



Octopus Energy

UK House,
164-182 Oxford Street,
London W1D 1NN

w: octopus.energy

e: hello@octopus.energy

p: 0808 164 1088

23 September 2022

By email to: retailpriceregulation@ofgem.gov.uk

Dear Dan Norton and Marzia Zafar

EBIT allowance in the price cap methodology

Thank you for an opportunity to comment on the proposals to review the EBIT allowance in the default price cap methodology. We have limited our response to a number of high level observations given the short time available to reply to this consultation.

Over the last year there has been a very significant uplift in the systematic risk we face, and therefore the cost and volume of capital we require to finance our business. However, we do not consider it is helpful either to the industry or to consumers/taxpayers for Ofgem to undertake a narrow, technical review of the EBIT allowance at this point.

With the introduction of the Government's Energy Price Guarantee (EPG) the role of the price cap has changed substantially - no longer setting the ceiling on the customer price for the next 2 years. This presents a very significant opportunity for Ofgem to conduct a more strategic review of retail regulation with a view to: lowering systematic risk and improving financial resilience in the retail sector; containing costs for the taxpayer; and providing a 2 year transition to a fully competitive, financially stable and vibrant retail sector which is able to make a significant contribution to achieving net zero. At the very least this should involve a wider review of the price cap methodology. But it could also include a review of the market stabilisation charge and the approach to financial resilience as a package.

A reassessment of the EBIT allowance in the cap would only make sense once this wider review has happened and to reflect the appropriate resulting required returns. We would be very pleased to work with Ofgem and other industry players to make the most of the opportunity the EPG has created.

We have four key observations on the consultation, which we explain in more detail below:

- Suppliers have experienced very substantial increases in the cost and amount of capital employed. [REDACTED];
- However, the right response is not a narrow review of the EBIT allowance;
- We are calling for a wider, more strategic review of key regulatory measures to improve financial resilience amongst other goals;
- In particular, there are fundamental issues with the price cap that the EPG provides an opportunity to address.



Octopus Energy

UK House,
164-182 Oxford Street,
London W1D 1NN

w: octopus.energy

e: hello@octopus.energy

p: 0808 164 1088

Suppliers have experienced very substantial increases in the cost and amount of capital employed

The current wholesale market level and volatility means that the cost and amount of capital retailers have to employ per customer is very substantially higher than when the price cap was set. This is confirmed by the conclusions CEPA has reached that the current cost of capital for the sector lies between 12-15% (pre tax nominal) compared to the 10% arrived at by the CMA¹. [REDACTED]

In your document you have correctly identified the key drivers of capital employed. While Ofgem has taken action to reduce the impact of wholesale volatility (e.g. the market stabilisation charge and speedier recovery of backwardation), some measures have introduced new risks (such as the additional shaping costs and difficulty of hedging in line with the quarterly price cap methodology). This, alongside the continued unprecedented roll to SVT and higher customer default, means we have experienced very significant upward pressure on earnings required over the last year. Our capital requirements will be further inflated should Ofgem go ahead with its ringfencing proposals - and this is one of the many reasons we do not support the ringfencing policy.

In reality high systematic risk also means that, whatever the EBIT margin, gaining access to capital is becoming increasingly difficult for the sector. [REDACTED]

[REDACTED] While we are well financed to ensure sufficient liquidity headroom above our planned requirement, there is a risk that this situation is creating financial strain on some other retailers and holding up much needed investment for net zero in the sector as a whole.

Against this backdrop in particular, it is worrying that Ofgem's document - and subsequent communications - suggest that the current EBIT allowance is providing an upside to suppliers, and may need to be revised downwards. Contrary to Ofgem's indications, we see little evidence that a balanced, evidence based review of the EBIT allowance would do anything other than increase the allowance and the level of the cap. We find it strange that Ofgem appears to want to move at pace to conduct and complete this review.

¹ [Default Tariff Cap cost of capital pg 4](#)



Octopus Energy

UK House,
164-182 Oxford Street,
London W1D 1NN

w: octopus.energy

e: hello@octopus.energy

p: 0808 164 1088

A narrow review of EBIT allowance is not in customers' interests nor appropriate at this time

We do not think a narrow, technical review of the EBIT allowance in the price cap is the right response from Ofgem to the volatile wholesale price situation, nor is this in customers'/taxpayers' interest. The level of uncertainty in the wholesale market means there is a risk of Ofgem making an EBIT decision which rapidly becomes out of date. The suggestion that EBIT would be reviewed on a routine basis to address this uncertainty would add an unacceptable level of regulatory risk to the sector and further drive up the cost of capital.

We note that several suppliers have requested a review of the price cap allowances to accommodate Ofgem's proposed RO payments and credit balance ringfencing requirements. This is better addressed by dropping these proposals and using other measures (such as an IATA-type industry insurance scheme) to provide for some of the costs on retailer failure. Particularly in today's wholesale market conditions, it makes no sense for Ofgem to require suppliers to place capital outside the business and then to increase the EBIT margin in the price cap by way of compensation. As well as increasing costs for the public purse, this move will make the sector even less attractive to transition investors who take larger risks but who will not accept utility style regulated returns. We urge Ofgem to revisit its ringfencing proposals and consider alternative measures to improve financial resilience in the sector which are more consistent with creating a competitive and vibrant retail sector.

We understand that Ofgem is concerned about the potential for retailers to profit in today's circumstances by selling down a long position (for example should demand drop significantly in the light of higher prices - or enforced rationing). We strongly suggest that an ex-ante adjustment to the EBIT margin is not the correct tool for addressing this possibility. Instead, if there is evidence in the round that suppliers are making gains that outstrip the losses carried in recent months then Ofgem could, following consultation, make one-off adjustments to the price cap as Ofgem did to compensate retailers when SVT volumes increased substantially. Given the uncertainty of market conditions and customer and retailer behaviour, we see no case for anticipatory adjustments to the price cap methodology.

The EPG provides an opportunity for a wider, more strategic review of the price cap and other regulatory instruments



Octopus Energy

UK House,
164-182 Oxford Street,
London W1D 1NN

w: octopus.energy

e: hello@octopus.energy

p: 0808 164 1088

In place of a narrow review of EBIT, we urge Ofgem to review the measures within its control that will mitigate the systematic risk which is driving up the cost of capital and the volume of capital employed and which is making it very difficult for the sector to raise capital. Instead of baking in a higher regulated return, such an approach could tackle the root causes of the upward pressure on the earnings required for an efficient retailer to finance its business and would help to improve the financial resilience and attractiveness of the sector and ultimately reduce the cost of the EPG on the public purse. In any case, and as argued in our 20 July response to Ofgem's Strengthening Supplier Financial Resilience consultation, measures to reduce systematic risk in the sector are needed before Ofgem can introduce a capital adequacy regime - without this, the regime would place unsustainable costs on customers/taxpayers.

A wider review could include a reassessment of the price cap methodology, the market stabilisation charge and capital adequacy requirements as a holistic package. As noted above, the introduction of the EPG provides a 2 year window in which to take actions to enable a resilient, efficient, competitive retail sector ready to play a significant role in net zero. The review will need to ensure Ofgem's instruments interact appropriately with the EPG (including in a rising, stable and falling wholesale market) and work together to achieve the desired outcome at the end of the 2 year period.

There are fundamental issues with the price cap that need to be addressed

Ofgem's consultation on the EBIT margin has further underlined the fault lines in the current price cap methodology. In particular, as recognised in the consultation, it is impossible to arrive at an allowance that neither over-rewards suppliers with Parental Guarantees nor under-rewards and jeopardises the financeability of those without. There is no answer within Ofgem's document on how this issue is to be addressed and yet, if regulated returns are to become a larger part of the overall cost allowances in the price cap, this is vital to ensure the price cap does not distort and damage competition.

Moreover, Ofgem's analysis fails to acknowledge the difficulties retailers face in accessing capital - these are unlikely to be addressed by an increase in the EBIT allowance, or addressed through CAPM analysis, alone. Indeed, there are questions over whether a CAPM approach (as is normally applied to asset heavy RAB financed utilities) is the appropriate methodology to use for retailers, especially in an energy crisis. It is not at all clear CAPM will be able to capture the additional costs and the complexity suppliers face today.

Finally, the quarterly price cap, while reducing volume risk, exacerbates the backwardation issues in a volatile wholesale market and makes hedging and obtaining shape more



Octopus Energy

UK House,
164-182 Oxford Street,
London W1D 1NN

w: octopus.energy

e: hello@octopus.energy

p: 0808 164 1088

difficult. The price cap wholesale methodology is misaligned with the drivers of wholesale costs for retailers, creating a risk which cannot be managed. All of this suggests that there could be considerable cost savings to the public purse if there was a more significant refresh of the price control methodology.

In conclusion

We hope that Ofgem is persuaded to suspend its current review of EBIT and take a broader, more strategic review of what can be done to reduce systematic risk and drive down the cost of and need for capital in a sustainable way, before returning to the question of appropriate returns. Should you decide to proceed with a narrow review of the EBIT allowance, we urge you to conduct a further consultation allowing sufficient time for retailers to conduct the necessary detailed analysis and provide a detailed Impact Assessment ahead of proceeding to statutory consultation.

Yours sincerely

Rachel Fletcher

Director of Regulation and Economics

Octopus Energy