CORNWALL INSIGHT

CREATING CLARITY

Money Right? Capital requirements, stability and competition in the domestic supply

October 2024

Giles McNaught

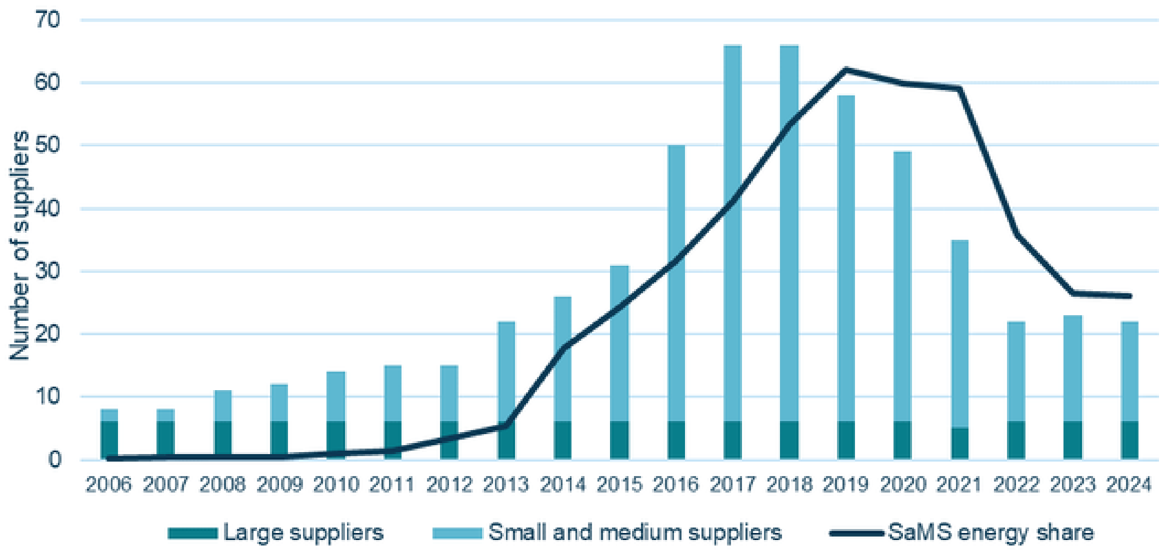
Part of Thought Leadership

Money Right? Capital requirements, stability and competition in the domestic supply market

With wholesale energy prices returning to comparative stability, one final financial stability measure in the domestic supply market is still to come into force: the Minimum Capital Requirement. This blog will look at the potential impact of the measure and the delicate balancing act the government and regulators must maintain to ensure healthy competition.

The last five years have seen unprecedented volatility. While readers of a certain age (or disposition) will recall earlier energy crises in the 1970's and 1990's, the recent wholesale price shocks unfolded under a different regulatory landscape. From 2012, the initially lauded explosion of competition, saw large numbers of new suppliers entering the domestic market, introducing brands including OVO, Octopus, and Utilita, These competitors to the old Big Six (British Gas, Scottish Power, E.ON, EDF, npower and SSE) typically offered cheaper energy prices but were not part of larger companies with generation assets. This left them vulnerable as wholesale prices soared, and the Default Tariff Cap (price cap) failed to reflect rising costs. From a peak of 66 suppliers, only 22 remain today.

Figure 1: Number of Domestic Suppliers over time vs Small and Medium Supplier market share



Source: Cornwall Insight

Fix Up, Look Sharp

The National Audit Office estimated that consumers would need to pay £2.7bn to cover the Supplier of Last Resort (SoLR) costs, of the 29 energy suppliers failing since June 2021, excluding Bulb's Special Administrative Regime.

This level of cost and failure saw scrutiny of the failed suppliers and Ofgem. The Public Accounts Committee concluded Ofgem had failed to balance competition promotion with financial resilience, and Ofgem's "low bar" approach to licensing worsened this risk. Reforms, including an Enhanced Financial Responsibility

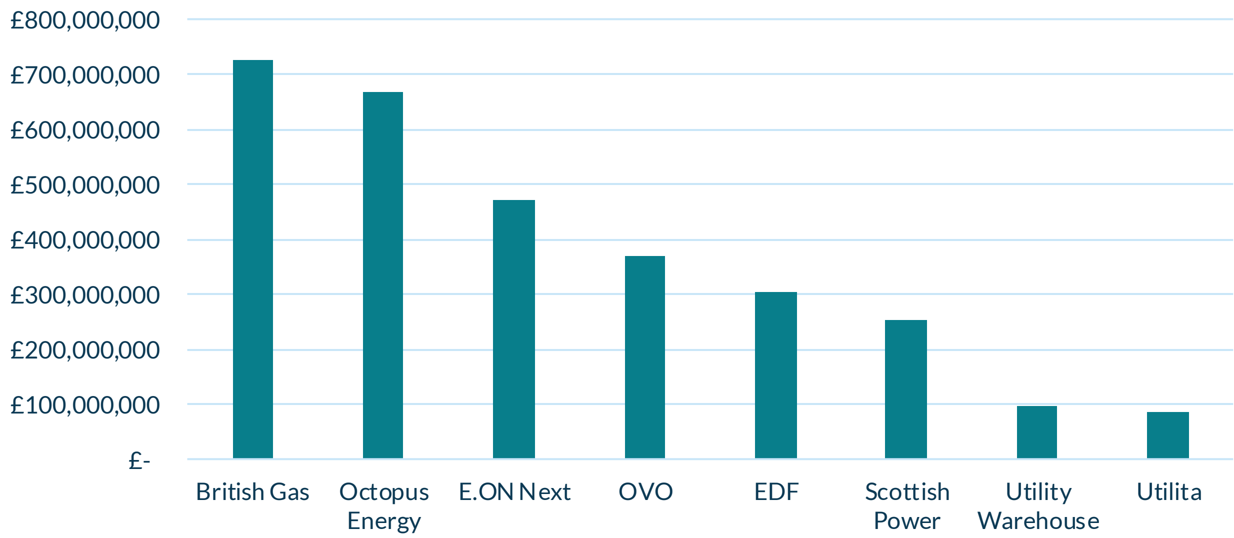
Principle (EFRP) focusing on more proactive risk reporting and mitigation, the ringfencing of Renewable Obligation receipts and adjustments to how customer credit balances could be used, were implemented, with the Minimum Capital Requirement the last measure to take effect.

On 20 September 2023, Ofgem introduced the Minimum Capital Requirement, setting a capital floor of £0 Adjusted Net Assets per dual fuel customer and a Capital Target of £115 per dual fuel equivalent customer (or £57.50 per single fuel) from 31 March 2025. Suppliers falling below this target but above the floor will enter an 'Intermediate Position,' requiring them to submit a credible Capitalisation Plan which is agreed with the regulator. Failure to do so will lead to transition controls, such as sales bans and a ban on non-essential payments. Ofgem also decided it will direct suppliers to ringfence Customer Credit Balances (CCBs) if suppliers fall below or are forecast to fall below in the next 12 months, the Capital Target. This will be set at 100% of CCBs, unless this would be contrary to the consumer interest.

Dance Wiv Me

This new requirement represents a fundamental shift in how supplier entrance and growth in the market is financed - away from relying on customer money held and toward investor capital. The regulator thinks this will provide resilience to external shocks and dampen risk taking behaviour. As can be seen from Figure 2, this decision mandates suppliers to have access to, either through held assets or prescribed alternative sources, large amounts of capital.

Figure 2: Large and medium supplier capital requirements



Source: Cornwall Insight

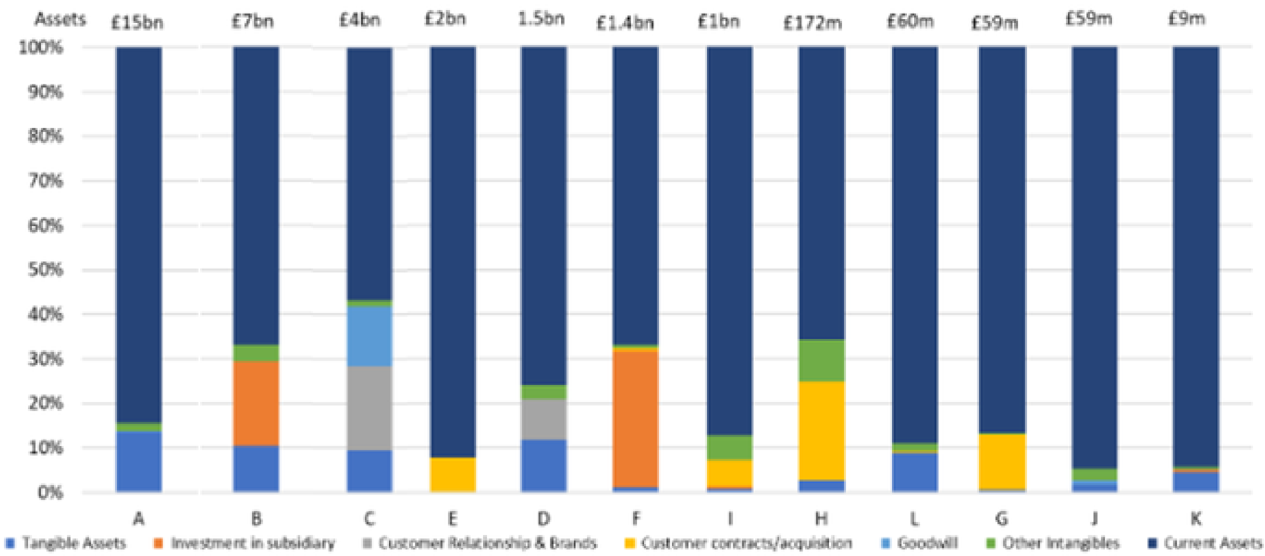
Utilita filed an appeal to the Competition and Markets Authority (CMA), arguing the Capital Target is "not appropriate to the objective, nor proportionate", reducing competition and favouring vertically integrated suppliers, who would be able to rely on loans and guarantees from the Group. Whereas standalone suppliers would be required to go to market to access alternative sources of capital which would come with costs for the provision.

The CMA rejected the appeal, finding Ofgem's process consistent and its methodology not unreasonable. It further noted that the regulator had acknowledged that parent companies could have an impact on competition but that it was in consumer interest to exclude them.

Old Skool

This episode highlights the balancing act Ofgem must perform. In the aftermath of what the Director General of Ofgem has recently referred to as a "once in a generation shock to the energy system", scrutiny of the capital target level is unsurprising. The regulator recently sought to bring to an end the temporary stability measures and re-stimulate competition, with the removal of the Market Stabilisation Charge and attempted removal of the ban on acquisition charges.

Figure 3: September 2023 Published Accounts Assets % (suppliers with intangible assets)



Source: Ofgem

The number of small and medium suppliers has fallen sharply. Since the Supplier Licensing Review, there have been no new entrants to the supply market. While this can be ascribed in part to still-high wholesale price, with very few tariffs much below the price cap, the requirements on suppliers entering the market are significantly more onerous. With the introduction of the capital requirement, market entrance and supplier growth will have to follow a different path. The incentive to take risks and innovate to the benefit of the consumer has been reduced. It will require political will from the government to guide any movement to reinvigorate competition and avoid the domestic market turning back 20 years to being dominated by large suppliers with very little separation in terms of cost.

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Cornwall Insight
The Atrium
Merchant’s Court, St George’s Street
Norwich, NR3 1AB

T: 01603 604400
E: enquiries@cornwall-insight.com