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23 September 2022

Dear Dan,

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

The timescales for this consultation have not allowed suppliers sufficient time to gather meaningful evidence and analysis to inform any decisions Ofgem makes as a result. In particular, the existence of the Government Energy Price Guarantee (GEPG), a significant change to the energy retail market that has numerous and significant interactions with the questions Ofgem asks, was not known when the consultation was written (at least not to suppliers), was announced halfway through the consultation period, and its design has not yet been finalised. We are extremely concerned that any decision Ofgem makes that is informed by input from this consultation process will be fundamentally flawed.

The consultation covers at a very high level a number of extremely complex topics with significant implications for the level of EBIT. Many of these topics warrant separate consultations in order to understand them well enough to meaningfully inform the EBIT assumption. Were this consultation a call for evidence, signalling the start of a detailed work program exploring these topics in further consultations, our feedback would be that the overall framework is sensible. However, Ofgem's plan to publish a statutory consultation in November is completely unrealistic and seriously underestimates the level of work needed to understand and inform any change to the EBIT assumption. It is akin to attempting to conduct a network price control review in a month.


Notwithstanding this concern, we have provided feedback below on certain principles, we have also commissioned Oxera to review the consultation and CEPA analysis. We attach Oxera's report to this response and refer to it in our answers below (referred to throughout as the "Oxera Report").

Ofgem's framework for its review of EBIT appears sensible and a step forward from the original CMA analysis underpinning the current EBIT assumption. This framework highlights numerous areas where capital requirements for suppliers have increased significantly as a result of the energy crisis, with the majority of these increases directly correlated to the increases in wholesale prices and corresponding increase in customers' bills, in some cases these capital requirements increase more than proportionately. Oxera's review of Ofgem's cost of capital proposals also highlights that Ofgem's current proposal under-estimates suppliers' cost of capital.

Whilst we recognise that the absolute level of EBIT allowance has increased in line with the overall price cap level, this EBIT allowance fails to allow even a normal rate of return, let alone excess profits. This is due to the design of the price cap and in particular the risks it imposes on suppliers.

Any meaningful review of evidence underpinning the current EBIT assumption in the price cap will show that the current EBIT allowance is not sufficient. As Oxera summarises in its report:

*“It therefore appears that the level of EBIT that is required to address the balance of risks in the sector is not being earned, notwithstanding these increases in line with wholesale costs.”*

Although its design is not yet finalised, the GEPG scheme is likely to have an impact on some of the risks suppliers face. In the time available and given the structure of the consultation (which was written before GEPG had even been mentioned to suppliers), it has simply not been possible to review these interactions and their implications. We would highlight however that many of the wholesale risks that underpin the significant increases in capital requirements for suppliers  are unaffected by GEPG. In addition, whilst customers' bills are lower than they would otherwise be as a result of GEPG, they are still double the levels seen last winter. Therefore, even with the introduction of GEPG, pressure on suppliers' working capital associated with high bills and bad debt risk remains significantly higher than it has ever been and significantly higher than when the current EBIT assumption was first developed.

Oxera's report highlights numerous areas where suppliers' capital requirements have increased beyond the levels implied by the current EBIT assumption, largely as a direct result of the design of the price cap. Oxera also highlights a significant risk suppliers face that has never been captured in the existing EBIT assumption: the free option that suppliers are required to offer to customers through the price cap. Oxera conservatively values this option at up to £100 per customer per year in the period before the energy crisis, its value increased to over £500 by the end of 2021, and will be significantly higher in 2022 (although the extreme wholesale volatility in 2022 makes modelling of the precise option value extremely challenging). This option value represents the risks suppliers face in providing the free option and, alone, is greater than the total EBIT margin suppliers were theoretically able to recover pre-crisis, before any other risks are taken into account. In the coming weeks we plan to supplement this analysis to reflect more recent changes to the price cap's design.

This analysis of the free option by Oxera highlights yet another significant example of the hidden costs of the price cap. A thorough and meaningful review of the EBIT assumption will show that suppliers require higher levels of EBIT to achieve a normal rate of return given the costs and risks imposed by the price cap. This drives a far more important question which should be the focus of any Ofgem or BEIS review: when costed properly, does the price cap really offer value for money to consumers?

Ofgem presents no analysis of the levels of capital required by suppliers, so it is not possible to comment on Ofgem's approach. Should Ofgem progress this topic, detailed proposals need to be developed and published with appropriate timescales for suppliers to review and challenge before any statutory consultation. We are extremely concerned by Ofgem's intent to publish a statutory consultation in November 2022, we cannot see that any such statutory consultation would have been informed by appropriate evidence with opportunities for suppliers to comment and challenge.

Ofgem asks a series of questions about the implementation of the EBIT allowance, without any detailed analysis of implications of changes nor any particular rationale for changing the approach. Whilst it is true that the current approach results in absolute levels of EBIT increasing in line with wholesale costs, it is also true that the majority of drivers of capital employed also increase in line with wholesale costs (and corresponding customer bills). Moreover, some drivers increase more than proportionately due to customers' decreasing ability to pay at higher bill levels. Therefore, we can see no rationale to change this approach.

In appendix 1 we outline our high-level thoughts on the topics Ofgem covers and reference the Oxera Report where relevant. We intend to follow up with further evidence in certain areas.

Overall, whilst we agree a review of EBIT is sensible, our understanding is that the industry as a whole has been loss-making since the price cap was introduced, despite a theoretical 1.9% EBIT allowance. Ofgem must recognise this, take a step back and take the time needed to analyse this topic in collaboration with suppliers and other stakeholders with the attention it requires, taking into account the fundamental changes in the retail market that are currently being implemented.

Yours sincerely  
Steve Davies  
Head of Regulation

## **Appendix 1**

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

This is an extremely complex question, Ofgem provides no context or framing around this question and what types of assumptions, and for what purpose, it intends to make. To provide meaningful input requires far more detail from Ofgem, we'd then suggest a series of workshops with suppliers would be necessary in order to identify the supplier attributes Ofgem would need to make assumptions on. Only then could Ofgem meaningfully gather evidence on the assumptions it will need to make for its efficient theoretical supplier.

One of the few areas where Ofgem does include further detail is around the use of parent company guarantees (PCGs), suggesting that larger or vertically integrated firms may be overcompensated if they use PCGs instead of posting collateral. Section 5.4.2 of the Oxera Report addresses this point, noting that the cost of PCGs is unfunded through the EBIT margin, that Ofgem itself recognised that PCGs require a cost of funding in its recent consultation on financial resilience and that other regulators have been successfully challenged on the cost of PCGs being explicitly remunerated in price controls. Ofgem presents no evidence of the relative cost of PCGs versus collateral.

In principle we agree with the proposal to create a market efficient theoretical supplier, however a far more structured approach to developing this model is required. It remains unclear what evidence Ofgem will be using to design the efficient theoretical supplier, and a much greater level of input is required from suppliers than the questions asked within this consultation.

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

Again, this is an extremely complex question. Ofgem presents no alternative to the CAPM model and no pros and cons associated with its use, other than stating it has a long regulatory precedent. In the time available to respond to this consultation, we have focussed on the CAPM model itself rather than exploring alternatives. We can see no obvious flaw in using CAPM but that does not mean we agree it is the most suitable approach. More time and detailed analysis from Ofgem would be required to make this judgement.

Regarding CEPA's approach to using the CAPM model, section 4.2 of the Oxera Report highlights

flaws in CEPA's analysis of the risk-free rate and total market returns. We cover this in Q4 below.

**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?**

CEPA's approach appears to be broadly in line with our experience and given the time available to us to analyse the report we have not highlighted any major concerns.

CEPA notes that some of the risks suppliers face are asymmetric, and as such they are not standard beta risks as typically captured in a capital asset pricing model, we agree. CEPA suggests that rather than increasing the rate of return via beta to address these risks, a better treatment may be to amend the specific cost allowances within the price cap. While it's positive that CEPA recognises the limits of dealing with these risks via margin, the analysis does not consider the impact of volume risk and how the layering of further costs into the cap increases that risk; there remains a significant risk that as customers leave the cap, suppliers will be left with stranded costs. In fact, increasing the cost allowances makes it more likely for customers to leave the cap. The prospect of stranded costs remains a significant flaw in the price cap methodology and runs counter to any argument that the cap promotes a competitive dynamic.

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

Oxera highlights a number of concerns with the CEPA analysis in section 4.2 of the Oxera Report.

We urge Ofgem to review this section of the Oxera Report in detail.

In summary, on the risk-free rate (RFR) Oxera highlights concerns with:

- CEPA's focus on five- and ten-year gilts, disregarding evidence on 20-year gilts;
- CEPA's reliance solely on gilt yields to proxy the RFR;
- whether the RFR methodology appropriately accounts for differences in retail and network price controls.

Oxera provides evidence to show the TMR range used by CEPA (based on Ofgem's RIIO II TMR range) erroneously relies on the geometric average of historical returns rather than the arithmetic average and needs to be updated to take account of the latest available historical inflation backcast. As a result, the CPIH-real TMR should increase to 7.1%-7.2%.

Correcting for these flaws, the nominal pre-tax cost of equity range should increase from 9.3%-10.9% to 9.9%-11.5%.

**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?**

As Ofgem highlights, there is a trade-off to be made. More frequent updates to the CoC may better reflect the underlying costs suppliers face at a particular point in time, but result in more volatile changes to the price cap which may impact consumers. Less frequent updates to the CoC give more stable pricing to consumers but risk over- or under-compensating suppliers. There is no right or

wrong answer to this question; on balance, less frequent updates may be favourable given the impact on consumers but we'd stress that Ofgem should monitor the underlying CoC and be prepared to adjust where necessary. A clear basis for calculating the overall EBIT allowance with CoC as an input will help do this.

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

We refer Ofgem to section 4.1 of the Oxera report which highlights that the frequency of update is intrinsically linked to the previous question about the balance between using long-term or short-term evidence in estimating the cost of capital. The answer to this question flows from Ofgem's decision on the balance between long-term and short-term evidence in the estimation of CoC.

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

The components of capital employed highlighted by Ofgem appear sensible and represent a step forward from the original analysis conducted by the CMA in its Energy Market Investigation.

Ofgem highlights in paragraph 4.41 that it intends to consult on the asset base, potential drivers and proposed methodology. This is a sensible approach as these are complex and detailed questions with extremely significant consequences for suppliers and customers. As part of its response to this consultation, Ofgem needs to set out a timetable of when it will consult on these topics, ensuring suppliers and other stakeholders have sufficient time to meaningfully respond. This is necessary before any statutory consultation; it is unclear how Ofgem intends to do this given its intent to publish a statutory consultation in November.

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

The drivers of capital employed listed within the consultation generally appear to be sensible as overall categories. However, Ofgem provides no detail as to what it intends to include in these categories or how it will assess the capital employed as a result. This is a fundamental component of any review of the EBIT assumption, Ofgem cannot expect to make any robust decision on EBIT without presenting thorough analysis and detailed proposals of how it intends to calculate capital employed with sufficient time for suppliers to thoroughly review and challenge. With the limited information Ofgem presents in its consultation document, there is a long way to go to reach this point.

We provide below some initial commentary on the drivers of capital employed and highlight various factors that Ofgem must take into account. This does not represent an exhaustive list, in the limited time available we have not been able to complete a thorough, bottom-up review of drivers of capital employed.

*Working capital*

As Ofgem highlights, increased customer bills increase the working capital requirement for suppliers as any delay in payment (for example though an average DD payment) has a greater impact on

working capital. This effect is likely to increase more than proportionately to the size of the bill due to customers' decreasing ability to pay at higher bill levels.

Likewise, Ofgem is correct to highlight the working capital impact of recovering costs in periods after they have been incurred. This effect on working capital is significant given the current levels of wholesale volatility which are driving significant exceptional costs. For example, in its Decision on Changes to the Wholesale Methodology Ofgem estimated that backwardation costs for this winter were £271 per customer. These costs are incurred over a 3-month period but recovered over 6 months. Similarly, adjustments for unexpected SVT costs are recovered ex-post, over a 12-month period. Again, these are significant costs.

Ofgem's recent consultation on financial resilience has implications that could directly impact the levels of working capital a supplier requires. It is not possible to comment on the precise implications until the outcome of that consultation is published.

### *Collateral*

This is a key driver of capital employed, particularly in periods of extreme wholesale volatility. Ofgem's analysis in this section is extremely limited and simplistic. This topic is worthy of a separate consultation in its own right.

Suppliers of all shapes and sizes are facing extreme impacts, Ofgem is wrong to dismiss the impacts of collateral in general trading arrangements for larger suppliers. Credit and collateral are key components of any supplier's capital employed. ✂

We are particularly concerned that, ✂ .

### *Risk capital*

The high-level drivers of risk capital Ofgem identifies are sensible, but its analysis and description of risk is extremely limited. This topic also warrants a separate and detailed consultation of its own.

Wholesale energy price volatility is a huge risk that suppliers face. This is a risk that is directly impacted by flaws in the design of the price cap. Ofgem needs to conduct thorough analysis to properly understand these risks and the limitations of its policies that attempt to address them.

As Oxera highlights in section 3 of its report, a key element of the wholesale price risk is the free option that the price cap represents, forcing suppliers to offer a product that customers can switch onto and away from at zero cost. Oxera's analysis shows the value of this free option, before the energy crisis, was up to £100 per customer; the value has increased significantly as wholesale volatility has increased. This free option manifests in volume risk which Ofgem has attempted to address through the quarterly cap and the market stabilisation charge. As Oxera highlights, the move to the quarterly cap is likely to reduce, but will not eliminate, the value of the free option suppliers are required to provide. We plan to follow up with analysis of the free option under the quarterly cap to quantify the true value going forwards. Similarly, the MSC only partially covers the risks suppliers face in the event of falling prices. As we have highlighted to Ofgem on numerous occasions, the MSC is only effective to the extent it is reliably in place when a supplier is hedging for its customers, and its current parameters still expose suppliers to costs of £hundreds of millions in certain scenarios.

In attempting to solve elements of the volume risk problem, moving to a quarterly cap exacerbates

other risks such as basis risk. Ofgem articulated these trade-offs when making its decision about moving to the quarterly cap and has introduced the backwardation adjustment as a result. However, that adjustment has its own inherent flaws in that it uses a deadband, which exposes suppliers to a portion of the risk (with an increase in risk capital requirement as a result), and is recovered, at least in part, ex-post (see working capital section above).

Shaping, balancing and weather risks all increase in line with wholesale market volatility. These risks are significant. In the time available to respond to this consultation ✂️. Ofgem needs to gather more specific and detailed evidence from suppliers in this area.

Ofgem makes no comment on the levels of liquidity in wholesale markets. This is a significant risk for suppliers and is another key component of wholesale price risk. The price cap assumes a supplier can purchase a slice of its energy requirement for its customers every trading day, at a price reflective of the index Ofgem uses to calculate the wholesale allowance in the cap. This has been challenging ever since the cap was introduced, as we have highlighted to Ofgem on many occasions. In the current environment, with trading extremely limited due to extreme volatility and credit/collateral requirements limiting the number of parties who can trade, ✂️.

The relationship between the price cap and liquidity in the wholesale market needs to be explored further and, in the absence of measures to improve liquidity (which we have long argued for) this needs to be taken into account when assessing risk capital requirements.

Ofgem is right to highlight bad debt as a source of risk capital. Whilst the cap includes an allowance for bad debt, Ofgem will be aware that we disagree with its approach and have provided evidence to show that ✂️.

As Ofgem highlights, suppliers are exposed to risk beyond the allowances in the cap, given the flaws in the bad debt allowance we have highlighted in other consultations, this risk is significant. In addition, whilst the GEPG scheme is likely to result in bad debt being lower than it would otherwise be, customer bills are still twice as high as they were last winter meaning bad debt as a percentage of turnover is also likely to be substantially higher than it ever has been since the price cap has been in place. This is because the propensity for a customer to fall into debt increases with turnover, due to customers' decreasing abilities to pay at higher bill levels. Whilst there are government support measures currently in place to address some of the increases in bills, other than GEPG there is no stated intention for these to continue beyond April 2023.

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

All of the drivers Ofgem highlights are directly related to either the level of wholesale prices or the overall level of customers' bills (which are themselves inherently linked). As highlighted above, some of the drivers increase more than proportionately when compared to the overall bill level. Therefore, we cannot see any reason why components and drivers would be anything other than variable.

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

There is no simple business metric to measure capital employed in the way it is needed to underpin a review of the EBIT assumption in the price cap. As highlighted above and through the Oxera Report, there are numerous drivers of capital employed in a supply business, many of which are a direct result of the implementation of the price cap itself and many of which are not explicitly recognised as risks by Ofgem.

To make an assessment of capital requirements Ofgem needs to perform a thorough, bottom-up analysis of all drivers for the theoretical efficient supplier, taking into account current market conditions. Given the significant impacts and complexity of this exercise, suppliers and other stakeholders need sufficient time to review and challenge.

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

In principle we agree with the approach of using an alternative efficient theoretical supplier-based approach, however it is unclear at this stage what parameters will be used to develop the efficient theoretical supplier model. On the basis that working capital requirements have changed given the recent and substantial increases in wholesale prices and market volatility, Ofgem must ensure that any model is based on current market conditions. As we highlight above, developing these parameters and calculating the level of capital required for the efficient supplier will be a complex task that will require a more robust consultation process than this one. This approach is therefore only reasonable if Ofgem thoroughly consults on the parameters, including numerical values and the basis upon which they are calculated. As Oxera states in the report:

*“Working capital requirements have changed recently in light of increase wholesale prices and market volatility, as well as for unexpected SVT demand. For this reason, Ofgem is correct saying that the levels of working capital should be based on an efficient theoretical supplier, but it has to be representative of the current market conditions.”*

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

The current approach to calculating EBIT using a % of customer's total bills appears sensible. As highlighted above, the key drivers of capital employed are all directly related to either the wholesale price or the overall level of customers' bills; in addition, some of the drivers of capital employed increase more than proportionately when compared to the overall bill level.

**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?**

As outlined in our response to Q5 above, there is a trade-off to be made between reviewing the EBIT allowance more frequently and reducing volatility in customers' bills.

Given our view that the EBIT allowance should remain a function of the overall level of customers' bills, and on the assumption Ofgem completes and consults on the necessary analysis to see the EBIT



allowance at an appropriate level, the need for more frequent review is limited.

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

We do not believe any of the alternative approaches suggested within the consultation are appropriate. As previously mentioned, all of the drivers Ofgem highlights are directly related to either the level of wholesale prices or the overall level of customers' bills therefore an EBIT margin which scales with the level of the customer's bill is the most appropriate.

**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?**

As highlighted throughout our response, Ofgem's approach to reviewing the EBIT allowance overall focusses too much on technical changes such as the implementation of the allowance and misses the much more fundamental questions about the risks and costs associated with the price cap, such as the free option described in section 3 of the Oxera Report. Our understanding is that the industry as a whole has been loss-making since the price cap was introduced, despite the theoretical 1.9% EBIT allowance. Ofgem must recognise this. Rather than seeking to develop complex, hybrid approaches to apply the EBIT allowance without time to assess them properly (which will almost certainly lead to unintended consequences), Ofgem's efforts are better spent on reviewing the risks properly and aiming to prevent mass failure of suppliers. This should then lead to a full review of the best way to ensure affordable energy for customers, including the fundamental design of the price cap with an honest view of its costs, and consideration of possible alternatives to the cap.