Decision

Making a positive difference
for energy consumers

Strengthening Financial Resilience- Minimum Capital Requirement and Ringfencing CCBs by Direction

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We consulted from 5 April 2023 to 5 May 2023 on further proposals to strengthen the resilience of the energy supply market. These were to introduce a common minimum capital requirement for domestic suppliers, and the ringfencing of Customer Credit Balances by direction in certain circumstances.

This document sets out our decision to proceed with these policies.

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Foreword

Wholesale gas and electricity prices remain historically high, and the volatility in energy markets continues to impact consumers and the energy sector. Despite this, the wholesale market has been more stable, and we expect the retail sector to return to profit this year. The most acute phase of the energy market crisis may therefore be behind us, but we must seize this opportunity to build a stronger, more resilient market in the interest of consumers. It is in this context that Ofgem[1] is delivering further reforms to strengthen the financial resilience of energy supply companies, working to ensure the necessary safeguards are in place to protect consumers in the event of a future market shock.

We are reforming the retail sector so that we do not see the extent of supplier failures we have seen over the past two years and the accompanying adverse impact on consumers. These reforms, alongside earlier decisions such as establishing the enhanced Financial Responsibility Principle and ringfencing the Renewables Obligation, are aimed at both reducing the likelihood of future supplier failures and reducing the cost of failure to consumers should suppliers fail.

A resilient, profitable, investable market is also essential for the sustainable competition we want to see, where suppliers have incentives to innovate in the pursuit of net zero and receive a reasonable profit as they drive up consumer service standards. At the same time, we recognise that excessive pursuit of resilience above other goals would have costs, stifling entry to the market and constraining competition. We believe we are striking the right balance for current and future consumers with these reforms.

We have also been clear, in both this decision and the decision in April to establish an enhanced Financial Responsibility Principle, that suppliers themselves should be the first line of defence. We expect suppliers to assess and understand their specific business risks and any profits should be retained to improve financial strength for those that are not sufficiently well capitalised.

Having consulted on a package of proposals in both November last year and more recently in April, we have decided to introduce a common minimum capital requirement for energy suppliers so that all suppliers have a financial buffer to absorb severe but

[1] The terms "we", "us", "our", "Ofgem" and "the "Authority" are used interchangeably in this document and refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.

plausible market shocks. The common minimum capital requirement will comprise a Capital Floor of £0 and Capital Target of £115 Adjusted Net Assets per dual fuel equivalent customer. There will be a Capitalisation Plan framework in place for those suppliers that are above the former but below the latter. Recognising that the sector is currently under capitalised, we have decided that these new rules will take effect from the 31st of March 2025. We have also decided to proceed with our proposals to modify supplier licences so that Ofgem can direct

suppliers to ringfence a portion of their Customer Credit Balances (CCBs) when we deem it to be in the consumer interest.

Overall, stakeholders are supportive of our aims to improve resilience within the sector and where there have been objections these have typically focused on the details of implementation rather than the objective of the proposals. We recognise that some stakeholders think we could go further, and others think we are going too far. After carefully considering all the responses we have received we believe this decision is reflective of our aims to balance the benefits of greater resilience with what is achievable, affordable and practical so that we have a competitive market, but also a sustainable one. The market will be significantly more resilient, but as in any competitive market, some companies will still fail from time to time. We will continue to engage with the sector and other stakeholders as this new regime evolves and we want to work closely with suppliers to understand Capitalisation Plans at an early stage.

Ofgem is fully focussed on protecting the interests of consumers. While we are making the energy sector more resilient to price shocks, many customers will still be facing financial difficulty this winter, through continued relatively high energy prices and the wider cost of living pressures. This decision sits alongside our work towards a market that offers a fair deal to consumers on prices and delivers better service standards. We look forward to working closely with government, industry, consumer groups and charities, to take all of this crucial work forward.

Rohan Churm

Interim Director of Financial Resilience and Controls

Executive Summary

The effects of the energy crisis have been significant and wide-reaching across the industry and for consumers. High levels of market exit have imposed increased costs on consumers, adding to what is already a challenging time for energy billpayers. Ofgem has taken several steps to improve the resilience of the energy supply market through interventions to reduce market risk, improve financial monitoring and strengthen supplier governance and financial controls. However, the need to build and sustain a financially resilient market remains of paramount priority and importance.

In April 2023 we published a further consultation[2] on our revised proposals to strengthen the financial resilience of the retail energy sector. We consulted on proposals to implement a common minimum capital requirement and modifying the licence so that Ofgem can direct suppliers to ringfence Customer Credit Balances (CCBs). In parallel, in April 2023 we published our decision to ringfence Renewables Obligations and introduce the enhanced Financial Responsibility Principle.

We proposed that suppliers must maintain a Capital Floor of £0 Adjusted Net Assets per customer from 31 March 2025 and meet a Capital Target equivalent to £130 Adjusted Net Assets per dual fuel equivalent customer from 31 March 2025. We proposed that suppliers not meeting the Capital Floor would be in breach of the licence. Suppliers not meeting the Capital Target would be required to submit a Capitalisation Plan showing how they intend to do so and would be subject to Transition Controls until they have an acceptable plan in place.

We proposed that ringfencing of CCBs should be available in circumstances where suppliers are not meeting the Capital Target and where they do not have sufficient funds to refund customer balances in a severe but plausible switching event – the Cash Coverage trigger.

We believe this approach strikes the best balance for consumers in providing strong incentives for suppliers in a stronger starting position to achieve and maintain the Target, but also enabling those currently less well capitalised to take longer if needed to avoid unnecessary market exits, while facing more scrutiny and controls to mitigate the risks for consumers.

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[2] Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement | Ofgem

Our Decision

Stakeholder feedback to our April 2023 consultation on the minimum capital requirement and directing Customer Credit Balance ringfencing was broadly supportive of our proposals in principle, though there were three suppliers strongly opposed. Most respondents focused primarily on the details of our proposals and how they would be implemented in practice.

Having carefully considered respondents' feedback and suggestions for alternative options, and conducted further analysis to refine our proposals, we have decided to proceed with the introduction of a minimum capital requirement Floor and Target supported by the Capitalisation Plan framework, effective from 31 March 2025, but we are removing intangible assets from the definition of capital and lowering the Target to £115 per domestic dual fuel equivalent customer. These changes will ensure that the capital being used to meet our requirements is of sufficient quality to meet our resilience policy objectives and reduce mutualised costs, and that the level of capital is sufficient to improve resilience while remaining proportionate.

We are proceeding with ringfencing CCBs as we consulted on but have explained in guidance that we would not expect suppliers who "pool" funds to an investment grade parent overnight to hit the Cash Coverage trigger.

To provide suppliers with assurance on our decision-making for the Capitalisation Plan framework, we are also sharing more detail about Ofgem's assessment process and making clearer our expectations of what constitutes a credible plan.

In reaching our Decision we have considered stakeholder responses and undertaken further analysis to understand the likely impact of the proposed policies. This Decision takes into consideration our June 2022 policy consultation, November 2022 Statutory Consultation and further Statutory Consultation published in April 2023, all of which aimed to address the issue of suppliers operating in the market without sufficient capital and with unsustainable business models. The minimum capital requirement will form part of our wider framework of financial resilience reforms, including but not limited to, the enhanced Financial Responsibility Principle, ringfencing RO obligations, asset control requirements, and enhanced monitoring and reporting.

In introducing these measures, we are seeking to transition the market in a way that is consistent with our consumer interest framework. We envision this market being one of sustainable competition, in which all suppliers have sufficient capital to make them more resilient to severe but plausible shocks. By making the market more resilient we expect that other consumer benefits will follow. We expect a more resilient sector will be better able to deliver improved customer standards and the investment and innovation required to transition to net zero. However, we recognise that improving resilience does come at a cost so we have sought to optimise the level of resilience while maintaining competition and fair prices. We believe that our decision provides sufficient flexibility to accommodate different business models while providing robust consumer protection and clear minimum standards that will make the sector more resilient and thus more attractive to investment in the medium to long term.

Introduction

Section summary

This section sets out the context of this Decision, alongside the previous policy and statutory consultations that have led to the introduction of the common minimum capital requirement and the introduction of ringfencing Customer Credit Balances (CCBs) by direction. This section also details the structure and overall headings for the remainder of this Decision Document.

Structure of this Decision Document

This document is formed of the following 5 chapters:

- The introduction- providing context for this decision.
- Chapter 1 sets out our proposals, stakeholder responses and Final Decision on the Level of capital.
- Chapter 2 sets out our proposals, stakeholder responses and Final Decision on the Definition of capital.
- Chapter 3 sets out our proposals, stakeholder responses and Final Decision on the Compliance Framework.
- Chapter 4 sets out our proposals, stakeholder responses and Final Decision on Customer Credit Balances.

Alongside this Decision Document we are also publishing the following:

- Electricity and gas decision notices for SLC 4B
- Electricity and gas decision notices for SLC 4D
- Updated FRP guidance
- Updated Impact Assessment and model
- Final CCB Protection Mechanism templates

Context

The case for intervention

The energy sector has faced extreme volatility in recent years, with rising wholesale prices contributing to the market exit of 30 suppliers since August 2021. This has led to significant impacts for consumers, with nearly 4 million experiencing the disruption of a supplier failure and all consumers facing higher prices due to costs being mutualised. While some level of failure in a competitive market is inevitable, we have recognised the need to act to prevent these harms to consumers. Since December 2021 a wide range of measures have been put in place to help deliver a more resilient supply market including robust stress-testing, seeking assurance on suppliers' risk management processes and governance, and using compliance and enforcement powers to address concerns arising from these assessments.

However, we recognise the need to go further and address the underlying issues of suppliers being able to enter the market and operate in a way that is too reliant on customer funds rather than investor capital. This has meant – as identified by the independent Oxera review[3] of Ofgem's regulation of the energy sector – that shareholders have been able to pursue a "free bet", pursuing growth fuelled by revenue from customers, which in the event of failure was costless from a shareholder perspective. These business models also faced high exposure to external shocks such as wholesale price volatility, creating the situation that led to high levels of market failure.

Building on our decision published in April 2023 to implement ringfencing of Renewables Obligation (RO) receipts and introduce an enhanced Financial Responsibility Principle (FRP) we are now taking forward the remaining elements of the proposed package – introducing common minimum capital requirements for domestic suppliers and modifying the licence so that Ofgem can direct suppliers to ringfence Customer Credit Balances (CCBs).

Objectives of the policies

The objective of our package of measures is to build the recapitalisation of the sector, enhance resilience to external shocks and put the retail market on a solid foundation to deliver the innovation, high standards and consumer outcomes needed to achieve our principal objective: protect the interests of existing and future consumers.

Moving to a model ensuring that business owners have capital at risk will in turn reduce their incentive to take excessive risks, and the act of raising capital prior to entry or on an ongoing basis will further encourage scrutiny of business plans and ongoing ability to trade.

[3] Ofgem publishes report into its regulation of the energy market | Ofgem

Ofgem has introduced a number of measures to improve the resilience of the sector and this decision builds on and complements these reforms. Taken together, we are introducing a framework to support the development of a strong, sustainable and competitive retail energy sector that operates in the interest of consumers and is attractive to investors.

Overview of April Statutory Consultation feedback

Fifteen responses were submitted for the April 2023 Statutory Consultation, from respondents comprising of suppliers, trade bodies, trade unions and consumer groups. There was broad support for the proposal to introduce a common minimum capital requirement and the feedback focused on the detail of how we will implement the proposals.

Stakeholders broadly supported our proposed timeline for the capital requirement to take effect from 31 March 2025, and the concept of the Capital Floor, Target and Capitalisation Plan. However, there were concerns about Ofgem's discretion in the Capitalisation Plan process and requests for greater assurances on the decision-making framework from Ofgem.

Most stakeholders agreed with allowing some form of the Alternative Sources of Capital to meet the proposed requirements but there were varying alternative proposals for our criteria. Most stakeholders agreed intangible assets have limited value in meeting the policy objectives.

There was broad support for the level of Capital Target and Capital Floor although some stakeholders expressed differing assessments of the proposed Floor and Target, with some arguing it was too high and others arguing that it was too low. A group of stakeholders requested that Ofgem keep the Capital Target under review with a clear process for how it would be reviewed in the future.

Overall, there was general support for proposals to modify licences so that Ofgem can direct ringfencing of Customer Credit Balances when it is in the consumer interest to do so. There were concerns about when Ofgem would choose to do this and mixed feedback on the reporting triggers where many responses put forward alternatives and suggested amendments to the proposals. Those stakeholders who were most opposed had concerns that the proposals did not go far enough or went too far to the extent that they undermined the policy intent.

Our decisions

- We are proceeding with the introduction of a common minimum capital requirement in the form of a Floor and Target with the Capitalisation Plan framework. The Capital Floor will be £0 Adjusted Net Assets per dual fuel customer equivalent and the Capital Target will be £115 per domestic dual fuel equivalent customer (i.e. £57.50 per domestic electricity customer and £57.50 per domestic gas customer). This will be complemented by the enhanced Financial Responsibility Principle to ensure that ultimately by March 2025 all suppliers have sufficient capital and liquidity to meet their business specific risks.

- We have decided that intangible assets will be removed from the definition of capital. Intangible assets are assets that cannot be easily realised for value in times of stress or have little to no value in an insolvency, such as goodwill or customer acquisition costs. As such we think that intangible assets do not meet our objectives for the capital requirement and could have the effect of inflating suppliers' net asset position without providing loss-absorbency in a stress scenario.

- We have decided to proceed with our proposals to modify licences so that Ofgem can direct CCB ringfencing in specific circumstances as consulted on, provided it is in the consumer interest to do so. Ofgem will be able to direct ringfencing of CCBs when a supplier is below the Capital Target and/or when a supplier is below the Cash Coverage Trigger (where a supplier's cash position goes below 20% of the value of its gross CCBs from fixed direct debit customers, net of unbilled.

Our decision-making process

June 2022 Policy Consultation

In June 2022 we consulted on changes to improve retail supplier financial resilience and ensure that risks were not being inappropriately passed on to consumers. We proposed measures to protect Customer Credit Balances and money collected to meet Renewables Obligation payments. We also proposed to introduce specific capital adequacy requirements for suppliers and sought initial proposals aimed at reducing the costs associated with hedging when a supplier fails.

November 2022 Statutory Consultation

Following the June 2022 Policy Consultation, we then published our November statutory consultation on our proposals to strengthen financial resilience across the energy market. This included the proposal of setting a common minimum capital requirement for all domestic suppliers as well as ringfencing of RO receipts attributable to domestic supply. This is supported by an enhanced FRP and monitoring framework across all energy suppliers. We decided at this stage not to proceed with the market-wide ringfencing of Customer Credit Balances, but instead proposed to set a monitoring threshold to avoid suppliers overly relying on these funds and to modify the licence so that Ofgem can direct individual domestic suppliers to ringfence CCBs when they are at risk of not meeting set financial standards.

April 2023 Statutory Consultation

In April 2023, we published a further consultation on proposals to strengthen the financial resilience of the retail energy sector alongside our Decision to ringfence Renewables Obligations and introduce the enhanced FRP. We proposed setting a Capital Floor of £0 and a Capital Target of £130 per dual fuel equivalent domestic customer and modifying the licence so that Ofgem can direct a supplier to ringfence its CCBs. We proposed that suppliers must always be above the Floor but can be temporarily below the Target provided they have a Capitalisation Plan in place that sets out how they will meet the Target as soon as possible.

General feedback

We are keen to receive your comments about this decision document. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments

Please send any general feedback comments to stakeholders@ofgem.gov.uk

1. Level of capital

Section summary

This section sets out our decision on the level of the Capital Floor and Capital Target. We are proceeding with the Capital Floor being £0 Adjusted Net Assets per customer and have decided to set the Target Level at £115 per domestic dual fuel customer equivalent (i.e. £57.50 per domestic electricity customer and £57.50 per domestic gas customer). We think this Target level strikes the right balance between improving supplier resilience to severe but plausible shocks while remaining proportionate and cost effective for consumers.

What we consulted on

1.1 We proposed that suppliers maintain a Capital Floor of £0 Adjusted Net Assets per customer from 31 March 2025 and meet a Capital Target equivalent to £130 Adjusted Net Assets per dual fuel customer equivalent (i.e., £65 per domestic gas customer and £65 per domestic electricity customer) from 31 March 2025.

1.2 This figure was informed by a review of financial data of existing domestic suppliers, a review of the operating profits/losses incurred by domestic suppliers over the last seven years, data from the working capital model which calculates the working capital position for the notional supplier dependent upon an agreed level of risk, and data from stress tests. We considered that the 5th percentile historical EBIT losses served as a good guide to the required loss-absorbing buffer. Taking into account the market at the time, the data analysis from our models, and changes that have occurred since that period to improve market resilience we considered that £145 per customer derived from these historical losses was an over-estimate and therefore proposed a target of £130 per customer.

1.3 We acknowledged the fact that potential future reforms to the energy retail sector could materially change the common risks facing suppliers. If these reforms do happen, we proposed that we should reconsult to amend the Capital Target.

1.4 We also proposed that the Target would be set on a single fuel customer basis and that the Target should be split 50:50 electricity and gas based on Typical Domestic Consumption Values (TDCV).

Capital Floor

Consultation responses

1.5 Only a small number of respondents commented on the level of the proposed Capital Floor, mostly in agreement, with one response concerned that it may not have much effect on resilience. One response commented that it should be higher to reflect working capital requirement assumptions and also highlighted a concern that suppliers could be technically insolvent due to having negative net assets but would still be above the floor with Alternative Sources of Capital.

Our decision

1.6 We have decided to proceed with the consulted Capital Floor of £0 Adjusted Net Assets, representing the absolute minimum a supplier should have at all times to supply to domestic customers. A supplier who is in a negative adjusted net assets position may not be able to pay their debts without support and is extremely vulnerable to any external or internal shocks. Our analysis, and that in the Oxera report, shows that all failed suppliers in the sample had negative, and deteriorating, net equity positions. It is also the case that a positive capital position may provide a buffer against mutualisation costs in a Supplier of Last Resort or Special Administration Regime event.

1.7 The Capital Floor must be maintained at all times, whereas a supplier can be below the Capital Target but will need to submit and adhere to a Capitalisation Plan to demonstrate it is on a path to meet the Capital Target. This is to recognise that suppliers may need to be below the Capital Target in times of stress and that it will take time for some suppliers to recapitalise following recent energy market volatility.

1.8 This is not to say that £0 is a sufficient level of capital or the level we expect on an enduring basis. The Capital Target sets clear expectations of an additional level of capital above this, supported by an enforceable framework to ensure that suppliers are incentivised to meet this. The Capital Floor and Target are also complemented by the enhanced Financial Responsibility Principle, which includes the requirement for a licensee to have sufficient liquid and capital for their business specific risks.

1.9 The Alternative Sources of Capital allow a supplier to continue to trade, pay their debts, and have access to capital when in a negative net asset position, which is why we have included these. We have designed the criteria for these sources to ensure that they are appropriate for this use, as opposed to short-term trading arrangements or other instruments which could be withdrawn, and which would be riskier in these circumstances. These sources are also loss-absorbing and provide capital for use where it is required. We have made some technical changes to the definitions post consultation to ensure that what sources of Capital will be considered as an Alternative Source of Capital is as clear as possible for licensees. We have also made clear that Alternative Sources of Capital must be approved by the Authority and explained our expected approach to this approval process in guidance.

Target level

Consultation responses

1.10 There were a range of views on whether the Capital Target should be set at £130, with five respondents explicitly agreeing with this number and one suggesting regular reviews of the figure in order to keep up to date with market trends. Four respondents thought the £130 target was too high, with one commenting that it is too simplistic and did not take into account the diverse nature of customers, products and business models. One respondent suggested that Ofgem could consider setting this Capital Target level on a supplier-specific basis if possible.

1.11 Another four respondents either did not comment on the number, or responded that they did not know whether the number was appropriate but supported it in principle. A final respondent agreed with the principle but not how the number was specifically calculated, and suggested that while the number may be appropriate, a more robust calculation could be beneficial to confirm. This respondent also thought that the number should not be lowered, and that it was at the minimum it should be.

1.12 A few of the respondents believed that the Target was unachievable for independent suppliers and this could drive these retailers from the market, not aligning with Ofgem's role of providing space for sufficient competition and leading to a vertically integrated market. One of these responses also questioned the Target in an industry which in their view is currently not attractive to invest in and cannot deliver sustainable and profitable returns.

Our decision

1.13 Based on further analysis and feedback from the consultation, we will be proceeding with a target level of £115 Adjusted Net Assets per domestic dual fuel equivalent customer.

1.14 Our aim with the target level is to establish a reasonable minimum that we expect a financially responsible, well-hedged, supplier would need to have as a buffer for resilience in the event of a severe but plausible shock. The capital adequacy requirement is also not aiming for a zero-risk, zero-failure market, or to be the only lever to manage risk; we expect all suppliers to follow effective risk management practices. The common minimum is complemented by the EFRP requirement that a supplier must have sufficient capital and liquidity for its business specific risks and we would expect suppliers who have greater risk to hold more capital through the EFRP.

1.15 In reaching our decision on the level we have considered the common risks that all suppliers face, including those who are well-hedged when sourcing and supplying energy to their customers. As discussed in the consultation[4], we recognise that no suppliers need the exact same amounts of capital at all times and we have specifically designed our regime to account for this. Our intention is not to define how suppliers should invest their capital, but rather to set a Capital Target for suppliers to achieve by the most appropriate means.

1.16 Building on the analysis and sources of data outlined at consultation, we have further developed our analysis to refine our view of the level. This analysis is summarised in the sections that follow.

Historic profit/loss of EBIT margins

1.17 We consider that observing the actual EBIT margin profits and losses incurred by suppliers is a good proxy for the possible impact on retained earnings of shocks, and therefore is one of the best indicators of the losses a supplier might incur in a future severe but plausible stress event.

1.18 As we published in the consultation, in the sample period of 2016-2022, the aggregate distribution suggests the 5th percentile EBIT margin could be about -

[4] Page 36-7 Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement

8% (shown in Figure 1). This would equate to £145 per customer if the typical annual bill per customer is £2000 (the approximate bill level implied by recent wholesale prices at the time of the consultation).

Observed distribution of domestic supplier annual EBIT margins (2016-22)

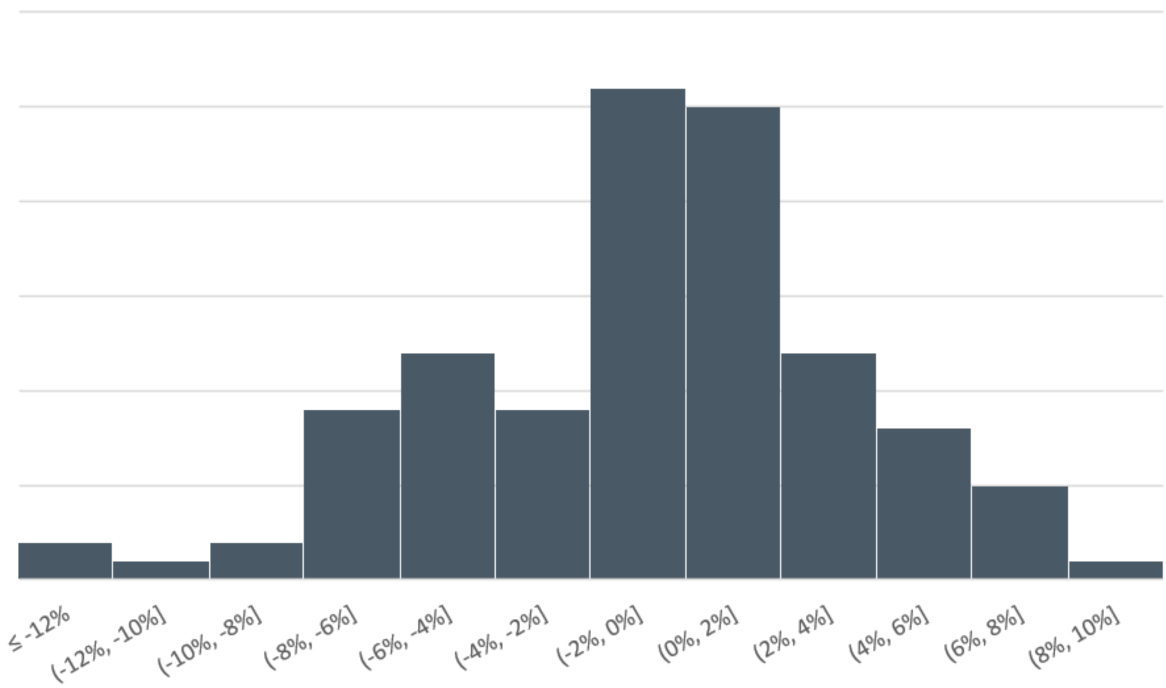

Figure 1: Source: Ofgem analysis of financials from 17 suppliers.

1.19 Some stakeholders fed back that within this dataset there may be several other factors (outside of the stress itself) that will have impacted on the headline losses but may not be fully representative of future risks. For example, subsequent policy changes such as to the price cap methodology - and the new enhancements to the FRP – are likely to result in lower exposure to future events.

1.20 This could mean that the £145 represents an over-estimate of the loss-absorbing buffer required and therefore setting the Capital Target at this value would represent an over-insurance for consumers. In the consultation we looked at some of these factors and removed 10% from the model output in recognition of this, and the fact that our other data points supported a lower number[5]. This took us to £130.

1.21 While there is no "perfect number" to quantify capital required for resilience for all suppliers in any stress event, we have a number of data sources that we have taken into consideration in coming to a balanced judgement on the most appropriate level. This level represents a market-wide minimum that reflects an appropriate loss-absorbing buffer for a financially responsible well-hedged supplier, with other appropriate risk management tools. To address the responses from the consultation we have revisited our analysis of the historical losses to finalise our view of the appropriateness of the £145 base level and its adjustments.

Impacts on data from historic losses model

1.22 As noted, the data used in the EBIT historic loss model is from 2016-2022, starting with a period of differing management and pricing decisions made by individual suppliers. For example, several challenger or small suppliers focused on growth using unsustainable low-pricing strategies. Many suppliers were also found to have inadequate risk management practices, such as limited hedging. This starting point increased the impact of EBIT losses during stress events. Since then, our Impact Assessment shows that suppliers have a reduced ability to offer unsustainably low-priced tariffs following the introduction of our resilience controls, lessening the impact of that segment of losses on the market as a whole. Together, these mean that suppliers should, in the future, be in a better position if another shock was to occur.

1.23 In addition to the policies we have already implemented to strengthen financial resilience, we made an important change to the price cap during the time of the observed losses, moving to a quarterly adjustment. Volume risk rose significantly with higher, volatile, wholesale prices during the energy crisis. We estimate that this change to the price cap reduced average volume risk relative to this higher level by approximately 75% as it would have allowed faster movement to reflect changes in the market[6]; this would have reduced observed losses had this been

[5] The two main reasons, as stated in the April Consultation, were the impact of supplier business decisions during the pre-crisis period, and the potential impact of regulatory changes made to improve supplier resilience.
[6] Price cap - Decision on changes to the wholesale methodology page 24

in place in 2022. With this in place for future shocks, losses from wholesale prices rapidly changing should be mitigated to an extent. Volume risk will still increase during volatile periods (as it will have in the sample in other years) but will be significantly lower than in 2022.

1.24 While the data points in this model are sufficient to draw conclusions on the likely losses in a severe but plausible event, it is sensitive to outliers. The model is comprised of a sample of 17 suppliers, some of whom made a large loss or profit which skewed the distribution. Some of these were prior to the stress events, and therefore unrelated (though changed the position of the supplier when in those events) and are affected by other business practices or business-specific risks. In a varied market such as this where different business models are encouraged, these impacts will vary as they are in different positions or are affected by the same events in different ways. We want to reduce the impact these have on the figure as a whole, as our aim is to set a common minimum value. While these effects could potentially raise or lower the average capital adequacy required, at the 5th percentile this would be focused on losses therefore it is appropriate to be wary of any significantly higher losses in this tail end.

1.25 The level derived through this method scales with bill levels. We have used a revenue per customer of £2000 as this was the average bill value at the time of consultation and this remains a good approximation based on current price levels. There is an argument for a range of numbers, above and below this £2000 value. While we note that the average bill during the tail losses (2020-2022) was £1700 (applying the 5^{th} percentile losses to this price level would result in a target of approximately £125), it is plausible that times of stress would likely be associated with increased wholesale prices, and individual price cap periods much higher than this.

The Capital Target level

1.26 Due to these factors, although we believe that the modelled historical losses of £145 per customer reflect a reasonable estimate of losses that might be incurred, we plan to adjust this number downwards to account to take account of how we anticipate the future market may look different. This judgement is inherently uncertain.

1.27 Our modelling could be used to justify a range of potential levels for the Capital Target. In coming to a decision on the preferred level, we therefore want to reflect the potential regret risks of setting the Target level too high, by choosing at the lower end of the range. As the Capital Target is part of a wider framework for improving resilience, most notably the enhanced Financial Responsibility Principle requirements for business specific capital and liquidity and additional monitoring, we consider that it is preferable to opt for a slightly lower Target at this stage to meet our principal objective to protect existing and future consumers while, wherever appropriate, promoting effective competition.

1.28 We have therefore decided that the Capital Target should be set at £115. This reflects an amendment to the estimate from historic losses based on the assumed reduced market risk of the quarterly price cap, and a reduction of 15% to the subsequent 5th percentile EBIT loss figure. This summarises our judgement of how we anticipate this price cap reform could go further in a volatile wholesale price event, how our suite of changes to supplier resilience could impact supplier behaviour and outcomes, our potential regret risks of setting the target too high, and the ability of the enhanced Financial Responsibility Principle to mitigate business-specific risks and outlier behaviour.

Business models and Target simplicity

1.29 Based on feedback from the consultation, we looked further into how different business models might have an impact on the capital required. We used two methods for this, looking at the size of suppliers and their historic losses and looking at the mix of payment types amongst customer groups:

Supplier size

1.30 There is limited evidence available to support differentiation by supplier type When our EBIT historical losses model is segmented by supplier size, the sample sizes are small and are highly likely to be skewed by individual suppliers and their individual performance.

1.31 While there are differences based on size or type of supplier, it is not clear how this could impact a common minimum. As discussed when looking at the Target, it is clear that some older pricing strategies are no longer viable and should not have such big an impact in the future. We also do not wish to model a high Target based on a few poorer performing suppliers – as we stated in the consultation we are not aiming for a no-fail market with the capital adequacy requirement, and our Target should reflect a financially responsible and well-hedged supplier, especially as this will work in tandem with the EFRP to ensure individual circumstances are considered.

Payment and tariff type

1.32 We acknowledge that different business models have different working capital requirements. The results of modelling these requirements using the draft EBIT notional supplier model[7] show this difference in working capital requirement for different payment types and tariff types, with prepayment requiring slightly less than direct debit and standard credit requiring a lot more. Fixed tariffs also require slightly less working capital than standard variable.

1.33 A differing working capital requirement, however, does not necessarily translate to a differing capital buffer. Our analysis and requirement is based on common risk factors across tariff types and the total capital adequacy required for a supplier, setting this at the minimum required across the market based on this analysis. We do not see compelling evidence of a fundamentally different level of risk exposure between these payment or tariff types given that many of the key risks are common, and therefore do not think a common minimum required buffer is sufficiently different between suppliers in the market.

1.34 In addition to this, to understand how this difference in working capital might translate across the market, we also used this model to look at the requirements based on a sample of real suppliers' customer mixes (without changing any other elements of the model). We found that while there was a spread of differing working capital requirements across the sample, these tended to group into two categories – those with lower proportions of standard credit customers, which sat within the £100-£160 working capital range, and those above that range with higher proportions of standard credit customers. Suppliers with even a modest number of standard credit customers had higher working capital requirements, even if they had a large majority of prepayment or direct debit customers.

1.35 While working capital needs are different, this is not something that the capital adequacy requirement is aiming to resolve. Different payment types have relevant uplifts in the price cap and the calculations for EBIT include these along with other working capital and fixed asset requirements, supporting suppliers to service their standard variable tariff customers. The EFRP has been introduced to ensure that businesses have the required working and liquid capital for their business-specific risks, which covers these differing requirements by business

[7] To note, these outputs are indicative only as the working capital model is in draft form, and subject to change following the recent consultation on EBIT.

model. The capital adequacy regime is being introduced to provide a buffer within this for suppliers so that in a market shock they are more resilient and more able to weather the expected losses.

1.36 The total target level has been reduced from the consulted £130 to £115 in recognition that the common risks across differing business models may be overestimated in this average loss. This Target aims to set a simple, common minimum with lower monitoring and covering a common set of risks. This is with the assurance that the EFRP could capture these higher-risk businesses with more specific monitoring and requirements based on individual circumstances.

Electricity/Gas split

Consultation responses

1.37 There was minimal negative feedback on setting the Electricity and Gas targets to be equal. All respondents who commented on this question, apart from two, agreed on the level of capital being based on 'per electricity and gas customer'. Of the two who opposed, one suggested that a single tariff ratio should be used based on the cost of annual consumption per fuel to better reflect the mutualisation cost. The other supplier stated that per dual fuel customer was too simplistic and that capital should be assessed on a supply point basis, then split by payment method.

Our decision

1.38 The price cap calculations imply a roughly equal split for dual fuel customers based on typical domestic consumption value over recent periods, and based on feedback from stakeholders, we have decided to go ahead with using an equal split for electricity and gas suppliers; introducing complexity and uncertainty here does not provide clear benefits to consumers.

Reviewing and the future

Consultation responses

1.39 A small number of responses requested more information about when and how the minimum capital requirement might be reviewed, with two responses recommending reviews of the Target to ensure it is market appropriate in the future.

Our decision

1.40 We are confident that our initial Capital Target is appropriate and robust both for the current market and potential changes such as the impact of other resilience measures and the stabilising of prices in the market. We are aware that there are factors that could impact this. As discussed in the April consultation, we could review the capital adequacy requirement to ensure that the level is still appropriate if there are significant changes in regulation or government policy, such as price cap reform or price protection changes, or if the common risks facing suppliers otherwise change materially, if it is in the consumer interest to do so.

1.41 If we believe that the Target should be changed as part of this review, we will consult on this change and ensure that a timeline for any potential changes to the Capital Target is put into place to allow suppliers to make decisions based on this information. We do not intend that the Target will be altered lightly, but we will review to ensure it continues to be robust and fair. As with all new policies we will monitor its implementation closely and welcome feedback on this.

2. Definition of capital

Section summary

This section sets out the reasons for our decision to use an Adjusted Net Assets measure for the definition of capital. This will comprise Net Assets, excluding intangible assets, plus permitted Alternative Sources of Capital. We have set out specific criteria for the Alternative Sources of Capital so that they are all long-term, unconditional, and committed. In setting this definition we are aiming to strike a balance between ensuring the Capital Target is achievable for the types of financing we see in the current market while ensuring that the capital is of sufficient quality to meet our policy objectives.

What we consulted on

2.1 In the April consultation we confirmed our intent to use the Adjusted Net Assets approach to the definition of capital. This was defined as (fixed assets + current assets) – (current liabilities + non-current liabilities), plus approved Alternative Sources of Capital. We proposed including intangible assets in the fixed assets calculation as they are recognised as fixed assets on the balance sheet and it simplified the measurement by aligning it with accounting standards. However, we consulted on whether all or some classes of intangible assets should be included, as we questioned whether these assets could be defined as loss-absorbing capital.

2.2 We clarified our position on what forms of Alternative Sources of Capital would be included and excluded in the definition[8], proposing that all sources must:

- allow for future planning and security by having a tenor of at least 12 months;
- cannot be terminated without good cause and with a termination period;
- be drawable in times of stress and able to be used where required; and
- be unsecured.

2.3 The party providing Alternative Sources of Capital in the form of undrawn working capital facilities or Parental Company Guarantees must have an Investment Grade credit rating (BBB- / Baa3 or equivalent). This is to ensure meeting the policy

[8] Table 1 and 2 in Statutory Consultation: Strengthening Financial Resilience - ringfencing customer credit balances and introducing a minimum capital requirement

aims of having capital available for use in times of stress, and to reduce losses in the event of an insolvency, are met. We consulted on: (i) whether any further debt instruments or other forms of capital should be considered; (ii) whether or not the 12-month tenor was adequate to be seen as loss-absorbing, long-term capital; and (iii) whether the credit rating requirement struck the right balance between consumer interest and business practices.

2.4 We also asked for input on how accounting standards could affect the net asset position and how this choice of methodology and level of assurance for the minimum requirement could be improved.

Adjusted Net Assets approach and Intangible Assets

Consultation responses

2.5 When looking at the Adjusted Net Assets approach to the definition of capital, two respondents suggested alternative proposals. One respondent agreed that our proposal was an acceptable starting point but included a report which proposed a future iteration of the policy having two definitions of capital, each with their own target to fulfil the policy objectives: equity capital (for skin in the game) and liquid capital (for loss absorbing funds and limiting mutualisation costs). Another response suggested we use share capital as an alternative approach, in which minimum capital adequacy is based on share capital and shareholder funding, with the ability to specify higher levels of capital adequacy where there are material concerns around resilience based on the reporting framework. This respondent also suggested adjustments to Adjusted Net Assets in relation to intangibles, as they had concerns that the net asset approach allowed too many illiquid assets.

2.6 Many respondents suggested that intangible assets should not be included on the basis that their value is limited in an insolvency/time of stress. In follow up conversations, some stakeholders highlighted that the value of many of these types of assets, especially customer acquisition, are directly related to accounting practices and their values can be inconsistent or even questionable as a result. One response stated that if there is any value to customers then a trade sale can be made instead of a Supplier of Last Resort event, however, in practice, a customer sale could not be made quickly enough to absorb losses during a stress situation.

2.7 Some respondents did see a case for including some or all intangibles. One stakeholder stated that customer acquisition costs do have value and would be part of the assets counted in potential mergers or acquisitions. One response stated that they did not see a balanced reason for intangible assets to be excluded and two respondents stated that while some should be excluded (such as Goodwill), other intangibles may hold value. One of these went on to say that if it was not possible to exclude only some intangibles, that excluding all would be more appropriate than including all. Another respondent noted that they did not think that Ofgem needed to be prescriptive around exact definitions of capital employed, but that all included capital should be sufficiently liquid.

Our decision

2.8 Having considered stakeholder views and evidence, and conducting further analysis, we have taken the decision to remove all intangible assets from the permitted definition. Therefore, the minimum capital requirement must be met using (tangible fixed assets + current assets) – (current liabilities + non-current liabilities), plus Alternative Sources of Capital approved by the Authority.

2.9 We believe that an Adjusted Net Assets measure best achieves our objectives by requiring shareholders to retain 'skin in the game'. As set out in the consultation, we want to ensure that shareholders have capital at risk in the company to drive the right behaviours and that their risk tolerances for investing in the company aligns with consumers' reasonable expectation that shareholders ensure that the company directors are managing the company for the medium to long-term, and have considered solvency in a shock scenario. It is also in the consumers' interest that there is a better balance of risk between shareholders and consumers when a company suffers a loss or if the company is mismanaged. A capital buffer aims to improve that balance of risk. Hence, Adjusted Net Assets will be used as the metric for a measure of capital as it has the closest alignment to consumer interests.

2.10 However, based on further analysis of the evidence and stakeholder responses to the consultation, we are removing intangible assets from the Adjusted Net Assets metric as these do not align in the same way.

2.11 Feedback from the consultation suggests that intangible assets cannot be accurately and consistently valued, and the majority of categories are illiquid and therefore cannot be easily realised for value in times of stress. This is especially true of asset categories such as Goodwill and IT and software assets (many of which are now leased or subscribed and therefore held as an operating expense rather than a capital expense).

2.12 Our analysis of a sample of administrator reports from failed suppliers shows that when comparing the value of intangibles reported pre-insolvency to their value in administration, there was no value in these intangible assets in 17 out of 19 suppliers (see figure 2). In some cases SoLR suppliers have chosen to reduce their levy claims somewhat in recognition of customer value, and in line with our preference to minimise mutualisation costs. However, the level of these costs absorbed by suppliers has varied considerably depending on market conditions and the nature of the portfolio, so in practice we have still seen substantial mutualisation costs and limited evidence of these intangible asset values being realised at a time of stress.

2.13 Overall, we believe that intangible assets would be limited in an insolvency and their value is difficult to liquidate during a stress situation. As such, including these assets could have the effect of inflating net assets without materially improving financial positions. While in some specific circumstances, such as an acquisition of a supplier by another, these could be included in the assets, this is not relevant to the majority of cases. We are also concerned that permitting customer acquisition costs to count as capital could create perverse incentives in certain circumstances. For example, some suppliers may, in a stressed scenario, compete for additional customers in order to capitalise the costs and improve their net asset capital position, when in practice this is a risky strategy for an undercapitalised supplier.

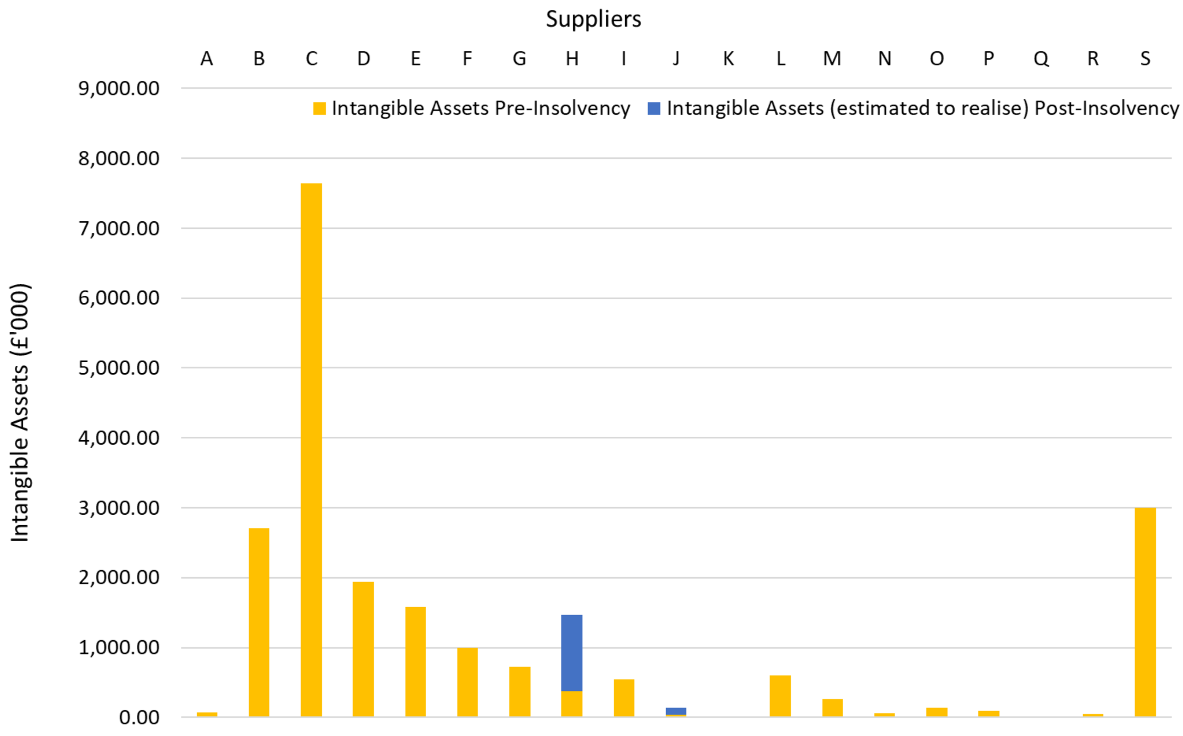

Figure 2: Intangible assets of 19 failed suppliers, both as valued pre-insolvency and again in administration. Figures from Companies House and administration reports.

2.14 We considered whether removing intangibles could create too much complexity in the Net Asset definition to make it impractical to implement and monitor. However, we concluded that this should not be an issue as intangible assets are a defined class of asset under accounting definitions and so their deduction is not a complex exercise. We also considered excluding certain categories of intangibles, however we deemed this to be a complex administrative process for no benefit – based on the disclosed intangible assets from a sample of suppliers across the market, the majority of intangible asset categories would likely be excluded. The resulting definition of Net Assets is equivalent to tangible net worth (total assets – total liabilities – total intangible assets) which is a standard company valuation.

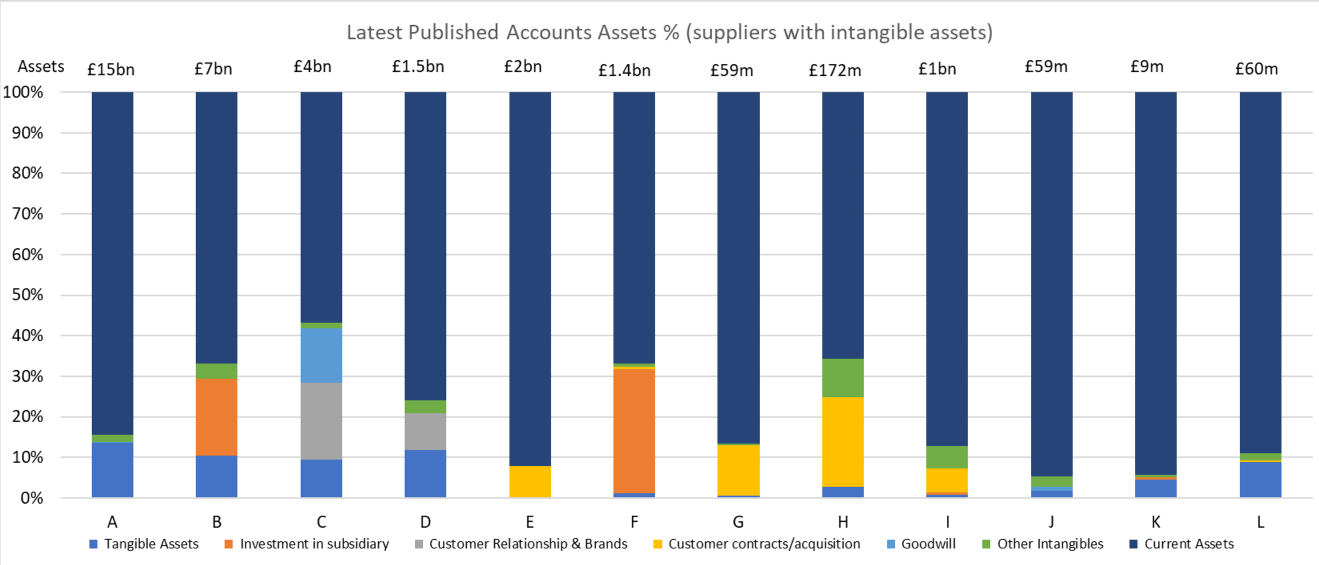

Figure 3: A sample of 12 suppliers and their asset types in their most recent published accounts, data from Companies House.

2.15 Figure 3 shows a sample of 12 suppliers and their proportion of tangible, intangible, and current assets. While the majority of the sample have a smaller proportion of intangible assets, we expect that removing intangibles from the definition may require some suppliers to raise more capital than they were expecting based on the proposals in the April statutory consultation. However, we do not consider this a sufficient reason to compromise our definition of Capital and risk our policy not meeting its objectives of protecting consumers by strengthening financial resilience. If a licensee is only able to meet the Target by using assets that do not hold value in times of stress or in failure, then we would not consider they have demonstrated sufficient resilience. The Capitalisation Plan is a more appropriate mechanism for accommodating temporary financeability challenges where a supplier does not have enough tangible assets or Alternative Sources of Capital to meet the Target, while still protecting consumer interests.

Alternatives to Adjusted Net Assets

2.16 We did consider approaching the capital requirement as an equity requirement or a liquid requirement was considered. However the complexities of administration and the additional burden on suppliers was deemed to outweigh the benefits of this approach. Removing intangible assets from Adjusted Net Assets mitigates many of the concerns about the liquidity of capital, and addresses much of the issues discussed in this proposal, especially in concert with the liquidity requirement in the EFRP and the cash coverage trigger. We believe that the

Adjusted Net Assets measurement is satisfactory for ensuring access to loss-absorbing capital in times of stress.

2.17 Similarly, the proposal on share capital also aims to reduce the potential illiquid uses of assets for meeting the capital requirement and, as such, we think the removal of intangible assets mitigates this issue. This alternative solution was also mentioned by the same respondent as an appropriate mitigation.

Alternative Sources of Capital

Consultation responses

<u>Available facilities and debt instruments</u>

2.18 A majority of responses agreed with the idea of permitting Alternative Sources of Capital, with a couple agreeing with our proposals and others suggesting some additional potential facilities or arguing for the inclusion of risk-reducing instruments. However, some challenger suppliers thought that our proposed Alternative Sources of Capital favoured incumbent or vertically integrated suppliers because facilities with the proposed criteria are unavailable to independent suppliers. A small number of respondents, that were critical of the Alternative Sources of Capital, thought that suppliers with investment grade rated parent companies could meet the requirements using capital that is effectively ‘cost-free’ which would undermine competition.

2.19 Two responses suggested that we should be less prescriptive, or have a more flexible allowance of instruments, which is open to review. One response suggested that all long-term unsecured debt should qualify, to increase the options available to companies who are not able to gain funding from parents or groups. Some responses shared concerns about financeability routes, as they think raising capital in the current market is challenging, especially where they do not have any debt instruments available to them, as they are either independent, or do not have funding options within their group available. While some responses provided additional instruments to consider, one response did not feel that there are any available instruments in the market based on current conditions at all, and that the requirement for the funding to be unsecured would prevent them from accessing funding for the capital requirement. One supplier suggested hybrid debt be considered, though noted that this is not liquid and therefore only provides equity capital, and another stakeholder requested clarity on Parent Company Guarantees to third parties. Some clarity was sought on the process for Alternative Sources of Capital being approved.

Long-term tenor or expiry of facilities

2.20 Most responses agreed that a 12-month tenor was appropriate for long-term facilities. However, one respondent stated that the requirement for 12 months to always be remaining on the term meant this was in practice an evergreen facility and was not standard accounting practice. This respondent suggested that a 12-month agreement that was agreed by a certain date should be accepted. Another response questioned the 12-month requirement as a whole, stating that this was requiring a 24-month guarantee, and that three months was more standard, and would be more likely to be available.

Minimum credit ratings

2.21 The responses received on credit rating were broadly supportive, though one respondent did question what would be considered ‘equivalent’ to the specific ratings, and that they felt Ofgem should not be too prescriptive with these requirements. They also questioned whether this equivalency was available for all limbs of Alternative Sources of Capital. A couple of other responses questioned whether the approach of only allowing investment grade parents to provide guarantees and undrawn facilities was fair to the breadth of supplier types in the marketplace.

Our decision

Available facilities and debt instruments

2.22 We plan to proceed with some amendments to the consulted definitions of Alternative Sources of Capital. The majority of these amendments are clarifications on the original meaning of these instruments, but we have also amended one of the definitions to include more types of facilities based on feedback from the consultation. We remain of the view that our chosen instruments strike the right balance between reducing costs for consumers while meeting our policy objectives of being loss-absorbing, reducing mutualised costs, and increasing skin-in-the game. However, we agree that while there aren’t currently many instruments available in the market for independent suppliers, we should be open to considering additional facilities should they become available.

2.23 As we set out in the April consultation, we are allowing suppliers to use Alternative Sources of Capital to meet the Capital Floor and Capital Target as a way of providing flexibility to the sector and in recognition of the reality of how the sector is funded. While our preference is that suppliers aim to meet the requirements using equity, which is the best form of loss-absorbing capital, we do not want to create disproportionate costs where we think alternatives can meet our objectives. We have therefore considered which instruments and facilities balance cost and practicality while being considered to sufficiently meet our objectives of increasing skin in the game, reducing mutualised costs, and strengthening the long-term capital base of the licensed supplier.

2.24 By allowing Alternative Sources of Capital, and the use of Capitalisation Plans, to give suppliers time to capitalise in a way that works with their business model and the interests of consumers, we are aiming for appropriate flexibility in our framework. We understand concerns around financeability, where some suppliers will need to finance this requirement through retained earnings or shareholder injections, where they are unable to use the Alternative Sources of Capital that we are permitting. However, the elements that make up our criteria are important to ensure that the funding is available in a stress event or insolvency.

2.25 We understand that unsecured debt instruments may not be available for some suppliers, or attractive to parent entities to provide However, disallowing secured debt is vital to ensure that the maximum amount of funds are available in the event of an insolvency, in order to reduce mutualisation costs. We do not believe it is in the consumer interest to further weaken the definition of capital, at the risk of not meeting the policy objectives - namely, to build the long-term capital base of the supplier to increase resilience to severe but plausible shocks and reducing the cost of failure in a Supplier of Last Resort or Special Administration Regime event.

2.26 As such, we will accept Alternative Sources of Capital that meet the following criteria and have individually been approved by the Authority. Clarifications on conditions are outlined in the next section:

- **Unsecured loans approved by the Authority** which satisfy each of the following conditions; (i) the loan is not repayable within the following 12 months, (ii) the relevant lender (nor any agent for the lender) has no right to accelerate the loan (including on the licensee’s insolvency or any other event of default or other event).

- **The full value of each fully committed, unsecured, documented loan facility from a parent / group company to the licensee (drawn or undrawn)**, which satisfies the following conditions: (i) the parent/ group company providing such commitment maintains a minimum long-term credit rating of at least two of the following: BBB- by Standard and Poor's, BBB- by Fitch or Baa3 by Moody's; (ii) the commitment is fully committed under a legally binding commitment letter or facility agreement for at least the next 12 months, and is not subject to any conditions to drawing or payment, (iii) the parent/ group company has no right to cancel its commitment.
- **Unconditional, unsecured, quantifiable, legally-binding, guarantee from a parent or group company to the licensee to discharge liabilities of the licensee**, which guarantee satisfies the following conditions: (i) the parent/ group company providing such guarantee maintains a minimum long-term credit rating of at least two of the following: BBB- by Standard and Poor's, BBB- by Fitch or Baa3 by Moody's; (ii) the guarantee is legally binding for at least the next 12 months, and is not subject to any conditions to drawing or payment, (iii) the parent/ group company has no right to cancel such guarantee, (iv) any counterindemnity or other obligation by the licensee to parent/ group company in relation to payments by the parent/ group company under such guarantee will comply with the conditions referred to in "unsecured loans" above.

Changes to the definitions above

2.27 The changes to the wording of these definitions clarify the meaning, intent and conditions of the originally defined Alternative Sources of Capital. The changes to each are outlined here:

- The shareholder loan facility has been updated to include other unsecured loans approved by the Authority. There is more information on this under the Alternative Instruments section below.
- Drawn facilities has been merged with undrawn facilities, to cover the total value of the facility. There were some inconsistencies in the consultation about how drawn and undrawn facilities were treated, and after further consideration, we believe any working capital facility or committed, documented, loan facility should be valued at the total amount of the available facility, no matter how much is drawn or undrawn. This is especially important where this facility is used for day-to-day working capital, to allow a

clear picture of what capital is available for use. These must be subject to the credit rating requirements, as previously. Suppliers who do not have an investment grade parent or group, can still use drawn loans from their shareholders, which would count under the first definition of Alternative Sources of Capital. Alongside these, suppliers may also use financially responsible treasury management practices, such as short-term loans back to the parent/group company.

- There is no substantive change to the Parental Company Guarantee, but some additional wording has been added to ensure clarity on the mechanisms and answer some questions we received in the responses to the consultation.

Long-term tenor or expiry of facilities

2.28 We remain committed to the requirement of a 12-month remaining tenor on any Alternative Sources of Capital agreements. We believe this is vital to ensuring a long-term guarantee of capital to be used, and to allow proper risk mitigation and business planning by the company, not continually facing a cliff edge on their capital position, and by Ofgem in its role preparing for a potential SOLR or SAR. This is especially true given the seasonal nature of the market. Businesses need to be certain of their capital position across the full 12-month cycle, summer to winter, to enable them to forecast, plan and invest. Facilities less than 12 months are typically considered under accounting rules and across finance market participants to be short-term in nature and so cannot be considered as long-term loss absorbing capital.

Minimum credit ratings

2.29 Undrawn credit facilities must have a high degree of assurance that those credit facilities will be available when called upon, for this reason we are committed to including the BBB-/Baa3 rating requirement which is an internationally recognised benchmark of investment grade rating. We consider that it represents an attainable and reasonable standard and is an acceptable standard for assurance.

2.30 One response to the consultation requested clarification on equivalent ratings. To be clear, the ratings must be from two of the three following institutions: Moodys, S&P, or Fitch. In the case of a split rating, we will base our assessment on the lower rating. A company with a split rating where one is not investment grade rated will not be acceptable.

2.31 These agencies have published, standardised criteria that follow the requirements for our policy objective. Internal or private credit analysis and rating processes of lending financial institutions do not fit our criteria as we cannot be certain that firms rated under these processes meet our standard of assurance.

Non-UK Parent or Group entities

2.32 As with the Protection Mechanisms in RO ringfencing, and guarantees for CCB ringfencing, Parent Company Guarantees, or Parent Company or group debt facilities used as Alternative Sources of Capital can be from a person established within the United Kingdom or in an EU member state, or European Economic Area member state, that is bound by the 2005 Hague Convention on Choice of Court Agreements, as long as they meet the rating requirements and the guarantee or credit facility meets the length, quantifiability, and repayment terms required.

Alternative instruments

2.33 Some challenger suppliers were of the view that the Alternative Sources of Capital favour large, incumbent suppliers and made representations that we should remove the investment grade rating or permit other instruments, such as trading arrangements and unsecured loans. We have thoroughly considered whether alternative instruments could meet our objectives and have concluded individually for each proposal set out below.

Unsecured, third-party loans

2.34 A response to the consultation suggested that unsecured loans from unrelated third-party entities should be included (as long as it meets the other requirements), with the suggestion that this does still provide 'skin in the game' for the investor.

2.35 We still feel that most third party loans do not meet our policy objectives for the reasons outlined in the consultation. However, we accept the argument that a third-party loan could meet our criteria, including being strict on the length and commitment, and lack of accelerated repayment terms, particularly as a complement to equity capital as part of meeting the Capital Target rather than a substitute for the full amount. While we don't currently see any instruments available in the market, we remain open to the possibility that these could appear, especially as resilience in the market increases.

2.36 In respect of this, we have changed the first option in Alternative Sources of Capital to include any unsecured loan that meets all the requirements. However, as with all Alternative Sources of Capital, we will need to approve any debt facility to be used for the capital requirement. Our current expectation is that these will only be for Shareholder loans, but we will update guidance if we see significant changes in the market.

Trading arrangements and risk reduction

2.37 Some suppliers have commented on trading arrangements and risk-reducing agreements as measures of resilience, and one response questioned why these were not included in the Alternative Sources of Capital. While we accept and encourage the use of a diverse range of risk mitigation strategies, we do not think these strategies negate the need for the licensed supplier to have a capital buffer. The minimum capital requirement is the least that we expect a supplier to have if it is following other effective risk management practices, including adequate hedging and access to sufficient liquidity to post as collateral or alternative trading arrangements. The cost of necessary working capital for these and other uses is accounted for within the price cap. As discussed in the current EBIT consultation, Ofgem are looking to ensure that suppliers are able to earn a reasonable profit and be able to have the working capital they need but this is outside of the scope of the minimum capital requirement.

Parent Company Guarantees to third parties

2.38 Parent Company Guarantees made to third parties, such as a guarantee on wholesale trading, are also not included in the list of Alternative Sources of Capital. While these do meet some aspects of the policy objectives, they do not fully meet our criteria and, as these types of agreements are between two unlicensed third parties, these would be difficult to monitor and enforce. One of the main aims of this policy is to build the capital base of a licensed supplier, to allow this capital to absorb losses when required in a stress situation or insolvency. We accept that guarantees to third parties could reduce potential mutualisation costs in the event of an insolvency by removing a creditor from the administration process, however it does not provide unconditional funding in a stress event, which is one of the criteria for these Alternative Source of Capital.

2.39 In selecting Alternative Sources of Capital, we want to ensure these are sufficiently close to equity capital that is available for use. We think that any guarantees should be made to the licensed entity themselves who are then able to call upon this in a stress event, to enable to them to use the funds as required. This allows proper oversight and business planning from the firm and ensures that the funds can be used where required, which may be different from where a specific guarantee such as a guarantee to a wholesale trading partner may cover.

2.40 We do not discount the potential risk mitigation of these types of guarantees and encourage the continued use of risk-reducing agreements, however for them to count as part of a suppliers' capital they need to increase the capital base of the supplier and be available for any use, at any time.

Hybrid debt

2.41 One respondent suggested we should consider hybrid debt as equity capital. While hybrid debt can increase equity, the ability to convert into equity is conditional and uncertain. The triggers for the conversion introduce an element of complexity as to the instruments form and treatment which means it will be difficult to determine whether it is truly loss-absorbing and guaranteed to provide a buffer in times of stress, therefore we are not minded to include this as an Alternative Source of Capital.

Competition concerns around acceptable instruments

2.42 While we acknowledge the competition concerns of allowing suppliers with Investment Grade parent or group entities to use alternative sources of capital which are not available to all suppliers in the market, we do not think that it is in the consumer interest overall to exclude them. There are a variety of different business models, sizes, and structures in the marketplace, all with individual challenges and advantages. Preventing a supplier from using lower-cost credit that meets our requirements does not promote competition in the consumers' interest; we will not exclude arrangements, such as these, that reduce costs for consumers (provided that they do not unduly increase consumer risk), even if not all suppliers can use them.

2.43 We do not agree with the responses that Parent Company Guarantees are 'cost-free' as these add a contingent liability to the parent and we would expect this contingent liability to be clear and available information, including as part of our assessment of such Guarantees for acceptance as eligible sources. These instruments need to be of a specified, contractual, value, ensuring both the parent and the supplier's ability to plan, and we will consider the size of the guarantee, and the source, when considering applications for Alternative Sources of Capital.

2.44 As a general point of principle, we do not think that competitive advantage arising from financial strength is a problem in itself, and therefore allowing access to a lower-cost debt facility does not conflict with our duty to promote competition in the market, especially as there are acceptable debt facilities available to all suppliers.

2.45 There is a debt instrument that does not require an investment grade rated parent or group: unsecured loans. In recognition of the reduced availability of credit to these suppliers, we have altered this definition in the licence to potentially allow in the future for other forms of loans, rather than just those from shareholders. While this line of credit may be higher cost, it is available and is held in equal stead for the capital requirement with the guarantees and work capital facilities and ensure that some form of Alternative Source of Capital is possible for all suppliers to get approved.

<u>Alternative Sources of Capital approval and monitoring process</u>

2.46 In order to use Alternative Sources of Capital, the supplier must formally notify Ofgem in writing no later than 8 weeks ahead of 31 March 2025, and thereafter 8 weeks before any addition of or amendment to any Alternative Sources of Capital that are used. In the case of new entrants, this notification must be 28 days prior to the granting of the gas/electricity supply licence. Ofgem will respond to the notification of this new or amended Alternative Source of Capital to approve, reject, or request more information.

2.47 The supplier must provide evidence of these agreements and show how these meet the requirements for Alternative Sources of Capital. This includes: (i) documentation of the instrument; (ii) an explanation as to how it meets the requirements (unconditional with no drawstop or early repayment conditions, unsecured, has at least 12-month tenor remaining, and if required that it comes from an investment grade parent or group company), with additional evidence if required (such as proof of credit rating); (iii) a highlight of any key clauses for our attention.

2.48 As part of the required Annual Adequacy Self-Assessment for the EFRP, details of the current Alternative Sources of Capital, as well as any a supplier is planning to use over the next 12 months, should be included. Evidence that this facility continues to meet the requirements will be required.

2.49 A monthly statement is required from the suppliers to confirm that the approved instrument has at least 12 months remaining and would be submitted as part of the RFI process.

2.50 If any changes occur to the approved Alternative Sources of Capital, it is a new requirement under the minimum capital requirement that the licensee must notify Ofgem in writing as soon as reasonably practicable (but no later than 7 days). If the change would impact the ability for it to meet the criteria, such as if the credit rating of the guarantee or lending party is reduced below the accepted Investment Grade rating, during the length of the contract, this funding source can no longer be used for Alternative Sources of Capital. If these changed terms put the supplier below the Floor or Target, the supplier must notify Ofgem about this also.

Accounting standards

Consultation responses

2.51 Respondents mostly agreed that differences between the most common accounting standards were minor and would not materially impact net asset calculation or reporting. All respondents who commented on this issue agreed that Ofgem should allow suppliers to use their own accounting standards, though some asked for clarity on how certain accounting practices will be treated by Ofgem, relating to such practices as: cash sweeping, hedge accounting, intra-company loans, and alternative shareholder funding.

Our decision

2.52 We will not be mandating any specific accounting standard for the preparation of accounts, or the meeting of the capital adequacy target, but the accounting standard for the preparation of statutory account must be consistent with the calculation of the Adjusted Net Assets to meet the capital adequacy requirements. Feedback from the consultation on this question agreed with this position: the minor differences between standards are immaterial, and requirement to use a specific standard is unnecessary.

2.53 We understand that suppliers' accounting standards are different, and some suppliers have limited accounting resources, but, overall, suppliers' valuations of their Net Assets and Adjusted Net Assets should be fair and credible. If a licensee's accounting practice has the effect of inflating its Net Asset position, it is possible for Ofgem to require them to hold more capital under the EFRP. Our expectation is that reporting in between statutory accounting periods should be consistent with the statutory accounts and, if not, then a clear reconciliation is provided back to the statutory accounts. Any reporting of accounts detailing suppliers' valuations of their Net Assets and Adjusted Net Assets position should be signed off by the company's chief financial officer and / or a company director.

3. Compliance Framework

Section summary

In this chapter we summarise our decision to proceed with the Capital Floor, Capital Target, and Intermediate Position compliance framework broadly as consulted on, but provide further detail on how we will make our assessments of Plans. We are proceeding with these proposals taking effect from 31 March 2025. From this date, licensees must be above the Floor at all times but can be below the Target temporarily but must have a credible Capitalisation Plan in place. Until licensees have a credible Capitalisation Plan approved, they are subject to default Transition Controls.

Capital Floor, Capital Target, the Intermediate Position and Transition Controls

What we consulted on

3.1 We proposed setting a Capital Floor and a Capital Target from 31 March 2025. We proposed that the Capital Floor would be the equivalent of £0 Adjusted Net Assets per domestic dual fuel customer equivalent and the Capital Target would be the equivalent of £130 per domestic dual fuel customer equivalent (i.e., £65 per Domestic Electricity Customer and £65 per Domestic Gas Customer). See earlier chapters for more information on the level of the Capital Floor and Target.

3.2 We proposed that suppliers must maintain the Capital Floor at all times and those that are below the Floor would be in breach of their licence conditions and could be subject to enforcement action.

3.3 We proposed that suppliers that are below the Target but above the Floor are in the Intermediate Position and will be subject to default Transition Controls until they have submitted a credible Capitalisation Plan. We proposed that these Transition Controls were:

a) Sales ban; and

b) Ban on non-essential payments

3.4 Once a Capitalisation Plan has been agreed we proposed that the default Transition Controls no longer apply but that most credible Plans would include at least some aspect of the Transition Controls, such as a commitment not to pay dividends. We also proposed that suppliers in the Intermediate Position could also be subject to CCB ringfencing, but it was not proposed to be an automatic Transition Control.

Summary of Responses

3.5 Concerns were raised relating to the Transition Controls. Some stakeholders were concerned that these (and the sales ban in particular) may in fact make it more difficult for a supplier to reach the Target, thus reducing resilience and potentially leading to supplier failure. However, others were supportive of the Transition Controls and felt they should be in place at all times until a supplier has met the Capital Target.

3.6 A number of responses related to concerns about the administrative burden for suppliers which 'dipped' into the Intermediate Position frequently due to market fluctuations requiring several Capitalisation Plans. One supplier suggested a deadband to address this issue.

3.7 Stakeholders also made reference to new entrants and the standards to which they should be held, with some calling for a higher Capital Floor and Capital Target and enhanced monitoring.

Our Decision

3.8 We are proceeding with introducing a Capital Floor and Capital Target, further details of which are set out in earlier sections of this decision. Alongside these, we are introducing the Intermediate Position compliance framework as proposed.

3.9 Suppliers must be above the Capital Floor at all times. We maintain that being below the Floor will amount to a breach of the licence condition and suppliers could be subject to enforcement action.

3.10 We expect that suppliers should seek to be above the Capital Target at all times. However, we recognise that there will be different pathways to meeting this Target at first and, once in place, it will also act as a buffer to absorb losses in times of stress. To allow for these circumstances, it is not a breach of the licence condition for suppliers to be below the Target. However, suppliers below the Target but above the Floor will be in the Intermediate Position and will be subject to default Transition Controls until they have a credible Capitalisation Plan in place. We have clarified in the licence modifications that suppliers must submit a Capitalisation Plan for our consideration as soon as reasonably practicable.

3.11 Some suppliers queried whether a Capitalisation Plan would be required every time a supplier was in the Intermediate Position, as there may be frequent fluctuations in and out of the Intermediate Position in times of stress. One supplier suggested the use of a deadband to allow for a buffer for temporary movements before Transition Controls were applied.

3.12 We have considered possible scenarios that may result in frequent fluctuations in supplier finances and whether that merited a change in process. We did not receive compelling evidence that this issue would result in an unnecessary burden, for instance these fluctuations occurring frequently enough under circumstances that did not warrant a Plan. Instead, suppliers may take account of these fluctuations in their Capitalisation Plan, which may reduce the need for multiple Plans/substantive changes of Plans.

3.13 Likewise, we do not plan to introduce a deadband for the Target. This would introduce further complexity and uncertainty into the process and may effectively result in a reduction of the Target, without clear evidence that this would be justified in practice. Suppliers that are concerned about frequent fluctuations may wish to create their own tolerance levels or set up additional internal monitoring to minimise possible administrative burden.

3.14 In line with the culture shift initiated through our enhancements to the FRP, we expect suppliers to take a responsible and proactive approach to managing and reporting risk. Suppliers are required to notify Ofgem within seven days once they have become aware that they are below the Capital Floor or Capital Target, or have identified that there is a Material risk they will be below the Floor or Target. Alongside this proactive reporting, we will monitor compliance using information submitted to Ofgem, such as the Monthly RFI and Quarterly Stress Test RFI. Suppliers must also set out how they plan to meet the Capital Target and Floor in their Annual Adequacy Self-Assessment.

Transition controls

3.15 We are proceeding with introducing the Transition Controls as consulted upon. We believe that the Transition Controls act to support the aim of recapitalisation, incentivise suppliers to be above the Target, and to submit a credible Capitalisation Plan in a timely manner. The default Transition Controls that we propose a supplier will be subject to until they submit a credible Capitalisation Plan are as follows:

- sales ban; and
- ban on non-essential payments.

3.16 We do not expect that paying dividends or making other non-essential payments is in the Consumer Interest while a supplier is below the Capital Target as capital flowing out of the business demonstrably makes it harder to meet the Target.

3.17 We appreciate that the situation is more nuanced for the sales ban because there could plausibly be scenarios in which shareholder investment that would meet the Capital Target may be based on maintaining a particular market share appropriate for the scale of fixed costs, and in a market with switching this would require some new customers. However, in general we think that there will be limited scenarios in which net customer acquisition could benefit capitalisation, in part because the Target is set on a per customer basis. Put simply, if a supplier is below the Target but gaining customers then all else equal it will be moving further away from the Target.

3.18 Balancing these considerations, we propose to continue applying these restrictions as default Transition Controls, but they will cease to apply automatically when a credible Capitalisation Plan has been agreed. This allows suppliers to demonstrate the level of acquisition consistent with their plans to recapitalise, if that is the case. Where suppliers have particular concerns about the automatic nature of these controls, it is within their gift to submit and agree Plans early which may avoid them being subject to controls. It remains our view that most credible Capitalisation Plans will include some restrictions on payments and growth, albeit not necessarily as strict as the Transition Controls, for the reasons set out above.

SoLR

3.19 One supplier asked for clarification on how the policy will apply to SoLRs, particularly whether the sales ban Transition Control would apply. We do not consider that additional conditions are required to how the Capital Floor and the Capital Target apply to SoLRs. Before entering into the SoLR competition process we would expect a supplier to have considered their capitalisation position in relation to the number of additional customers that could feasibly be absorbed as a SoLR. Further, in line with our usual SoLR processes we will consider a supplier’s financial position when deciding who to direct as the SoLR supplier. However, in the event that a successful SoLR application will result in the supplier being below the Capital Target, the supplier will be expected to provided details of its re-capitalisation plan and pathway back to compliance in the normal way.

New entrants

3.20 One supplier asked for clarification on how the policy will apply to new entrants. We can confirm that the minimum capital requirement policy applies to new entrants in the same timeframe as existing suppliers, coming into effect from 31 March 2025. However, in the licence application process new market entrants must already demonstrate how their business will be financed in accordance with their growth forecasts. As such, we expect all prospective new entrants to demonstrate that they are adequately capitalised from the outset. We would expect, therefore, that they will have robust and evidenced plans to have adequate capital for their planned size and customer growth trajectory.

Capitalisation Plan

What we consulted on

3.21 In the April consultation we proposed that where suppliers were below the Capital Target, they would be required to submit a credible Capitalisation Plan with Quarterly Progress Milestones, that sets out how they plan to achieve the Capital Target and over what timeframe. Each Plan would vary according to the supplier's specific circumstances, but the proposed licence condition set out what the Capitalisation Plan must include at a minimum in order to satisfy us that there is a credible trajectory to meeting the Capital Target.

3.22 We recognised that there might be circumstances that could require amendments to the Capitalisation Plan, for example significant government policy changes, economic downturns, sector specific developments, and significant changes in the supplier's business structure or ownership. We set out the process for amending a Plan in SLC 4B.21 and 4B.22 for suppliers and Ofgem respectively.

Summary of Responses

3.23 From the responses it was clear that suppliers wanted more visibility, clarification and reassurance on the Capitalisation Plan process and how this would work in practice. There were also requests for more guidance on what constitutes a 'credible plan' and the associated timelines.

3.24 Whilst stakeholders mainly agreed with the concept of the Capitalisation Plan, a significant number were concerned that the requirements may not be applied consistently across suppliers, with some suggesting that we could come under pressure to accept weak plans from undercapitalised competitors.

3.25 A small number of stakeholders commented that the discretionary approach to the Capitalisation Plan may increase regulatory uncertainty and make it harder to raise capital. One stakeholder said that Ofgem cannot compel capital investment and it needs to make the sector investable first. Two stakeholders were concerned that a standard completion time scale had not been proposed, and this raised the risk that licensees may plan for longer time scales than needed for a return to Compliance.

3.26 One stakeholder challenged that the Capitalisation Plan process is damaging to competition and undermines the independent supplier model which in turn would reduce innovation in the sector and hamper the drive to net zero.

3.27 A small number of stakeholders questioned Ofgem's appetite for enforcement, stating that the Capitalisation Plans will only be worthwhile if they are accurately followed and enforcement is enacted when necessary.

Our Decision

3.28 We are proceeding with the Capitalisation Plan broadly as we consulted but we are providing additional information on how we will make decisions relating to the Plans and providing further Guidance on the process. The Capitalisation Plan is key to the compliance framework, as it will allow us to hold suppliers to account for achieving the Target while providing appropriate flexibility for different business models.

3.29 Some suppliers felt that this supplier specific approach could result in some suppliers gaining a competitive advantage by being permanently below the Target and suggested we set deadlines for completion. We expect that being below the Target is temporary and the Capitalisation Plan must set out a credible plan to achieve the Target in the shortest reasonable time achievable for that supplier. We would expect to see evidence that the supplier has considered all options and why the preferred option is the shortest reasonable.

3.30 We do not think setting market-wide deadlines is consistent with our policy objective for the Capitalisation Plans to be proportionate and take into account business-specific factors and the state of the market at that time. We think that the default Transition Controls and Quarterly Progress Milestones provide sufficient incentive to ensure suppliers do not stay in the Intermediate Position indefinitely. If a supplier does not adhere to its Quarterly Progress Milestones we can take enforcement action if we think it is in the consumer interest to do so.

Expectations of what constitutes a credible Capitalisation Plan

3.31 Some suppliers were concerned that the level of flexibility and discretion within the Capitalisation Plan process would increase regulatory risk if we were to act in an unpredictable or harsh manner. In this decision, we are seeking to provide further clarity in response to these concerns. We are issuing further Guidance on the features we consider to be part of a credible Capitalisation Plan, the key elements of which are set out below. We also propose to hold a workshop to give suppliers an opportunity to ask detailed questions on how the process will work in practice.

3.32 All Capitalisation Plans will be assessed by considering the specific business model of the supplier, wider market conditions and the consumer interest. A credible Plan will be evidence-based and include SMART metrics such that progress can be robustly evaluated at each Quarterly Progress Milestone. Any breaches of the Quarterly Progress Milestones would be a breach of the licence condition and allow Ofgem to take enforcement action. Monthly RFI data will be used to track suppliers' compliance and progress throughout the year, working towards these Quarterly Progress Milestones. Ofgem will assess credibility of projections against peers in the market and look sceptically towards optimistic outliers.

3.33 We further expect the licensee to evidence and demonstrate that they have established robust governance to provide assurance on the development and delivery of the Plan, with a senior responsible owner who is accountable for this. We have the power to request an independent audit[9] if supplier governance is weak or its Capitalisation Plan needs additional assurance.

3.34 In line with our April consultation, we continue to see circumstances outside a supplier's control when amendments to the Capitalisation Plan may be required – for example there has been a significant economic or market development, or a significant change in government policy. We are willing to consider representations to amend Plans, as per the process set out in SLC 4B.21 and

[9] SLC 5B of the gas and electricity supply licences.

4B.22 for suppliers and Ofgem respectively. However, we do not expect that Plans should be continually reopened, as we think that doing so would undermine the credibility of the Plan.

Governance

3.35 We also see benefits in providing further transparency on the internal processes we intend to follow when assessing Capitalisation Plans and progress against these. To provide further confidence in the robustness of these decisions and clarity on how stakeholders can interact with these processes, we have set out below, in Figure 4, a summary of the Intermediate Position process.

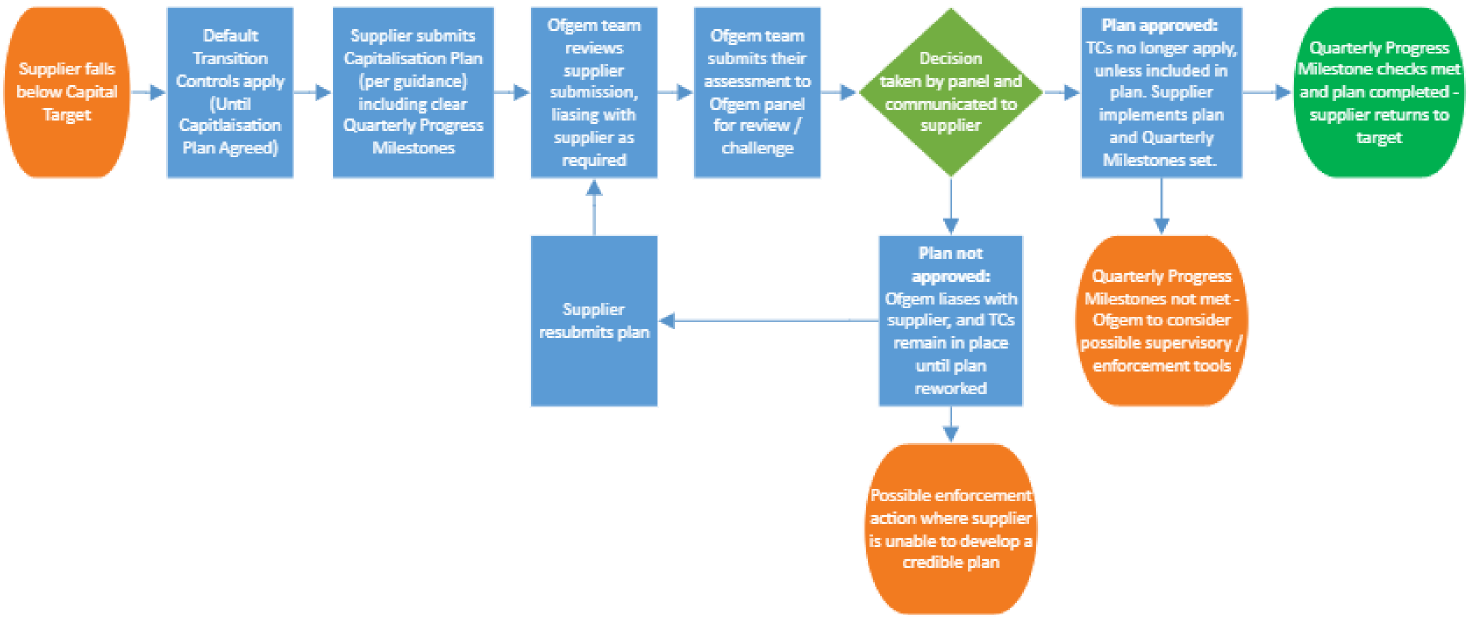

Figure 4: Summary of the Intermediate Position process

Figure 5: Accessible version of Intermediate Process diagram

1. Supplier falls below Capital Target
2. Default Transition Controls apply (Until Capitalisation Plan Agreed)
3. Supplier submits Capitalisation Plan (per guidance) including clear Quarterly Progress Milestones
4. Ofgem team review supplier submission, liaising with supplier as required
5. Decision taken by panel and communicated to supplier.
    a. **If a plan is not approved**:
    Ofgem liaises with supplier, and TCs remain in place until plan reworked.
        i. Possible enforcement action where supplier is unable to develop a credible plan. or
        ii. Supplier resubmits plan. Return to Step 4.
    b. **If plan is approved:**
    TCs no longer apply, unless included in plan. Supplier implements plan and Quarterly Milestones set.
        i. Quarterly Progress Milestones not met – Ofgem to consider possible supervisory/ enforcement tools. Or
        ii. Quarterly Progress Milestone checks met and plan completed – supplier returns to target.

3.36 Assessments will be undertaken by a supervisory team and reviewed via a panel process. Assessment panels will be made up of key senior staff across a range of disciplines with the appropriate skill levels to make complex financial judgements, including economists and finance specialists, policy experts and legal advisors. Assessment panels will draw on supplier data, market metrics and wider macro-economic intelligence when making their decisions. The panel structure will align to the Ofgem Delegation Framework, with escalation to senior executive level where appropriate.

3.37 Where a supplier is in breach of the licence, Ofgem can take enforcement action. As with all enforcement decisions, any decision to enforce will be made in line with Ofgem's Enforcement Guidelines and by reference to our statutory duties.

Timing of implementation

What we consulted on

3.38 In our April consultation we proposed that the minimum capital requirement will take effect from 31 March 2025. We considered this a reasonable transitional period, taking into account the impact of volatile market conditions on raising finance, and our desire to implement a trajectory that resulted in improved resilience at the most efficient cost to customers. Before this date we would monitor suppliers' capitalisation through our regular monitoring but also through the Annual Adequacy Self-Assessment (Self-Assessment), which has been introduced as part of our reforms to the enhanced Financial Responsibility Principle. We proposed that as part of this first Self-Assessment, suppliers would 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.

Summary of Responses

3.39 There were mixed responses to the proposed implementation date, though six respondents did not comment on the date specifically. Three stakeholders supported the implementation date. A number of stakeholders wanted to go further than the proposed 2025 date with four stakeholders suggesting an earlier start, one from 2024, two as soon as possible, and a final one treating the 2025 date as a backstop. Conversely, two suppliers suggested that 2025 was too early a start date and did not provide sufficient time for suppliers to build up the capital required following the crises of the previous years. Another respondent suggested that there should be eight contiguous price cap periods (the equivalent of two years) prior to implementation, again to allow for sufficient capital to be built up.

Our Decision

3.40 We are proceeding with the introduction of the Capital Floor and Capital Target on 31 March 2025, with the first Annual Adequacy Self-Assessment setting out how suppliers plan to meet the Capital Floor and the Capital Target by this date.

3.41 We remain of the view that a transition period is reasonable given recent challenges in the sector and the feedback that we received in the consultation. Near-term market conditions appear to be improving somewhat due to recent falling prices and government energy support schemes. However, several suppliers are under-capitalised having weathered the recent market shocks. Furthermore, introducing a capital adequacy regime is a significant regulatory and structural change and, looking to the introduction of capital requirements in other sectors, it is entirely reasonable to provide sufficient time for capitalisation.

3.42 We want to realise the consumer benefits of increased resilience as soon as possible but this must be balanced with the ability of suppliers to raise the requisite capital to meet the requirement. We think it is in the consumer interest to take a pragmatic approach to the pace of introducing the common minimum capital requirement, which means not setting a time horizon for implementation or approach to compliance that many market participants cannot meet.

3.43 It is important, however, that during this transition we see less well capitalised suppliers on a clear trajectory to increasing their capital base, timetabling the moving of existing funding arrangements to meet our Alternative Sources of Capital criteria and that Ofgem has sufficient assurances that suppliers are making progress.

4. Customer Credit Balances (CCBs)

Section summary

In this chapter we summarise what we consulted on in April in relation to CCB ringfencing, stakeholder feedback and what we have decided to implement. We have decided to proceed with directing suppliers to ringfence CCBs when they are below the Capital Target and/or the Cash Coverage Trigger. We have also decided to proceed with ringfencing CCBs at an Adjustment Percentage that is in the Consumer Interest overall.

Trigger framework

What we consulted on

4.1 We proposed an approach which would allow us to monitor levels of resilience and over reliance on CCBs and respond as needed. We expected that our Strengthening Financial Resilience policies would result in an overall improvement in supplier resilience and, as part of this package, we proposed that CCB ringfencing should be an option in circumstances when suppliers are not meeting the Capital Target, to address concerns about reliance on CCBs as a source of working capital. In addition, we had identified a further trigger, the Cash Coverage Trigger, which would see suppliers maintaining monthly cash balances at a level equal to or greater than 20% of gross CCBs net of unbilled consumption owed to their fixed Direct Debit customers. This would allow us to identify unsustainable business practices early and ensure that a minimum level of liquidity relative to credit balances is retained by all suppliers. We also proposed modifying licenses to allow us to direct CCB ringfencing where there is a Material risk that, within the next 12-month period, the licensee will be below either or both of the triggers.

Summary of responses

4.2 A number of stakeholders raised concerns about the impact of the CCB threshold triggers on the ability to build capital or deliver against a Capitalisation Plan (required where the licensee is below the Capital Target). These stakeholders wanted confirmation that there would be no unintended consequences relating to the capitalisation of suppliers as a result of having to meet the triggers.

4.3 Support for the triggers was mixed with individual suppliers responding with differing views. Three stakeholders expressed support for the Cash Coverage trigger, while only one explicitly expressed a strong disagreement towards the Cash Coverage trigger due to what they perceived as a too high cash coverage to be held, at 20%.

4.4 Other stakeholders expressed disagreement with the Capital Target trigger, with one asking for it to be brought in after the price cap operating allowance has been reviewed. Another questioned whether that the Capital Target trigger implies that the supplier has sources of capital not counted in the Capital Target.

4.5 A final stakeholder disagreed with both triggers as it felt that any supplier who had weathered the turbulent market over the course of the last couple of years had already proven itself to be a resilient supplier.

Our Decision

4.6 We are proceeding modifying the licence so that Ofgem can direct CCB ringfencing under certain circumstances, if a supplier is below either the Capital Target or the Cash Coverage trigger level. We do not agree that the triggers will have the effect of making it harder for licensees to meet the Capital Target nor that only one trigger is necessary. The triggers are designed to alert us to possible over-reliance on CCBs, which may be indicated either by insufficient capital (as measured by the Capital Target) or insufficient liquidity (as measured by the Cash Coverage trigger).

Capital Target trigger

4.7 We are proceeding with the Capital Target as a trigger for CCB ringfencing. Our policy aim is to make sure suppliers are sufficiently capitalised and are not overly reliant on CCBs for capital. Suppliers with capital below the Target are likely to be insufficiently capitalised and therefore overly reliant on CCBs. Where a supplier is below the Capital Target we will consider whether to direct a licensee to ringfence some or all of its CCBs.

Cash Coverage trigger

4.8 We are proceeding with the Cash Coverage trigger for CCB ringfencing (though we have explained in guidance that we do not consider that certain cash pooling arrangements would cause a supplier to hit this trigger). This trigger requires the licensee to maintain monthly balances of cash in the bank at a level equal to or greater than 20% of gross CCBs net of unbilled consumption owed to their fixed Direct Debit customers.

4.9 We expect suppliers to maintain liquidity at an appropriate level and introducing this trigger provides us with an indicator of where this may not be the case. One respondent suggested that our framework should include a liquidity measure to ensure suppliers were sufficiently resilient to shocks. We consider that the Cash Coverage trigger is a proxy for the liquidity of a supplier, and so see its introduction as an important part of the overall framework.

4.10 In determining the level, we are following the approach outlined in April. Then, we explained that there are at least two distinct possible calls on supplier cash balances related to the refund of CCBs:

1) When a customer switches to a new supplier, the incumbent supplier must refund credit balances to the customer who is leaving.
2) Suppliers must refund any credit balance in a timely manner to a domestic customer upon request by the customer 'save where it is fair and reasonable in all circumstances for the licensee not to do so', pursuant to current SLC 27.16.

4.11 In terms of switching,[10] over the course of 2017 to 2021 the average yearly percent of gas and electric customers switching suppliers was 18%, from 2010 to 2021 this figure was 15%. Of the customers that do not switch, we expect suppliers to be sufficiently resourced to refund credit balances on request, requiring an additional buffer above this potential switching level. Hence, we think there is a reasonable case for suppliers being prepared to refund at least 20% of gross CCBs net of unbilled consumption at all times through appropriate cash coverage.

4.12 We believe that setting the cash coverage level at 20% strikes the right balance between ensuring that suppliers are able to settle CCB refund requests sustainably whilst recognising the impact of "inactive" capital that could be more effectively deployed. Noting the analogies in some other industries (e.g., travel, durable consumer goods), we are of the view that it is in consumers' interests overall for suppliers to not be prohibited from using some CCBs as part of working capital, providing there are strong protections in place to avoid excessive

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[10] Quarterly domestic energy switching statistics - GOV.UK (www.gov.uk)

accrual and excessive risk taking. We expect suppliers to do so responsibly and our wider framework for financial resilience, including the minimum capital requirement, rules on calculating direct debits, the enhanced FRP, and directing CCB ringfencing act together to ensure that suppliers are not over reliant on CCBs and taking excessive risk.

4.13 We expect the licensee to record daily cash levels and provide an average across the month, as well as providing a month end balance. These data points will be requested as part of our regular reporting.

Cash alternatives

4.14 We are aware that some suppliers "pool" cash within their group. We would not expect a supplier utilising financially responsible cash pooling practices with their parent group / company, for example by providing an overnight maturity loan or overnight cash sweeping, to breach the Cash Coverage Trigger.

Trigger implementation timing

What we consulted on

4.15 We proposed that the Cash Coverage trigger would take effect at the same time as the CCB ringfencing policy (56 days after the date of our decision). The Capital Target Trigger would, we proposed, take effect when the Capital Target requirements become effective on 31 March 2025.

Summary of responses

4.16 There was broad agreement for introducing the Cash Coverage trigger straight away and the Capital Target trigger in line with the Capital Target implementation date of March 2025.

Our Decision

4.17 We are proceeding with the trigger implementation timetable as we proposed. The Cash Coverage trigger will be implemented when the licence changes take effect, and the Capital Target trigger will be implemented from 31 March 2025 in line with the broader Capital Target requirements.

Directing an Adjustment Percentage

What we consulted on

4.18 If the supplier is below either of the CCB triggers, we proposed that the Authority would direct CCB ringfencing unless it would not be in the Consumer Interest to do so. We proposed that we would notify the licensee that we were minded to issue a CCB ringfencing direction and allow seven working days for the licensee to make representations as to whether or not ringfencing was in the Consumer Interest.

4.19 We proposed that, where we make a ringfencing direction, we would direct an Adjustment Percentage (the proportion of CCBs to be ringfenced) of 100% unless in our review of Supervisory Financial Monitoring data / other information sources we considered that directing CCB ringfencing at that level would have a Material adverse effect on the licensee's ability to finance its activities. In that case, we proposed that we would instead direct ringfencing at an Adjustment Percentage which would ensure that the supplier had sufficient Working Capital to make essential payments.

Summary of responses

4.20 Some stakeholders requested clarity on the Adjustment Percentage process and how it would work within the Consumer Interest framework. A couple of stakeholders felt that they needed additional information to draw conclusions about the approach Ofgem have chosen to take.

4.21 One stakeholder expressed concerns that Ofgem may require a supplier to ringfence a level equivalent to greater than 100% of CCBs.

Our Decision

4.22 We are proceeding with our proposals on setting the Adjustment Percentage as we proposed but we are clarifying our considerations as part of this decision.

4.23 Where a licensee is below the Capital Target and/or the Cash Coverage Trigger, or is forecast to be below the Cash Coverage Trigger and/or the Capital Target in the next 12 months we may direct them to ringfence a percentage of CCBs, subject to certain considerations (see paragraph 4.24-4.26 for these considerations). We plan to set this level at 100% unless directing the supplier to ringfence this proportion of its CCBs would be contrary to the Consumer Interest, in which case we may direct an Adjustment Percentage of less than 100%.

4.24 We have decided to clarify our intent to assess the Adjustment Percentage with reference to the Consumer Interest rather than just with reference to the impact the Adjustment Percentage would have on the supplier's ability to finance its business and make essential payments. This is to bring this aspect of our decision in line with our considerations when deciding whether to issue a ringfencing direction.

4.25 The supplier's ability to finance its business and make essential payments would still form part of our considerations within the Consumer Interest test but applying this as a standard allows us to consider wider factors (such as competition, innovation and the level of customer service in the market – i.e., Fair Prices, Resilience, Quality and Standards, and Low-Cost Transition to Net Zero in the Consumer Interest Framework) in determining the appropriate Adjustment Percentage. In applying this test, we will generally analyse the circumstances of the trigger event, the overall resilience picture and will request any additional data needed to inform a decision to direct. We will also consider any representations received from the supplier. If the licensee is in a position where mutualisation is likely and the supplier is close to the zone of insolvency, we recognise that ringfencing may not be feasible. In these circumstances, and where there has been a breach of the licence, we will consider appropriate enforcement action.

4.26 The effectiveness of this policy depends partly on early identification of CCB over-reliance. The licensee has a requirement to self-report where they have identified that they have fallen below the Capital Target or are below the Cash Coverage trigger (self-reporting on this element was not, in error, included in the SLCs consulted upon and we have therefore amended the licence modifications to include this obligation so that it is in line with Capital Target reporting). Suppliers must also submit an Annual Adequacy Self-Assessment as required under the enhanced FRP, which should set out how they will meet the Capital Target and the Cash Coverage trigger. Finally, our monitoring regime of monthly and quarterly RFIs, together with forecasted data, will show the position of the licensee over the next 12 months.

Consumer Interest representation

What we consulted on

4.27 We said we would consider the Consumer Interest carefully before directing CCB ringfencing. Where we do not receive representations, or we do not agree that ringfencing CCBs would be detrimental to the Consumer Interest, we may issue a direction to ringfence CCBs.

4.28 Consumer Interest is the likely impact of any ringfencing on Resilience, Prices, Quality and Standards, and the Low-Cost Transition to Net Zero.

- Resilience considers the impact of any adjustment on the proportion of the market at risk of failure and the likely Mutualised cost that would result.
- Fair Prices means the impact of any adjustment on charges for the supply of electricity and / or gas.
- Quality and Standards relates to the impact of any adjustment on the level of competition, innovation, and customer service in the market.
- Low-Cost Transition to Net Zero considers the impact of any adjustment on the ability of licence holders to progress towards an energy system which relies on renewable zero-emission sources and facilitates the use of zero-emission technologies.

Summary of responses

4.29 There was broad agreement across stakeholders in response to the consumer interest representation. However, a small number of stakeholders did ask for further clarity on the criteria of the consumer interest assessment.

Our Decision

4.30 We are proceeding with Consumer Interest representation as we proposed. When issued with a notice of our intent to direct CCB ringfencing, the licensee will have the opportunity to submit a representation where they consider that ringfencing or the proposed Adjustment Percentage would not be in the Consumer Interest. The licensee will have at least seven days after receiving notice of our intent to issue a direction to submit their representations. In defining Consumer Interest, we are aligning with the wider Ofgem Consumer Interest Framework- details in Figure 5 below.

4.31 When considering whether CCB ringfencing and the appropriate Adjustment Percentage is in the Consumer Interest we recognise that a one size fits all approach would not be effective. There will be a number of variables to consider, including the financial position of the licensee, the risks to the wider market, the competitive environment and impact on the products, services and prices provided to customers.

Figure 6: Within this policy, consumer interest means:

	Interpretation for policy	Ofgem CI Framework	Ofgem CI Sub objectives
Resilience	The impact of any adjustment on the proportion of the market at risk of failure and the likely Mutualised cost that would result.	Consumers have secure supply and trust that industry Participants are resilient to market shocks. The sector attracts sufficient long-term investment to deliver consumer interests	Maintain security of supply. Robustness to market developments and external shocks. Ensure sector is investable.
Fair Prices	The impact of any adjustment on charges for the supply of electricity and / or gas.	Costs are efficient and fairly distributed. Undue price discrimination is prevented and action to minimise consumer welfare risks (e.g. fuel poverty and self disconnection) is supported.	Prevent excessive profits. Achieve cost efficiency. Protect consumer welfare.
Quality and Standards	The impact of any adjustment on the level of competition, innovation, and customer service in the market.	Customer services throughout energy supply chain are accessible, transparent and responsive. Consumers are suitably empowered and protected from harm, with enhanced protections for the vulnerable.	Accessible & responsive. Transparent & enables choice. Enhanced protections for the vulnerable.
Low-Cost Transition to Net Zero	The impact of any adjustment on the ability of licence holders to progress towards an energy system which relies on renewable zero-emission sources and facilitates the use of zero-emission technologies.	Sustainable, carbon-free energy and associated infrastructure at least cost to consumers (and taxpayers). Consumers are supported to make greener choices and are fairly rewarded for their contributions to the system	Enable infrastructure & markets required for net zero transition. Minimises net cost of transition. Apply innovative solutions to support & protect consumers

4.32 The efficacy of CCB ringfencing by direction will therefore depend on the circumstances, which we will consider through this framework. For example, where a supplier holds excessive CCBs but believes that it has sufficient access to funds, we may consider it in the consumer interest to protect some of these CCBs. Conversely, where a supplier has very limited liquidity and ringfencing CCBs may precipitate failure, we may decide that it is not in the consumer interest to do so.

Frequency of calculation

What we consulted on

4.33 To reduce the risk of over or under calculation in cases where a direction to ringfence CCBs is issued, we proposed a monthly reporting cycle using actual data to keep the levels of protection close to the amount of CCBs held and minimise the risk of forecasting errors.

Summary of responses

4.34 One stakeholder did question the frequency of CCB monitoring in particular, stating that it is excessive given seasonal fluctuations in Customer Credit Balances and debit.

Our Decision

4.35 We are proceeding with the frequency of calculation as we proposed and therefore will continue to proceed with a monthly calculation of the percentage of gross credit balance of net unbilled consumption owed to their fixed Direct Debit customers. We also plan to proceed with a reporting cycle which will reflect the expected fluctuations in credit balances across the year and therefore reduce the risk of under or over protection. We expect the licensee to record daily cash levels and provide an average across the month, as well as providing a month end balance. These data points will be required as part of the monthly RFI reporting.

Defining Customer Credit Balances

What we consulted on

4.36 While we considered a range of options for the calculation of the protected amount, we proposed basing the calculation on gross Customer Credit Balances net of unbilled consumption (of all Fixed Direct Debit customers) multiplied by the Adjustment Percentage (the percentage Protection required). This definition being both impactful on reducing mutualisation costs and effective in reducing access to CCBs as risk free working capital.

4.37 It was our view that a calculation based on gross credit balance net of unbilled consumption strikes the right balance between protecting a meaningful amount of CCBs and the costs of protection and alternatives such as only protecting net credit balances would not provide sufficient protection in the event of supplier failure.

Summary of responses

4.38 There were no objections from stakeholders to the definition of CCBs.

Our Decision

4.39 We remain of the view that gross credit balance net of unbilled consumption is the most suitable definition for prospective ringfencing arrangements. This is primarily because this approach would protect a meaningful amount of CCBs in the event of supplier failure throughout the year. It is therefore more likely to inhibit the inappropriate use of CCBs as risk-free working capital and disincentivise excessive risk-taking and poor business models. We also recognise debit balances will ordinarily be pursued by the administrator and not be recoverable by the SoLR in the event of supplier failure, which means that the net credit balance approach may not reduce CCB cost mutualisation materially when a supplier fails.

Implementation of protection mechanisms

What we consulted on and responses

4.40 On 3 March 2023, we published a series of draft Protection Mechanism templates intended to be used by suppliers to standardise the ringfencing of RO receipts and CCB balances. We published the following templates; a Standby Letter of Credit (SBLC), a First Demand Guarantee (FDG), a Declaration of Trust (Trust) and the terms for an Escrow Account (Escrow). We sought comments on these documents by 17 March 2023. The feedback received is summarised at paragraph 2.30 to 2.36 of our Decision on Strengthening Financial Resilience[11] (April Decision), with more detailed information and our decision regarding the templates insofar as they related to RO receipts detailed at paragraph 3. The table at Appendix 2 of the April Decision sets out each comment we received and our response.

Our Decision

4.41 We have published final templates for the CCB Protection Mechanisms alongside this decision.

4.42 Some of the feedback received was RO specific but where a comment related to both CCB and RO, our position remains as set out in the April Decision. As explained at paragraph 3.24 of the April Decision, we have decided to remove the option of Escrow as a protection mechanism because, as with RO, we consider that suppliers who may have opted for Escrow can protect CCBs as effectively through a Trust.

4.43 Some comments were CCB specific. For CCBs, the SBLC and FDG templates were in favour of the Authority, but the Authority had the right to assign the drawing rights to any third party. Respondents queried the scope of that right to assign and highlighted that the wording regarding assignment in the templates may be unacceptable to a range of banks as a matter of policy. In response to this feedback we have amended the SBLC and FDG templates to remove the Authority's right to assign the drawing rights. Instead, where a Supplier of Last Resort (SOLR) or special administrator is appointed in respect of a failed supplier, the Authority will issue the demand under the SBLC or FDG and will assign the proceeds to the SOLR or special administrator, and therefore, on the face of the demand, request that the issuing bank or guarantor pay the proceeds to the SOLR's or special administrator's bank account (as applicable). This mechanism will enable the SOLR or special administrator to access any ringfenced CCB funds (reducing mutualisation) but avoids templates which include an unrestricted right to assign the right to draw on the relevant SBLC or FDG.

[11] https://www.ofgem.gov.uk/sites/default/files/2023-04/Decision%20on%20Strengthening%20Financial%20Resilience.pdf

4.44 We also received feedback that, for FDGs, non-UK guarantors may be subject to different bank holidays and may have difficulty making payment with the 3 business days required in the template FDG. We explained in the April Decision that 3 business days was proposed in respect of RO to allow us to leave the demand as close as possible to the late payment deadline for RO. This is not a consideration for CCBs and the template FDG and SBLC therefore allow for 5 business days for payment.

4.45 The SBLC and FDG templates also envisage that the SBLC or FDG will renew annually unless the Beneficiary receives a Non-Extension Notice. In practice, a bank or guarantor is more likely to issue such a Non-Extension Notice where the supplier has entered, or is on the borderline of, insolvency. Therefore, where a supplier fails and has arranged for an SBLC or FDG which will shortly expire, it is important that the Authority issues a demand under that SBLC or FDG as soon as possible to avoid missing the opportunity to assign the proceeds to a SOLR or special administrator (who would be required to use the proceeds to honour the failed supplier's CCBs). Where a supplier has recently failed, the Authority may need to issue a demand before it can determine that supplier's CCB liability. In that situation, we expect that the Authority will demand the full amount protected under the SBLC or CCB and assign the proceeds to the SOLR or special administrator. The relevant SOLR or special administrator will be required to declare a trust over those proceeds such that the SOLR / special administrator only has the right to the proportion of proceeds (unless alternative arrangements are agreed with a special administrator) required to honour the failed supplier's CCB liability (once that is known). Any surplus proceeds will be held on trust for: (a) in relation to the SBLC, the applicant for the SBLC (usually the failed supplier); or (b) in relation to the FDG, the guarantor under the FDG and the failed supplier (but in the case of the failed supplier only to the extent, if any, to which the failed supplier has reimbursed the guarantor for all amounts paid by the guarantor under the FDG in response to demands made on the guarantor under that FDG by the Authority).

4.46 We have also amended the definition of Credit Event in each of the FDG and SBLC CCB templates to allow the Authority to issue a demand where a Non-extension Notice is issued. This is to give the Authority the opportunity to secure the ringfenced funds for a SOLR or special administrator to use to honour CCBs where an SBLC or FDG expires before their appointment. We have amended the terms of the licence modifications to ensure that they are line with these changes to the template Protection Mechanisms.

4.47 We have also amended the Trust to include a security power of attorney in favour of the Authority and any delegate, to give the Authority power to instruct the bank holding the Trust account to transfer the sums held to a SOLR. As above, we have amended the licence modifications to bring them in line with this change.

Termination

What we consulted on

4.48 We proposed that the obligation for CCB ringfencing under direction would continue until revoked by the Authority. A revocation notice would be issued when the Authority was satisfied that the licensee was able to meet its financial resilience obligations or when there was no longer a risk that the licensee would fail to meet the enhanced FRP requirements within the next 12-month period (as appropriate).

Summary of responses

4.49 There were no objections from stakeholders on the termination of CCB ringfencing under direction.

Our Decision

4.50 Our proposals for the termination of a ringfencing direction remain the same with an obligation to continue to ringfence according to the direction issued until revoked by the Authority following a return to a position above the trigger thresholds.