Consultation

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Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance

Subject	Details
Publication date:	26 August 2022
Response deadline:	23 September 2022
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The default tariff cap ('the cap') protects customers by ensuring that an efficient supplier can recover its costs and earn a modest level of profit. The level of return allowed through the cap can affect customers in the short term (via near term prices) and in the longer term (via investment in the sector). We are consulting to seek views and evidence on our proposed review of the returns that suppliers receive via the Earnings Before Interest and Tax (EBIT) price cap allowance. We welcome views from all stakeholders with an interest in the domestic retail energy supply market. We particularly welcome responses from energy suppliers, consumer groups and charities. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at Ofgem.gov.uk/consultations. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive summary

The default tariff price cap ('the cap'), introduced in 2018, protects customers by restricting efficient energy suppliers' normal rate of return for the capital they employ.[1] The total cap is determined through a sum of several different allowances, including an Earnings Before Interest and Tax (EBIT) allowance. This allowance was determined in 2018 using a similar methodology to that adopted by the Competition and Markets Authority (CMA) during its Energy Market Investigation (EMI) in 2016.[2] A flat EBIT margin of 1.9% is currently applied to the other allowances within the cap and consequently the EBIT allowance in the cap scales with customer bills. This may result in profits being unduly high in a high-price and high-cost environment, which is why we are consulting on whether the flat percentage margin rate continues to be the most appropriate method of setting the EBIT allowance or whether there are alternative methodologies in setting the EBIT allowance that ensure the allowance remains appropriate over a wider range of market conditions.

Since summer 2021, we have seen volatility and price increases unlike anything else in recent energy market history. The volatility has been driven by factors such as the post-pandemic economic recovery and some outages and supply disruptions across Europe. Russia's invasion of Ukraine placed additional pressures on global gas prices in 2022.

In response to these challenging conditions, we have introduced several changes to the cap, and the wider market, which seek to mitigate the heightened risks to customers and suppliers we now see. Some of these changes, such as quarterly cap updates and changes to the wholesale cost allowance, balance the cost that customers face in the near-term against the additional cost customers will face in the future if suppliers fail due to genuine costs not being recovered within a reasonable timescale. In this high-price context, it is important that we consider whether the current EBIT allowance continues to be appropriate. One potential concern is whether the current approach, which applies a fixed flat rate of EBIT margin in the cap, compounds the impacts of the price increases for customers and could unduly provide high returns to suppliers. Equally, an EBIT margin that delivers a return that is too low could pose risks to consumers through potential negative impacts on long-term investments, including those needed to help deliver the net zero transition.

[1] The normal rate of return is a standard economic concept, reflecting the minimum profit that providers of capital require, given the risks involved and the amount of capital employed.
[2] CMA (2016), Energy market investigation
https://www.gov.uk/cma-cases/energy-market-investigation

Under the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'),[3] we have a primary duty to protect existing and future domestic customers on default tariffs. We are also required to have regard to an efficient supplier's ability to finance their activities and that they have sufficient incentives to improve their efficiency (amongst other things). As such, we are seeking stakeholder views to understand if the flat EBIT margin (1.9%) within the existing cap continues to deliver an appropriate rate of return on the capital held by an efficient supplier, given the recent increase in energy prices and volatility suppliers and customers are subject to.

Recent supplier exits have placed significant burdens on customers, from increased overall costs to customer services issues particularly during SoLR, as well as many facing anxiety over the protection of their credit balances. As of August 2021, 29 suppliers had exited the market and by December 2021 we had consented to the Suppliers of Last Resort making initial levy claims totalling £1.83 billion.[4] Although some supplier exits are expected in any functioning competitive market, we consider it important to improve supplier financial resilience, which ultimately reduces costs for customers. To reduce the risk of supplier insolvency, and the associated costs to customers, we are currently reviewing suppliers' capital adequacy requirements to understand if suppliers hold enough capital to withstand market shocks.[5] This is part of Ofgem's wider effort to strengthen supplier financial resilience, with strong links to our proposals to protect Customer Credit Balances (CCBs) and Renewable Obligations (ROs), which is being addressed through our Financial Resilience and Controls (FRC) work.

As the cap level for cap period 9a is three times higher than its historic range and the EBIT allowance has scaled with the overall cap level, this suggests there may be a need to review whether this remains an appropriate EBIT allowance and implementation approach. To address these concerns, this consultation explores three areas: Cost of Capital (CoC); capital employed, both of which determine the appropriate allowance; and the appropriate approach to implement the EBIT allowance. These three areas are considered below:

[3] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[4] Ofgem, Price Cap (2022), Decision on changes to the wholesale methodology, decision consultation https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology
[5] Ofgem, FRC (2022), Strengthening Retail Financial Resilience, policy consultation https://www.ofgem.gov.uk/publications/policy-consultation-strengthening-financial-resilience

- For the CoC, we propose to utilise the Capital Asset Pricing Model (CAPM) methodology previously used by the CMA. We propose to recalculate the components of the CAPM by: reviewing relevant data for the model's components; completing our own analysis; utilising analysis provided by third parties; and considering any analysis and data provided by stakeholders. We will also review the appropriate timeframe of market evidence to review and inform the CoC. We invite stakeholder views on our proposed methodology and its key inputs.

- For capital employed, we propose to use the current level as a starting point, and further build on the methodology through analysis, modelling and stakeholder views to determine an updated range of capital employed. We propose to model our view of the appropriate level of capital that should be employed for an efficient theoretical supplier that is representative of the market, and reference this against the CMA analysis, and in light of Ofgem's wider FRC work.

- We also consider how the EBIT allowance should be implemented. At present, the EBIT allowance within the cap is represented as a fixed percentage (currently 1.9%). We apply this fixed percentage to the sum of the cap allowances for wholesale costs, network costs, policy costs, operating costs, and the payment method uplift to calculate an EBIT allowance. As a result, the allowance scales directly with customer bills. Within this consultation, we outline potential alternatives and invite stakeholder views on the most appropriate method for implementing the EBIT allowance.

1. Consultation process

What are we consulting on?

1.1. This is an initial consultation, seeking views on our proposed updated methodology for calculating the Earnings Before Interest and Tax (EBIT) allowance in the cap to ensure it remains suitable to provide an efficient supplier with a normal rate of return on capital employed. We welcome submissions of data and analysis by stakeholders to support our review of the Cost of Capital (CoC) and capital employed. We are also seeking views on the approaches for implementing the EBIT allowance.

1.2. This document is split into five chapters:

- Chapter 1: Consultation process;
- Chapter 2: Introduction;
- Chapter 3: EBIT methodology review: case for change;
- Chapter 4: Amending the cap methodology and options for consideration; and
- Chapter 5: Implementation of EBIT

1.3. We invite stakeholders to submit comments on any aspect of this policy consultation on, or before, **23 September 2022**.

1.4. We intend to publish a statutory consultation in November 2022 and a subsequent decision document in February 2023. Any potential changes may come into effect from 1 April 2023 (cap period 10a).

Related publications

1.5. The main documents related to reviewing the EBIT methodology in the cap are:

- 2018 decision on the cap methodology ('2018 decision'): https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
- Competition and Markets Authority (CMA) 2016 Energy Market Investigation: https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf
- Policy consultation on Strengthening Financial Resilience: https://www.ofgem.gov.uk/publications/policy-consultation-strengthening-financial-resilience
- CEPA (2022) Default Tariff Cap cost of capital:

- https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance

How to respond

1.6. Responses to this consultation, and any supporting evidence, can be submitted to Ofgem by emailing RetailPriceRegulation@ofgem.gov.uk. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

1.7. We have asked for your feedback in each of the questions throughout. Please respond to each one as fully as you can.

1.8. We are also happy to speak to stakeholders during the consultation period, to understand their initial views. If you would like to arrange a call, please contact us through retailpriceregulation@ofgem.gov.uk.

Your response, data and confidentiality

1.9. You can ask us to keep your response, or parts of your response, confidential. We will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.10. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you do wish to be kept confidential and those that you do not wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we will get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.11. If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ('UK GDPR'), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix A.

1.12. If you wish to respond confidentially, we will keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We will not link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits, without undermining your right to confidentiality.

General feedback

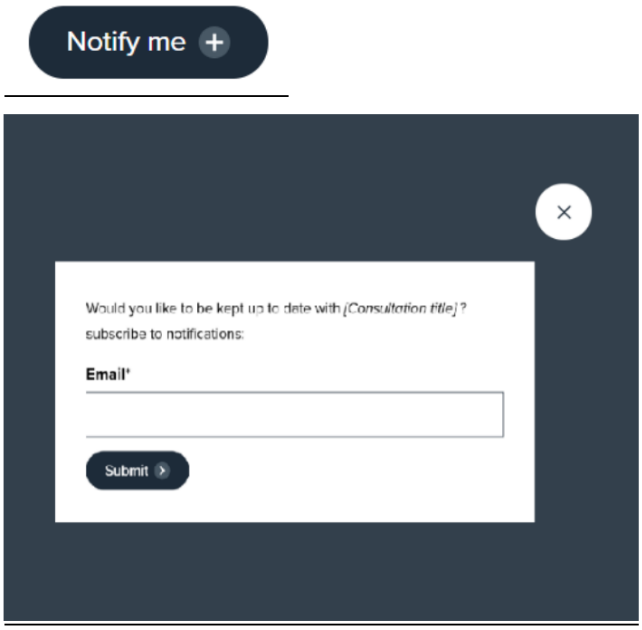
1.13. We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:

Do you have any comments about the overall process of this consultation?
Do you have any comments about its tone and content?
Was it easy to read and understand? Or could it have been better written?
Were its conclusions balanced?
Did it make reasoned recommendations for improvement?
Any further comments?

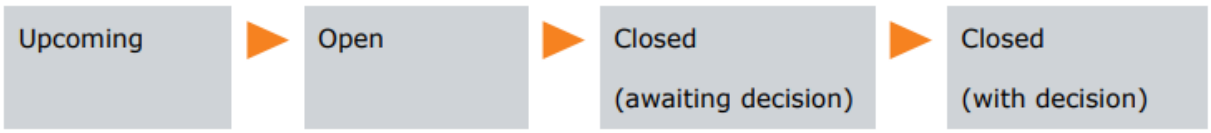
Please send any general feedback comments to stakeholders@ofgem.gov.uk.

How to track the progress of the consultation

You can track the progress of a consultation, from any upcoming publications to decision status, using the 'notify me' function on a consultation page when published on our website Ofgem.gov.uk/consultations.



Once subscribed to notifications for a particular consultation, you will receive an email to notify you when its status has changed. Our consultation stages are:



2. Introduction

Chapter summary

This chapter sets out in further detail the EBIT allowance, including how the allowance was calculated by the Competition and Markets Authority (CMA) in their 2016 Energy Market Investigation (EMI) and how it is currently accounted for in the cap.

Background

Price cap and supplier rate of return

2.1. The default tariff cap ('the cap') protects approximately 24 million domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that the price of energy only reflects the underlying costs of providing it.[6] The cap is one of the key activities which falls within the 'Future of Retail' strategic change programme as set out in our Forward Work Programme for 2022-23.[7] We set the cap by considering the different costs suppliers face. The cap is made up of a number of allowances which reflect these different costs.

2.2. One of these allowances is for supplier returns. This allowance is meant to deliver a normal rate of return for an efficient supplier on the capital it uses in its business. A normal rate of return reflects what you would expect to see in a competitive market and enables an efficient supplier to cover their legitimately incurred costs and makes it viable to continue operating given the alternative uses the capital employed could be put to. A normal rate of return in this context is equal to an economic profit of zero.[8]

2.3. Our view is that a competitive market where an efficient supplier could recover their costs is in the long-term interest of all customers.[9] A competitive market ensures suppliers

[6] As of August 2022.
[7] Ofgem (2022), Forward work programme 2022/23. https://www.ofgem.gov.uk/publications/202223-ofgem-forward-work-programme
[8] Economic profit is money earned after taking explicit and implicit costs into account. Accounting profit is the net income for a company or revenue minus expenses.
[9] Ofgem (2022), Price Cap – Decision on the potential impact of increased wholesale volatility on the default tariff cap, p5. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesalevolatility-default-tariff-cap

have adequate incentives to become more efficient and provide a better quality of service to their customers, promote innovation and deliver a greater range of products and choices for customers.

2.4. We are mindful of the investment required to transition to net zero. Whilst government support for suppliers to promote clean energy, as set out in the government's Energy White Paper (2020), could support the reduction of wholesale energy price volatility, the transition will require investment.[10] Investment attractiveness can be driven by the rate of return on capital employed.

2.5. Appropriately financed suppliers should be more able to drive efficiencies as well as being less likely to fail. Failures can create additional costs which could ultimately be recovered through increases in customer bills.

EBIT allowance

2.6. The cap allowance that accounts for a normal rate of return on supplier's capital employed is called the EBIT allowance. It is applied as a percentage uplift on the sum of the cap allowances for wholesale costs, network costs, policy costs, operating costs, payment method uplift, and an adjustment allowance. It can be thought of as the profit margin allowed for within the cap.

2.7. When setting the first cap in 2018, we used the CMA's estimate of the EBIT margin that was consistent with the Six Large Energy Firms earning returns in line with their Cost of Capital (CoC) (ie a normal rate of return). The CMA estimated a capital employed per customer figure and a Weighted Average Cost of Capital (WACC) of 10%. This resulted in an EBIT margin of 1.9%, which is the basis for the current 1.9% EBIT allowance. The CMA's assessment was set out as part of their 2016 EMI.[11]

[10] BEIS (2020), Energy White Paper: Powering our net zero future. https://www.gov.uk/government/publications/energy-white-paper-powering-our-net-zero-future/energy-white-paper-powering-our-net-zero-future-accessible-html-version
[11] CMA (2016), Energy market investigation. https://www.gov.uk/cma-cases/energy-market-investigation

Capital requirements

2.8. In this consultation we have sought to break down the different reasons suppliers need to hold capital. This will enable a more granular discussion about the drivers of, and trends in, capital requirements and how they may impact the appropriate rate of return.

2.9. We have separated requirements into three conceptual buckets (as described in Chapter 4, paragraph 4.45):

- **Working capital**
- **Collateral capital**
- **Risk capital**

2.10. We recognise these components may not be exhaustive and welcome stakeholders to provide their views on other appropriate components.

Case for change

2.11. The CMA calculation used in 2018 to set the initial cap was a robust methodology to determine the WACC and capital employed by suppliers. As such, the 1.9% EBIT margin that emerged was deemed suitable for use in the cap methodology and has helped ensure that default tariff customers pay a price for energy that reflects the cost of providing it.

2.12. The flat rate of 1.9% EBIT margin was set at a time when typical bills varied between c. £1,000 and £1,300. The cap level for cap period 9a is three times higher than this historic range and the EBIT allowance has scaled with this. As the EBIT allowance scales in line with the overall cap level, there is a need to review whether the flat percentage margin rate continues to be the most appropriate method of setting the EBIT allowance or whether there are alternative methodologies in setting the EBIT allowance that ensure the allowance remains appropriate over a wider range of market conditions.

2.13. We understand that recent changes in the market landscape, changes to the cap policies, and the proposed introduction of policies on supplier financial resilience may impact the capital requirements and capital costs for suppliers. Under the Act, we are required to have regard to various matters, including an efficient suppliers' ability to finance their activities and to create incentives for suppliers to improve efficiency. Having appropriately

financed and regulated suppliers reduces the risk of supplier exits which could reduce the additional costs to customers resulting from such failures. This in turn will protect existing and future domestic customers on default tariffs.

2.14. We consider this is an appropriate time to review the EBIT allowance as this will enable us to better reflect appropriate costs, both when risks are increasing as well as decreasing. Subsequently, customers could see the benefits faster with a more market-reflective EBIT allowance approach as the market returns to more normal conditions.

2.15. Lessons learned from last winter show that supplier exits can place significant burdens on customers through the Supplier of Last Resort (SoLR) levies, with some experiencing supply issues and many facing anxiety over the protection of their credit balances. The costs of protecting the credit balances of customers from failed suppliers and ensuring they continue to receive energy from their new suppliers, are at prices under the cap, which has raised energy prices to all customers. Although some supplier exits are expected in any functioning market, we consider it important to improve financial resilience of suppliers, which ultimately reduces costs for customers.

2.16. Although we recognise that the aforementioned factors may have impacted the capital requirements and the CoC for suppliers, we also intend to consider existing interventions that have reduced equity risk, and thereby may have reduced the CoC and capital employed**.** In such a scenario, we will aim to reflect this change within the allowance and pass savings to customers. We note that some of these interventions were factored into the CMA's analysis in 2016 (eg Standard Variable Tariff (SVT) churn risk).

Consultation scope

2.17. It is our intention to review and consult on three areas: Cost of Capital (CoC); capital employed, both of which determine the appropriate allowance; and what the appropriate approach to implementing the EBIT allowance should be.

2.18. We propose to consider the following:

- whether an EBIT allowance that scales with the bill level remains appropriate, considering the impact of recent high price volatility on customer bills; and

- whether the cap methodology continues to deliver an appropriate level of return which adequately protects existing default tariff customers while also enabling operationally

efficient suppliers to be financially resilient, reducing the risk of failures and the associated costs to customers.

2.19. This consultation is a forward-looking document and does not seek to assess whether previous or existing EBIT cap allowances were sufficient. Following this and future consultations, we will consider whether changes should be made and, if so, in what timescale. However, it is expected that any changes would not come into effect until April 2023 at the earliest.

Statutory framework

2.20. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'). The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to four matters:

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts; and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

2.21. The requirement to have regard to the four matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future customers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often a balance must be struck between competing considerations.

2.22. In setting the cap, we may not make different provisions for different holders of supply licences.[12] This means that we must set one cap level for all suppliers.

Approach to considering adjustment to the cap

2.23. In our 2018 decision, we said that: "if in the future we consider there are material systematic issues that require correction, we might modify the licence. This would allow us to make any changes required to correct how the cap was updated, if it systematically and materially departed from an efficient level of costs." We also said that: "The type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes."[13]

2.24. We have applied this test when considering changes to the cap. We broadly consider the case for amending the cap methodology against the test of whether a change in the costs facing suppliers is material and systematic, considering the market as a whole.[14]

2.25. Additionally, in allowing an efficient supplier to make a normal rate of return, we are having regard to the matters set out in the Act - in particular "the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence."[15]

[12] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[13] Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[14] Ofgem (2021), Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 4.16. https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap
[15] UK Public General Acts (2018), c.21, Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21/contents/enacted

3. EBIT methodology review: case for review

Chapter summary

This chapter sets out further detail on some of the factors that, taken together, have led to it being considered appropriate to review the current EBIT allowance methodology at this point. We set out our thinking as to how the changes specified might impact the appropriate EBIT margin under the cap.

We welcome stakeholder views on our consideration of the issues.

Background

3.1. As discussed in Chapter 2, there have been significant changes in energy markets and policy since the EBIT allowance was first set in 2018. Some of these developments, and potential future developments in policy, could impact the level of capitalisation suppliers need and the cost of the capital they can access.

3.2. Changes in the amount of capital employed or the CoC may change the EBIT margin and therefore, under the current methodology, could influence the EBIT allowance.

3.3. In this chapter we discuss in more detail how the following factors may impact the EBIT allowance:

- **Increased price and market volatility and the associated risks;**
- **Changes to the cap methodology and wider policies to address those risks;**
- **Proposed reforms on suppliers' financial resilience** (including capital adequacy and ringfencing policies); and
- **Changes in working capital due to deferred recovery of costs** (eg backwardation and unexpected SVT demand).

3.4. This may not be an exhaustive list of developments with implications for the EBIT allowance, but it serves to illustrate some of the reasons for reviewing this element of the cap at this time.

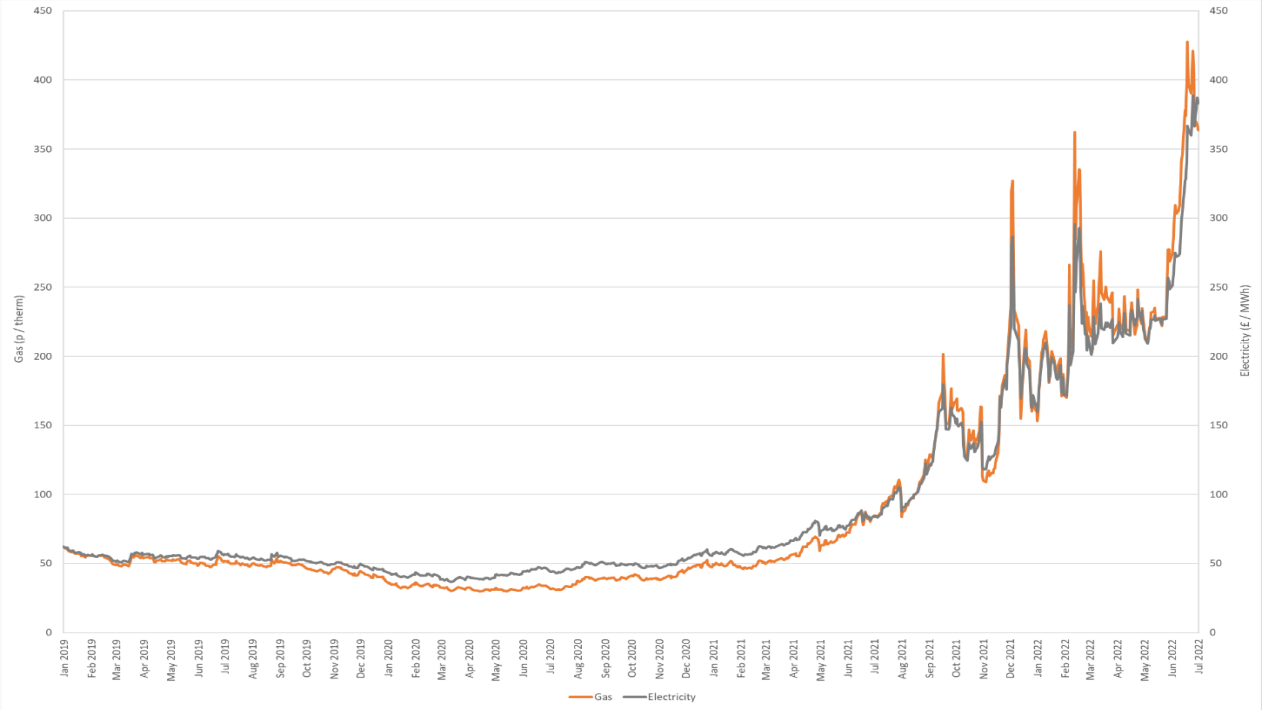
Increased prices and market volatility and the associated risks

Context

3.5. The current cap methodology reflects the relative stability of the wholesale markets prior to, and at the time of, implementing the cap. Since summer 2021, the wholesale gas and electricity markets have changed considerably, and suppliers are now having to procure gas and electricity for customers in a fundamentally different environment.

3.6. As Figure 1 below shows, forward prices for gas and power have increased considerably since the beginning of the cap in 2019. Alongside the price increase, price volatility has also increased appreciably since we first set the EBIT allowance, peaking around March 2022.

Figure 1: Gas and Electricity forward prices under the 3-1.5-12 quarterly wholesale indexation approach (2019-2022, p/therm / £/MWh)



Source: Figure 2.1, Page 12. Price cap – Decision on changes to the wholesale methodology.[16]

[16] Ofgem (2022). Price cap – Decision on changes to the wholesale methodology. https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

Our considerations

Impact of price volatility on the CoC

3.7. Higher wholesale price volatility may impact the systemic risk associated with an efficient supplier because it may not be possible for suppliers to perfectly hedge their exposures. Greater systemic risk could increase the financing cost of capital employed, increasing the EBIT margin required and the Return on Capital Employed (ROCE) that is commensurate with the risk borne. Under the current methodology this would have implications for the EBIT allowance.

3.8. We note, however, that the wholesale risk allowance within the cap accounts for residual wholesale price risk. Therefore, a systematic risk associated with wholesale price volatility would only be applicable if current volatility exceeds the existing allowance.

Impact of higher wholesale prices and higher price volatility on capital employed

3.9. Increased wholesale prices and price volatility can drive up components of the capital employed by suppliers, namely working capital, collateral capital and risk capital.

3.10. **Working capital:** as a result of wholesale cost increases, the working capital necessary to cover any difference arising in the period between paying for energy delivered and receiving payments from customers, standard credit customers in particular, may have increased. A higher wholesale price may require suppliers to hold more working capital in order to stay operational as this difference grows.

3.11. **Collateral capital:** this may see increases given suppliers' obligation to cover certain activities which are themselves affected by increasing wholesale costs.

3.12. **Risk capital:** suppliers may also be required to hold greater risk capital given wholesale price increases. This is because risk capital is used to cover any losses which might arise due to the holding of open risks during normal operations. When the prices that suppliers are exposed to in the wholesale market are higher, potential losses can also be greater. As a result, suppliers may need to hold greater risk capital to protect against any such losses. One component of risk capital is shaping and balancing costs. Under high price volatility, the risks associated with shaping and balancing around existing hedged positions, and volume risk, are higher.

3.13. We recognise that higher capital requirements may not necessarily translate into a higher EBIT allowance as the EBIT allowance is set as a percentage of other cap components including wholesale costs. We consider the EBIT allowance will only need to be updated if the increase in capital employed is disproportional to the increase in wholesale costs (ie capital employed has increased at a faster rate than wholesale costs).

Changes to the cap methodology and wider policies to address price and volatility risks

Context

3.14. We have introduced several interventions to the cap and wider market to mitigate the risk of price volatility since December 2021. Many of these risks were present, at a much lower level of materiality, when the original assessment of the EBIT margin was made. By creating explicit allowances for these risks, the residual equity risks to suppliers will be lower than originally expected.

3.15. These offsetting factors need to be considered when assessing the impact of changed market conditions on the appropriate rate of return.

Our considerations

Quarterly cap updates and reduced notice period

3.16. Updating the cap quarterly with a reduced notice period will reduce volume risk significantly compared to the previous six-monthly update frequency.

Changes in backwardation cost recovery

3.17. We previously expected suppliers to cover the risk that backwardation costs and contango benefits may not net off in a reasonable period. Through recent changes to the wholesale allowance methodology, the costs of backwardation beyond historical norms can now be recovered more quickly.[17]

[17] Ofgem (2022), Price cap – Decision on changes to the wholesale methodology https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

Unexpected SVT demand cost recovery

3.18. A range of implemented and proposed measures mean that it is now less likely that, in the short term, customers will switch away from SVTs. This reduces the demand risk suppliers are exposed to from customers rolling-off of fixed price contracts. These measures include the Market Stabilisation Charge (MSC), a ban in acquisition-only tariffs and the tightening of rules around supplier entry.

3.19. Introducing the MSC and ban on acquisition-only Tariffs, temporary measures which have been extended to the end of March 2023,[18] help mitigate the risk of customer losses in a falling market and the full mark-to-market loss of the hedges held for that customer.

3.20. Tightening the rules around supplier entry and introducing milestone assessments will help create a more measured approach to market entry and growth meaning that existing suppliers are less likely to face unsustainable competition.

Proposed reforms on supplier financial resilience

Context

3.21. Recent events in the energy market have demonstrated that retail businesses have too often had insufficient capital to manage the business of supply. Additionally, some supplier business models have been overly reliant on Customer Credit Balances (CCBs) and Renewable Obligations (RO) receipts to meet working capital requirements.

3.22. Recent events have reinforced the risks suppliers and customers could face due to insufficient capital in the face of shocks. In light of this, our FRC team published a policy consultation covering proposed changes to improve retail supplier financial resilience.[19] The consultation set out proposals including protecting, or 'ringfencing', CCBs and RO receipts. It also considered the need for an updated capital adequacy regime with more specific

[18]Ofgem (2022), Decision on extending Short-Term Interventions and adjusting MSC calculation. https://www.ofgem.gov.uk/publications/decision-extending-short-term-interventions-and-adjusting-msc-calculation

[19] Ofgem (2022), Policy consultation: strengthening financial resilience. https://www.ofgem.gov.uk/cy/publications/policy-consultation-strengthening-financial-resilience

requirements and a greater level of regulatory oversight of the levels of capital energy suppliers hold.

3.23. These policy proposals, if they go ahead, have the potential to impact the amount of capital employed by suppliers as well as the CoC. This could therefore impact the EBIT margin required for an efficient supplier to deliver a normal return and consequently the EBIT allowance in the cap.

Our considerations

"Ringfencing" Customer Credit Balances and Renewables Obligations

3.24. Under the current market arrangements, suppliers can use CCBs and RO receipts as sources of cost-free, risk-free working capital. Some supplier business models may have become overly reliant on this source of capital. If a supplier becomes insolvent, the cost of CCBs and RO receipts are passed onto customers entirely through the SoLR levy and RO mutualisation arrangements. For this reason, we have consulted separately on a modification to the supplier licences to limit the working capital that can be obtained from CCBs and RO receipts, requiring suppliers to put in place 'protection mechanisms' to ensure that they are available to a customer's new supplier if their previous supplier fails.

3.25. Under the 'ringfencing' proposals set out in our recent consultation,[20] suppliers would no longer be able to rely on some or all of CCBs and RO receipts as a source of capital. To the extent there is any resulting capital deficit, this would have to be made up elsewhere and suppliers may have to look to other sources of finance to ensure they have sufficient capital to operate their businesses whilst remaining compliant to the relevant licences and industry codes.

3.26. The ROCE from other sources of finance may be different to the cost-free, risk-free sources of CCBs and RO receipts. It may be more expensive for suppliers to raise capital elsewhere, particularly under current market conditions. The prospect of such a policy change is therefore a factor that may influence the appropriate EBIT allowance that is needed to ensure that an efficient supplier is able to finance their activities.

[20] Ofgem (2022), Policy consultation: strengthening financial resilience. https://www.ofgem.gov.uk/cy/publications/policy-consultation-strengthening-financial-resilience

Impact of capital adequacy decisions

3.27. In addition to proposals to ringfence CCBs and RO receipts, we are also looking at proposals to improve the capital adequacy of suppliers more generally. Key characteristics of failed suppliers include negative equity balances and low levels of working capital. To minimise the probability and overall mutualised costs of supplier failures, it is important that suppliers are sufficiently capitalised.

3.28. One option being considered to ensure capital adequacy is to set a regulatory minimum amount of capital that a supplier needs to hold through licence conditions, alongside ongoing monitoring of individual supplier's financial resilience to determine the need for further capital or other interventions if necessary. The minimum regulatory amount of capital could be identified through the exercise proposed in Chapter 4, whereby potential drivers for each component of the asset base would be analysed to determine the overall level of capital employed required for an efficient theoretical supplier to remain resilient under a certain level of stress. However, the exact approach to translating this exercise into any minimum required amount is subject to further consideration.

3.29. While the detail of any change to capital adequacy requirements is yet to be decided, any change to the levels of capital that suppliers are required to hold could have implications for the amount of capital employed. Under the current EBIT allowance methodology, this would have implications for the appropriate EBIT margin under the cap, and therefore is another relevant factor to consider in our review.

3.30. The interaction between our review of the EBIT allowance and the on-going consideration being given to policies focused on supplier financial resilience will require us to consider the timing and sequencing of these related decisions. There may be a need to take a flexible approach when setting any new EBIT allowance. We discuss options related to implementation and future reviews in Chapter 5.

Increases in capital employed due to deferred allowances

Context

3.31. Suppliers have always had to manage the timing differences between payments and receipts. However, steeply rising energy costs that create conditions such as the cost of backwardation and unexpected SVT demand, where allowances have been made to recover

the costs in subsequent cap periods, can result in the supplier not being able to recover the costs of the demand through the period where that energy is delivered.

3.32. We have adopted a standard practice of allowing deferred allowances to be recovered over twelve months. However, when considering the impact of the backwardation cost allowance, we adopted a six-month recovery due to its materiality this winter, informed by our assessment of supplier financial resilience. We stated that we would keep this decision under review should our assessment of supplier finances change.

Our considerations

3.33. Some stakeholders have raised concerns that suppliers may need to raise additional capital to cover the time lag between incurring and recovering costs.

3.34. We will consider that the capital employed to cover the time lag may have increased, thus necessitating a review of the current EBIT allowance to ensure that it continues to allow for a normal rate of return on any changed capital requirements. We also recognise that these capital requirements may not be permanent.

3.35. Notably, potentially increased capital requirements due to deferred allowances do not automatically necessitate a higher EBIT margin. This is because, while it may increase the amount of capital suppliers need for a period of time, the recovery of costs through subsequent periods will also increase supplier revenues. As the EBIT allowance is set as a margin (ie as a percentage of revenues), the net effect on the EBIT margin needed to generate a 'normal' return is ambiguous. The deferred allowances are also supported through other allowances in the cap, namely the headroom and payment method uplifts.

4. Amending the cap methodology and options for consideration

Chapter summary

This chapter sets out the approach we are considering with regards to the assessment of the EBIT allowance within the cap. This proposed approach is informed by the modelling and analysis of an efficient market theoretical supplier. We propose our focus to be primarily on the two key inputs into this EBIT methodology, namely CoC and capital employed.

To estimate the CoC, we propose utilising a similar Capital Asset Pricing Model (CAPM) methodology used by the CMA. We intend on recalculating the components of the CAPM by: reviewing relevant data for these components; completing our own analysis; utilising analysis provided by third parties; and considering any analysis and data provided by stakeholders. The details of its proposed implementation are discussed below.

To facilitate our consideration of capital employed, and what might impact the level of capital employed, we consider it would be useful to characterise the capital employed using the following components: working capital; collateral; and risk capital. We recognise these components may not be exhaustive and welcome stakeholders to provide their views on other appropriate components.

Both the CoC and capital employed will closely inform our proposed methodology. Part of this methodology is the identification and use of an efficient market theoretical supplier. This is also discussed below. We welcome stakeholder views on our proposed approach.

Context

4.1. Given the factors discussed in Chapter 3, subject to consultation, we may reassess whether the current level of EBIT allowance continues to deliver an appropriate rate of return for efficient suppliers.

4.2. In reassessing the level of EBIT allowance, we propose identifying an efficient theoretical supplier around which to base our modelling. As we are required to provide only a single EBIT allowance under the cap and cannot differentiate by suppliers, we intend to define an efficient theoretical supplier that will be market representative.

4.3. Furthermore, to support this assessment, we consider that the methodology to determine two key inputs of the EBIT allowance need to be reviewed:

- **Cost of Capital (CoC)**
- **Capital employed**

4.4. The current level of EBIT allowance was determined using a methodology developed by the CMA in its EMI analysis in 2016. As part of this, the CMA used a CoC of 10%[21] and determined an appropriate level of capital employed per customer.

4.5. We have recently commissioned Cambridge Economic Policy Associates (CEPA) to conduct an in-depth analysis of the CoC and capital employed to support our consultation on the EBIT allowance within the cap. CEPA's report on the CoC outlining an updated approach and analysis is published alongside with this policy consultation.[22]

4.6. Our assessment and consideration of these two inputs will be partly informed by the analysis provided by CEPA, our own analysis, and any analysis and data provided by stakeholders. We welcome stakeholder views on CEPA's approach in determining a supplier's CoC.

Market representative efficient theoretical supplier

4.7. As outlined within the Act, we are required to set a single allowance across all suppliers. We therefore consider it appropriate to establish a single market representative efficient theoretical supplier around which to build our assumptions which best reflects the whole energy market. This will be used to determine the appropriate CoC and level of capital employed.

[21] CMA (2016), Energy market investigation: Appendix 9.12: cost of capital, paragraph 2. https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf

[22] CEPA (2022), Default Tariff Cap cost of Capital. https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance

4.8. We recognise there are challenges in using market benchmarks. We are in what could be considered atypical market conditions, where the CoC and capital employed data may not be reflective of normal market conditions. At the moment, benchmarking may consider suppliers in financial distress and as a result our findings may not reflect what we would consider an efficient theoretical supplier.

4.9. Whilst it is possible to complete a full benchmark using market data for several different suppliers, this could be more onerous and take longer to deliver than defining an efficient theoretical supplier. Given the challenges of a full benchmarking against suppliers in the current market, we propose to define an efficient theoretical supplier. In setting this efficient theoretical supplier, we intend to consider the diverse position of suppliers across the market and aim to be broadly representative of the market.

4.10. We recognise an EBIT allowance set with assumptions around an efficient theoretical 'independent' supplier (ie one not part of a vertically integrated group) may risk significantly overcompensating suppliers who are not required to post collateral, for example if they have Parent Company Guarantees (PCGs), as these suppliers may have more access to internal capital at a much lower CoC. Diversified groups may well also have a lower risk capital requirement due to offsetting risks within the enterprise portfolio.

4.11. However, setting the allowance closer to the CoC for suppliers who may benefit from their PCGs could risk pushing smaller, independent suppliers out of the market. With levels of the CoC which are not financeable, this could also deter new suppliers from entering the market, reducing competition and potential customer benefits from a more competitive market.

4.12. For the purpose of the rest of the document, we will refer to our intended future position on this decision as an efficient "theoretical supplier". For example, we will consider the asset base in the context of this efficient theoretical supplier. We make no proposal around the assumed characteristics of this efficient theoretical supplier in this document and welcome views.

4.13. Over the coming months Ofgem is consulting on two inter-related policies: methodology for setting the EBIT allowance (in this document); and Capital Adequacy

requirement.[23] For the purpose of having an open discussion with stakeholders, both consultations model an efficient theoretical or notional supplier to test the different questions being asked for each consultation. In initiating the consultations, what may be described as an efficient theoretical supplier in this consultation may differ in certain aspects to the notional supplier described in the capital adequacy consultation. Through the course of these two consultations, we will align them once we have reviewed the stakeholder responses and the details of capital adequacy requirements have been defined.

Question 1: What efficient theoretical supplier assumptions should we use?

Cost of Capital (CoC)

Context

4.14. Under the financeability duty in the Act, we are required to have regard to the need to ensure that holders of supply licences who operate efficiently can finance licensed activities. We propose to achieve this in part by considering an efficient theoretical supplier's ability to generate an appropriate return on the capital it employs. An appropriate estimation of the CoC, therefore, is necessary to feed into an accurate EBIT allowance within the cap. We are consulting on whether the CoC of 10% remains appropriate.

4.15. We consider it is important to review the existing methodology and assumptions to determine the CoC to ensure they remain robust given the key changes described above. This section covers:

- **CAPM:** our proposed overall method to make the calculation;
- **CAPM components:** the specific components of the CAPM formula;
- **The time horizon:** the short-term vs. long-term view of the CoC; and

[23] Ofgem (2022), Policy Consultation: Strengthening Financial Resilience. https://www.ofgem.gov.uk/publications/policy-consultation-strengthening-financial-resilience

- **The frequency of updates to the CoC:** how often we propose to review and change the CoC

Capital Asset Pricing Model (CAPM)

4.16. We propose to calculate the CoC by utilising the CAPM as a tool.

4.17. We propose defining an efficient theoretical supplier as a fully equity financed supplier, which is consistent with the CMA methodology, on the basis that we are using an efficient theoretical GB energy supplier. Several parties submitted to the CMA during the EMI analysis[24] that an efficient theoretical retail supplier would not be able to carry debt on its balance sheet.

4.18. The CAPM has been used in recent works by us and the CMA, establishing a long regulatory precedent. We consider our proposed approach to be consistent with this precedent set, and we do not consider any deviation to be necessary.

4.19. When estimating the CoC using the CAPM, there are further considerations to be made. These concern the specific components of the CAPM formula, the time horizon view of the CoC and the frequency of CoC updates.

Question 2: Do stakeholders agree the CAPM model is still appropriate to estimate the CoC for supply businesses moving forward? If not, then why?

CAPM components

4.20. We are proposing a CAPM formula that relates the CoC (rE)[25] to a risk-free rate (rf), the expected return on a market-wide portfolio of investments, known as Total Market

[24] CMA (2016), Energy market investigation. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

[25] Note that we are assuming there is no debt here, so the cost of capital here is more commonly known as the cost of equity. In the absence of debt, the cost of capital and the cost of equity are equal.

Returns (TMR), and a business-specific measure of investor exposure to systematic risk (β). This formula is represented below:

$$rE = rf + \beta(TMR - rf)$$

4.21. In other terms, we are considering the following: Nominal cost of capital = Nominal risk-free rate + Beta (Real Total Market Returns – Real risk-free rate).

4.22. We have commissioned CEPA to provide a view and analysis on how and what these values should be set at. We are seeking stakeholder views on the most suitable value to associate with each and any suggested proxies or analysis that could inform these values.

Systematic Risk (β)[26]

4.23. One component of the CAPM formula is a measure of an investor's exposure to systematic (non-diversifiable) risk. This is denoted by beta (β). When the CMA conducted its analysis, it used a range of beta estimates from across various sectors as well as a theoretical consideration of systematic risks faced by energy suppliers to arrive at an appropriate beta.

4.24. CEPA's report indicates that the CMA's original asset beta range of 0.7 to 0.8 might still be considered a plausible long-term view of the relative risk of an energy retailer. The report also suggests that there might be reasons to believe that energy suppliers are temporarily exposed to greater systemic risk under current market conditions, and so an asset beta as high as 1.0 to 1.2 might be appropriate in the short term.

4.25. However, we recognise from CEPA's report that the sample size is small and there are few direct comparators to a retail energy supplier in Great Britain. We would welcome views from stakeholders on:

- whether CEPA's estimate of a supplier's long-term beta is an appropriate estimate;

[26] Note that we are interested in asset betas and equity betas. In the absence of debt, the equity beta and the asset betas are equal.

- whether there are other comparators that may be better than those considered by CEPA to estimate beta;

- what consideration should be taken of CEPA's view that suppliers might be temporarily exposed to greater systematic risk so an short-term asset beta of 1.0 to 1.2 might be more appropriate; and

- if there is a sizable difference between the short-term asset beta and long-term asset beta, should the EBIT margin be assessed periodically?

Risk-free rate (rf)

4.26. The risk-free rate, denoted by rf in the formula, represents the theoretical return an investor would expect to earn on a riskless investment.

4.27. CEPA's report produces an estimated range of the *real* risk-free rate of -1.12% to -0.86% or a range of 1.8% to 2.07% for the *nominal* risk-free rate. These estimates reflect the market data for gilt yields and inflation swaps at 5 and 10-year tenors.

Total market return (TMR)

4.28. The TMR in the formula represents the expected return on a market-wide portfolio of investments.

4.29. CEPA, seeing no strong grounds to use an alternative approach, chose to align their assessment of the total market return with that of our assessment under the RIIO-2 price controls resulting in an estimated range for the *real* total market reform of 6.25% - 6.75%.

Question 3: Do stakeholders agree with CEPA's approach to estimating beta? Are there other comparators that stakeholders believe should be used to estimate beta?

Question 4: Do stakeholders agree with CEPA's suggested approach to estimating the other components of the CAPM model?

Time horizon

4.30. We intend to make a determination on whether to adopt a longer or shorter-term view of market evidence for estimating the CoC. The view taken will impact the range of values within which the CoC lies.

4.31. Given the CoC will be impacted by the chosen time horizon, there are trade-offs associated with these two views. A short-term view would represent an elevated CoC relative to a long-term view. Time horizon is a relevant concern given that investors demand different levels of risk premiums depending on the tenor of equity investment. There are a number of factors which are likely to impact this consideration:

- whether a long or short-term view should be taken on the risks and returns associated with the retail energy business;
- whether recent volatility will have impacts affecting the long-term view of the stability of the energy sector; and
- how much consideration should be given to the cap itself, regarding to the adjustments to the cap, eg recent changes to protections against backwardation have relatively near-term impact on the cost of capital employed by suppliers. Additionally, the cap has a defined end date at present, and draft legislation to extend the cap requires a review by parliament at least every two years.

Question 5: What are stakeholder views on the appropriate balance between using long-term or short-term market evidence in our estimation of the CoC?

Frequency of CoC updates

4.32. Whether the CoC is updated more or less frequently involves a trade-off to be made in terms of stability versus reflecting market needs. The less frequently updates are made, the more stability is provided to both customers and suppliers. This could mean less volatility in the prices customers ultimately have to pay. For suppliers, having a constant CoC can assist in the planning of business operations. Additionally, this added stability can prove more attractive for investors on account of less volatility and greater planning.

4.33. On the other hand, updating the CoC more frequently carries the obvious benefit of it being able to more accurately meet the demands of market conditions. For customers, lower

costs, and therefore savings, could be passed through more quickly. This flexibility, while carrying greater uncertainty for customers, can mean that the level of return that suppliers receive is better aligned to what their capital requirements dictate.

4.34. There are several approaches that could be taken with respect to updating the CoC. The choice of approach is necessarily contingent on the appropriate frequency. Some of these approaches include:

- a regular scheduled update to the CoC;
- a trigger-based update depending on when we, suppliers or other stakeholders consider there is a material issue with the ROCE; and
- updates to coincide with every update to the cap itself.

Question 6: How often should we update the CoC, and what might the trigger(s) be? Should there be a periodic review?

Capital employed

Context

4.35. Under the financeability duty in the Act, we are required to have regard to the need to ensure that holders of supply licences, who operate efficiently, can finance licensed activities. One way we achieve this is by considering an efficient theoretical supplier's ability to generate an appropriate return on their capital employed.

4.36. We understand that capital requirements may have changed in light of factors discussed in Chapter 3. We are consulting on whether the current level of capital employed remains appropriate and if it continues to deliver a normal rate of ROCE.

4.37. The current level of capital employed, based on a cap of c. £1,000 - £1,300, was determined using the CMA approach of 2016. With the rise in SVT revenues, this has increased the EBIT allowance in absolute terms, increasing the implied capital employed. We aim to consider whether or not this increase in implied capital employed exceeds the capital employed required by an efficient theoretical supplier.

4.38. We intend to consider current market conditions and the introduction of proposed new Ofgem policies, some of which may increase capital employed, some of which may reduce capital employed.

4.39. Further to this, due to increases in the energy market prices, increases in price volatility and market exits that have occurred since 2021, we also aim to consider whether the use of recent historical ROCE provides an accurate reference point for what capital should be employed by an efficient theoretical supplier.

4.40. We propose to use the current level of capital employed based on current SVT EBIT values as a starting point, but further build on the methodology through analysis, modelling and judgement to determine if an updated range of capital employed is required.

4.41. To support our analysis of an appropriate range for capital employed, we will aim to consult on the following:

- **Asset base:** the proposed buckets where capital would be employed and the components that make up this asset base;
- **Potential drivers:** identify the potential drivers and appropriate business metrics for each component of the asset base; and
- **Proposed methodology:** an updated approach to determine a suitable value of each component of the asset base.

Asset base

4.42. We recognise that the capital employed by an efficient theoretical supplier to form their asset base is driven by a multitude of components and is reflective of wider business structures. In order to estimate a level of capital employed to base the EBIT allowance around, we consider it to be important to align on our view of how capital employed is structured.

4.43. To facilitate discussion, we propose characterising capital employed at a more granular level in order to review how changing markets conditions could have impacted capital requirements. We consider it to be in the interest of customers to ensure there is a balance between supplier financial resilience and customer costs that remains fair and equitable.

4.44. Whilst we consider the proposed list of components to be the major areas where capital is employed, we do not consider this proposed list to be exhaustive. We welcome stakeholders to also provide their view on what other components we should consider.

4.45. We propose characterising capital employed into the following three components:

- **Working capital:** capital used to cover differences between when goods and services are paid for by suppliers, and when customers pay their bills. This can also be considered as the net current assets of a supplier;

- **Collateral capital:** money a supplier may be required to deposit to cover certain activities, such as:

  - network liabilities (over 6 weeks of network cost), Low Carbon Contracts Company (LCCC) Contracts for Difference (CfDs) and Feed-in Tariff Scheme (FiTS);

  - energy balancing liabilities with system operators, as set out in the Uniform Network Code (UNC) and Balancing and Settlement Code (BSC); and

  - trades: The requirement to post collateral for trades will be dependent on the trading arrangements a supplier has and the creditworthiness of the supplier or the parent company of the supplier. Suppliers that are investment grade or are part of a group whose parent is investment grade, may not need to post collateral. The latter, if they trade in their own right, may be required to provide a PCG. Suppliers that are sub investment grade, and do not have access to a PCG can post other forms of credit such as a letter of credit. In the absence of suitable credit arrangements, collateral may be required to be posted for trades delivered and not paid for, plus any Mark to Market (MtM) losses on trades. The CMA assumed trade delivered through third-party trading arrangements did not require collateral to be posted as in their trading agreement, and the customers book could be used to collateralise trade exposures in the event of default.

- **Risk capital:** money required to cover cost/losses that arise from holding open risks, eg shaping and balancing costs and bad debt. This is typically in the form of equity or equity-type instruments on the balance sheet.

Question 7: Do you agree with the above components of capital employed? If not, what other components should we consider?

Potential Drivers

4.46. Following definition of the principal asset base where capital is employed by an efficient theoretical supplier, it is key to develop an understanding of the potential drivers behind each of these components, in order to consider what the CoC is over a range of market and policy scenarios on these components of capital employed. In determining the CoC of these components we want to understand what the optimal approach is to remunerate the capital employed though EBIT to maintain the determined CoC over a range of market scenarios.

4.47. We recognise that changes in the recent market conditions and policy may have altered the potential drivers across the three components of capital employed.

Working capital

4.48. We consider that the following may be potential drivers of changes in the working capital:

- **Increases in the cap level:** There are several ways that rapidly increasing energy costs can impact suppliers' working capital requirements in serving SVT customers: 1) Suppliers have a large population of direct debit customers on 'annual' payment plans, therefore even in normal market conditions the monthly direct debit taken does not equate to the monthly cost resulting in the working capital requirement fluctuating over a course of a year. At higher price levels, the difference between the monthly direct debit taken and the corresponding monthly cost may increase, consequently this may require more working capital. 2) To the extent that a supplier has incurred costs which are recovered through deferred allowances, the additional energy cost above what was allowed in the cap is borne by the supplier until subsequent price periods;

- **Cap price and market price differential:** The difference between the cap price and market price may become wider if wholesale energy prices continue to rise. Notably however, the effect of this driver may be diminished with Ofgem's recent decision to implement more frequent cap updates.

Collateral capital

4.49. We consider that the following are potential drivers of collateral capital:

- **Gas and Electricity power balancing:** with volatile wholesale prices, gas and power balancing collateral requirements have increased significantly which have to be covered by increased collateral capital;

- **General trading arrangements:** large suppliers will tend to trade through related businesses or parent companies leveraging the credit worthiness of the overall organisation. However, small and medium suppliers may need to post collateral. The amount of collateral they need to post increases with wholesale prices;

- **Collateral requirements for trading arrangements:** the CMA concluded that third-party trading arrangements did not require collateral payments. To the extent that an efficient theoretical supplier is deemed to be trading under third-party trading arrangements the question arises if these trading arrangements remain uncollateralised in a post 2021 world. In the past, suppliers that utilised third-party trading arrangements had been able to use their customer books to act as collateral against trade and MtM exposures for all or some of these exposures. However, the events since 2021, and the learning from supplier failures may lead to providers of third-party trading arrangements being less certain that the customer book provides collateral, and they may require an efficient theoretical supplier to post more collateral to access wholesale markets.

Risk capital

4.50. We propose that the following are potential drivers of risk capital:

- **Wholesale energy price volatility:** with volatile commodity prices, the ability of suppliers to accurately reflect the indexation in the cap is subject to increased risk. For example, unexpected SVT demand in either direction may create additional risk capital;

- **Shaping and balancing costs:** with more volatile wholesale prices, the potential risk faced by suppliers in shaping and balancing may have increased;

- **Bad debt:** different bad debt levels could have an impact on the level of risk capital for a supplier. The current cap allowance assumes a level of bad debt. If levels of bad debt rise above or fall below the allowance, the supplier may no longer be compensated or over-compensated for those costs under the normal cap allowances. Consequently, suppliers are exposed to the risks beyond the cap; and

- **Unexpected weather events:** the cap has no specific allowance for weather risk – it is deemed to be covered by the wholesale risk allowance, headroom, and EBIT as there may be offsetting benefits over time as well as costs. At present, suppliers are potentially exposed to high costs in cold weather, (although in normal circumstances this can be a benefit) with high wholesale energy costs projected through the winter period, which may require additional capital. Alternatively, there could be a substantial benefit for suppliers this winter if demand is lower than expected due to warm weather, should prices remain high. Demand could also be lower than expected due to non-weather-related effects, eg from customer turndown at high prices which could result in a windfall gain for suppliers.

4.51. There may be other drivers of capital employed. We do not consider these lists exhaustive. We welcome stakeholder views on this.

Question 8: Do you agree with our view on the potential drivers of capital employed by a market representative efficient theoretical supplier?

Question 9: What are your views on what components and drivers are fixed and variable?

Question 10: What are the appropriate business metrics to measure capital employed?

Proposed methodology

4.52. We recognise the market has changed and we consider the previous CMA approach to calculate an EBIT margin informed by static companies to be no longer appropriate. We consider an approach built around an efficient theoretical supplier to be better as it also links up with our other work on MSC. Therefore, we propose an alternative methodology to understand the appropriate level of capital employed in the current market.

4.53. We propose to model our view of the appropriate level of capital that should be employed for an efficient theoretical supplier, that is representative of the market, and reference this against the CMA analysis. We intend to take a balanced view to assess the robustness of our findings and define the capital employed for an efficient theoretical supplier.

4.54. This approach ensures we are not starting our analysis from square one, but are able to test this new approach against the current status quo – helping us assess what, if any, change is required.

4.55. In being minded to adopt an efficient theoretical supplier approach, we recognise that we are not in typical market conditions and that there may not be appropriate suppliers in the market which we can base our modelling around. Instead, we consider that designing the methodology around what we would consider an efficient theoretical supplier will be more appropriate, although we note that we will draw on the existing market data where deemed appropriate.

Question 11: Do stakeholders agree that using an alternative efficient theoretical supplier-based approach is reasonable?

5. Implementation of EBIT

Chapter summary

We are seeking stakeholder views on what is the most appropriate approach for setting the EBIT allowance in the cap. We lay out some initial thoughts in this section.

Context

5.1. Alongside consulting on the underlying components that drive the EBIT margin in Chapter 4, we also want to consult stakeholders on the method of implementation going forward.

Considerations

5.2. In reviewing the EBIT allowance implementation methodology, we need to consider a range of factors and trade-offs, such as complexity, accuracy and practicality, before making a decision on the right approach to take forward.

5.3. In the section below, we outline our initial thoughts on how the EBIT allowance should be implemented. We invite stakeholder views.

The current methodology

5.4. As mentioned in Chapter 2 (paragraph 2.7), we used the CMA's estimate of EBIT margin as the basis for calculating the EBIT allowance in the cap in our 2018 decisions.

5.5. Under the current approach, we update the EBIT allowance each time the cap is updated. We apply the fixed 1.9% EBIT margin to the updated allowances for wholesale costs, network costs, policy costs, operating costs and the payment method uplift.[27] As a result, the EBIT allowance scales directly with customer bills.

5.6. Under the current market conditions, some cost components are highly variable, such as wholesale costs. As a result, the EBIT allowance varies significantly in the recent cap

[27] Ofgem (2018) Default Tariff Cap: Decision, Appendix 9- EBIT. https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_9_-_ebit.pdf

updates. We want to assess whether the current approach for applying the fixed flat EBIT margin to variable cost components is still appropriate, given the recent increase in energy prices and volatility suppliers and customers are subject to. We would like to ask:

- Do stakeholders consider this approach to be the most appropriate in calculating the EBIT allowance in the cap?

- The EBIT margin that used for calculating EBIT allowance has not been amended since the first cap was introduced. Do stakeholders consider it is appropriate to undertake periodic reviews for the EBIT margin or not? If not, what might be grounds for reviewing EBIT margins in future? If so, how often should it be reviewed and why?

Alternative approaches

5.7. We would be interested if stakeholders have alternative approaches that potentially better achieve our objectives on providing the appropriate EBIT allowance to renumerate the rate of return on the capital held by an efficient supplier and protecting the interests of customers. We do not intend to be prescriptive at this stage in what these alternatives could be as we are not seeking to infer we have a preference than the existing approach. Some suggested alternatives are:

- a fixed approach that sets an absolute term, such as pounds per customers.

- a hybrid approach that sets an absolute (£ per customer) term and a variable term or terms that relate to costs such as the underlying cost of energy; and

- a hybrid approach with a cap and collar.[28]

5.8. We invite stakeholders to propose alternative approach, please:

- Outline the approach – how it would be calculated to deliver a defined EBIT allowance or EBIT range;

[28] The allowance would be bounded between an upper limit (cap) and a lower limit (collar), with the allowance changing when required to best reflect market conditions.

- What the advantages are compared to the existing approach;
- How it might perform in a range of market conditions; and
- How practical it would be when implementing.

Question 12: Do stakeholders consider the existing approach to be the most appropriate in calculating the EBIT allowance in the cap?

Question 13: Do stakeholders consider it is appropriate to undertake periodic reviews for the EBIT allowance or not? If not, what might be grounds for reviewing EBIT allowance in future? If so, how often should it be reviewed and why?

Question 14: Which of our suggested alternative approaches is the most appropriate for setting the EBIT allowance going forward?

Question 15: If the proposed approaches are not appropriate what alternative approaches not proposed in this policy consultation would be appropriate for setting the EBIT allowance going forward?

Appendix A - Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

4. With whom we will be sharing your personal data

We may share consultation responses with BEIS.

5. For how long we will keep your personal data, or criteria used to determine the retention period

Your personal data will be held for six months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete

- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making

9. Your personal data will be stored in a secure government IT system

10. More information

For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise."