where forward prices of each fuel evolve over time. This split should be updated at regular intervals to ensure it takes account of such forward price movements.

**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?**

Yes, we support the use of these reporting triggers.

**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.**

Yes, although Ofgem must ensure this is not used as a way to avoid effective and quick action by Ofgem where the CCB trigger is breached. For example, we would expect a time limited and unexpected trigger to be considered differently than a sustained and long-term breach.

**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.**

The Capital Target trigger should not be brought in before the Capital Target is implemented.

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

Please see our comments above in the covering letter regarding the CCBs protection measures. We also request that Ofgem provides certainty to suppliers that the level of CCBs to be ringfenced will not exceed 100%. This could be achieved through an amendment to the definition

of Adjustment Percentage in SLC4D. Furthermore, Ofgem needs to consider what the implications would be for a supplier picking up customers through a Supplier of Last Resort (SoLR) event and the immediate impacts, if any, on its Capital Target and Credit Balance Triggers.

**EDF May 2023**