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Investor Relations Call

From: Investor Relations Team	Date: 25/05/2023 Time: 14:00-15:00	Location: Microsoft Teams

1. Present

Rohan Churm, Ofgem

Dan Norton, Ofgem

Marzia Zafar, Ofgem

Shai Hassid, Ofgem

Marcus McPhillips, Ofgem

Steve Alcorn, Ofgem

Raz Anghel, Ofgem

Ross Anderson, Ofgem

External Guests

2. Introduction – Steven Alcorn & Rohan Churm

Steven Alcorn 8:44

Welcome everybody.

I'm just waiting a moment for a few more people to join.

There's a couple of last people I do apologize for us starting slightly late.

Welcome everybody to this investor call hosted by Ofgem on the earnings before interest and tax and a very good morning, afternoon or evening.

From whether you are joining us, I'm Stephen Alcorn, head of strategic financial planning. and investor relations.

And today we're going to update you on the latest developments in the EBIT workstream.

Plus a couple of other items that are announced this morning.

This, which should last about 20 minutes and then we'll open the floor to questions when

we open up for the Q&A section.
We'll go through the procedures, but please do note that this call is being recorded Today, I'm being joined by my colleagues Roman Chen, director of Financial resilience and controls, Marzia Safar, deputy director for Strategy Shai Hassid, head of Strategy, and Dan Norton, Deputy director for the price cap and so over to Rohan who will give an overview of today's announcements. Rohan

Rohan Churm
Thank you, Steve for the Introduction and thanks everyone for attending. And for those of you I haven't met previously, my names Rohan churn and I joined OFGEM in March as director of Financial Resilience and controls.
Now the first time I spoke with this group of you back in April, it was to talk about our decision on enhanced financial responsibility and our consultation on a common minimum capital requirement. The backdrop to that call was suppliers had loss making in aggregate in 2022 and there was a lot of interest from you in the outlook for profitability and indeed what Ofgem would propose today on the EBIT allowance in the price cap. So I hope today's presentation and material published will provide some of the answers you are seeking them.

As you may know from previous interactions, we are keen to see the end of aggregate supplier losses and more stable sector and a sector which is therefore more attractive to outside investment and has more capacity for the innovation that we need towards net zero. Indications are that the sector will be profitable this year, but we recognize that is partly because of a temporary boost where price cap allowances allow some catch up from previously incurred costs and it's in that context, we have put out a number of publications today.
I'll provide you with a brief overview.

To begin with, it would be remiss not to mention the most high-profile announcement today from Ofgem, which is our quarterly update to the price cap. I suspect that many of you had already predicted to a high level of accuracy what it would be, but it really is a material change.

Wholesale energy prices have fallen quite dramatically and this feeds into a price cap at £2074.00, down from £4279.00 in the first quarter of this year. So a really substantial drop. That price cap of £2074.00 will mean that prices are below the energy price guarantee level, potentially making it more likely that suppliers can offer additional fixed rates as well.
Also, today we have published our decision on how we will incorporate the removal of the price cap end date from supply licence conditions and the models we'll use.

and we have published our final decision on typical domestic consumption values. Additionally, we've published a statutory consultation on a new model for the earnings before interest and taxes (or EBIT) allowance within the price CAP and a call for input on operational expenditure.

My colleague Dan Norton, deputy Director for price protection, will speak a little bit more about the price cap decisions and the call for input on operational expenditure later on this call.
Before then, Marzia Zafar and Shai will explain the thinking behind our consultation on the EBIT allowance.

There are two headlines to those proposals, an increase to the assumed cost of capital boosts the EBIT allowance, while the introduction of a hybrid methodology reduces the slope, increasing the EBIT allowance at lower price cap levels and reducing it at higher ones.

Finally, it is important that profits, including any extra profits as a result of an increased EBIT allowance, are used responsibly to ensure that we can build towards a more resilient market that we want to see in the consumer interest. The policy purpose of a proposed transition period to common minimum capital requirements is to allow suppliers that time to build resilience and for that reason we have also published an open letter for me on financial distributions and retail energy suppliers which I'll return to later on this call.

So there's a lot to read today about our next steps within the UK energy market, but I

hope this session helps you understand navigate what that means for you and your clients. We will have plenty of time for questions after our presentations, so I'll now pass over to my colleague Marzia Zafar will speak to you a little more about the new model for EBIT, which we have gone out to consult suppliers on today.

3. EBIT Update – Marzia Zafar & Shai Hassid

Marzia Zafar 14:01
Hi everybody again my name is Marzia Zafar, I'm going to quickly turn it over to Shai, who is really the expert in this area.

What I wanted to say and just echo what Rohan said is that the idea of EBIT or that our intention with EBIT, with similar intention to FRC, is to make this market resilient and is to make it more investable.

Shai Hassid 14:53
Thank you, Marzia and Rohan.

First of all, I want to start by asking "why are we doing this now?"
So we decided to review the EBIT allowance because we've observed that the market has changed.

Shai Hassid (4.41) 15:03
We see more volatility, we see suppliers that have exited the market and we also see that the price have evolved over time to mitigate some risks.
So we decided it's a good time to actually relook into the EBIT allowance, given that the allowance we introduced back in 2018 couple of years ago, we also decided that we can improve the methodology which used to be all about scaling completely the allowance based on the price cap levels.

Shai Hassid 15:26
We thought that it's good to make it a bit more cost reflective by adding also a fixed component.
I'll explain about it later. if we look at how we derive the EBIT allowance, at the underlying assumptions behind it. The high level assumptions is that the EBIT allowance is quite simple, it is the multiplication of 2 numbers.
It's the capital employed, currently at around £380 per customer, expected for 11A and then the cost of capital with 12.2% for the capital employed. It includes 3 main components.

It includes the working capital, it includes fixed assets, and it includes collateral capital and then lots of explanation about how we derive those – and we also published the model alongside the publication to help to basically be transparent about how we derived the working capital numbers. I just want to be up front and say this is a model that is specific for the purposes of establishing the allowances within the price CAP and it may look different to other financial models that you're used to.

And how does the EBIT allowance methodology that we have introduced, compare to the previous one? If you take the highly indicative numbers for 11 A, which is based on expectation of the forward curve that we look at currently, we believe that the allowance will be around £10 higher than it would have otherwise been, being at 47 pounds instead of 37 - and it will present the margins as slightly higher than 1.9% at that point of time, it will be 2.4%. It's also important to mention that those numbers are highly uncertain and allowing that still does scale when they overall cap level goes up or down.

Next slides please, and to demonstrate that, practically we introduced the fixed component to the allowance, which means that the overall level of the curve is higher and the slope is lower.

What makes it less sensitive to changes in overall price cap levels than the previous allowance?

And that reflects this essentially that there are some components within suppliers finances like fixed assets that don't change when the price cap level goes up and down so the slope should be less sensitive to just changes.
We also increase the overall level of the line, which is affected by the fact that in most areas that the Orange line is higher than the blue line and that shows essentially that the increase in the cost of capital from 10% to 12.2%.
And if we look at what we see here is that for price cap levels above 4000, the allowance would be lower.
So if we have very high price cap spikes in the future, that allowance will be lower.
But for most levels, it's expected to be slightly higher and allows suppliers to recapitalize better than they did before and increase the resilience of the sector. That altogether stablished the new EBIT analysis that we are currently proposing.
And we think it's a good direction to the market and it could enable the suppliers to reinvest in their business, improve the quality of service and also aligns with the financial resilience reforms.

Next steps with the statutory consultation. So we published the statutory consultation itself today and you can see all the details behind how it was derived that we have there in the slides. On the 28th of June, the consultation closes, at the end of June, we make the decision and October or price cap period 11A is where we started eventing the proposal allowance.

4. Price Protection Announcements Overview – Dan Norton

Rohan Churm
Thanks Shai, now over to Dan Norton, please.

Dan Norton 19:01
Thanks very much.

So I'm sure you all very aware of the price CAP announcement that we made today in terms of the level update, I think the context with regard to EBIT and investability as I'm sure many of you are aware and your clients are aware, that the EBIT level itself is important in terms of the signal for future investability.

But on a day to day basis in terms of suppliers being able to recover the costs that they incur in serving customers, the other allowances in the CAP also need to be reflective of costs that suppliers incur and over the past 18 months or so, we've made a number of changes to the cap in order to ensure that it continues to reflect the true cost to a notional efficient supplier of serving customers.

Dan Norton (4.41) 20:08
This so we've made a couple of extra announcements today on non EBIT cap amendments.
I think the most important one is the call for input on operational expenditure.
This is very much a start of a process on OpEx where we're opening up and potentially combining 3 separate allowances currently in the CAP.
The underlying OpEx allowance, the payment method differential and the allowance for smart metering and looking at how we might build a new OpEx allowance in the cap that reflects those three elements and as part about looking at how we share those costs between customers on different payment types.

We’ve made a couple of smaller decisions. So one is around the price cap extension, which is just purely reflecting the fact that there's no longer a fixed sunset clause for
for the price cap at the end of this year and we're just really just been updating all of the license condition documents to reflect that decision.
And the final one is about changes to our typical domestic consumption values, which will apply from the 1st of October.
So our next price CAP will actually be reported on the basis of lower TDCV levels for both gas and electricity, which will give us the presentational difficulties but doesn't really affect the underlying costs and benefits for customers or suppliers.
And then I mean, you know, before handing back to Rohan for the final piece, it's worth

just saying that you know this is in the context of the price CAP programme of work that we set out earlier this year and it builds upon call for inputs that we put out last month on allowances for debt related costs, which I'm sure you know many of you are keen to follow and a call for evidence on levalisation of payment type differences.

So this would be a methodology to present less variation in payment types to customers, but have an underlying mechanism to make sure that suppliers would be able to recover the costs that they that they incur.

So I'll be here for the Q&A, if you've got any questions about the overall package of price cap allowances, but I'll hand back to Rohan now.

5. Open Letter on Supplier Dividends – Rohan Churm

Rohan Churm 20:08

Thanks, Dan.

And so the final bit of our presentation is today that we have published an open letter alongside the announcement setting out our expectations for dividends and other shareholder distributions.

This approach is based on thecupdated financial responsibility principle and also in some areas, basic corporate law. It's not any new sort of formal guidance or rules or license condition, but we do think the letter provides clarity to suppliers and wider stakeholders, including yourselves. The letter sets out our position that responsible distributions are important and necessary for investibility and thus ultimately a key enabler for resilience. We judge that there may be conditions now or soon where some suppliers could be commenced distributions, should their boards choose to do so.

Any distribution must be within an appropriately responsible framework, must not, of course, place the supplier in breach of their regulatory or other obligations.

In terms of that responsible framework we expect that in relation to 2023 and 2024 financial results supplier should not make distributions to shareholders.
If after the distribution, their capital position is below the level of capital judged sufficient by their board in judging the sufficient capital position, the board should take into account the suppliers credible trajectory to meet prospective quantitative regularly regulatory capital requirements that exist at that time, such as a common minimum capital target with a future live date. That credible trajectory can include the prospective transition period, and this part of the letter is carefully worded not to preempt any given number or date given those are part of a live consultation and they will change. Suppliers in a negative net asset position should not make distributions and should retain profits to build resilience.

In simple terms, the point of allowing a transition to capital requirements is to enable under capitalized suppliers to use retained profits to improve their resilience.
And so we want to confirm our expectations that they do that.
I have to say that I would expect to at least some suppliers and perhaps some of you, the letters are a statement of the obvious, but I don't mind that. I just want to be clear on the expectations. So yeah, just to reemphasize, our approach is based on the existing requirements of the financial responsibility principle. It's not a view license condition or requirement, but we do think that it's helpful to understand our perspective. So I'll stop there and back to you, Steven.

6. Q&A – Steven Alcorn

Steven Alcorn 25:32
Lovely.
Thank you very much for that, all.

OK, sorry, there's already a few hands up in the in the in the.
In the chat there, but just for clarity if you're joining via the phone. Then, as it says there. Please type Star 5 on your keypad to raise your hand then when it's your turn, you'll need

to unmute yourself, which is star 6.
But I can see we've already got a few hands up, so we'll jump straight into the.

Mark, I think you should be hopefully the first person to speak.
You'll need to unmute yourself.

Freshney, Mark (VQYB 1) 26:13
Thank you very much, Steven.

Steven Alcorn 26:13
Go ahead.

Freshney, Mark (VQYB 1) 26:14
Just two things.
Firstly, regarding the famous figure A 1.1, can you confirm which is the right one?
Because I understand I've had forwarded me documents showing a 6% margin if bills were 1000.

So can you please clarify which is the correct chart to look at?

Shai Hassid (4.41) 26:42
Yeah, happy to take that.

So the correct chart and thanks for flagging, the correct chart is the chart that you see in this presentation and the chart that you see, if you now look at the statutory consultation have on the website if corrected that.

So thanks, flagging that, yes the chart that you see now in this presentation is the correct one.

Freshney, Mark (VQYB 1) 27:00
So the margin, if bills were to go back to 1000, the margin would be 2-point-whatever it is, rather than almost 6%, which is what I think some people were getting excited about this morning.

Shai Hassid (4.41) 27:18
Yeah, correct.
It's more towards 3.5%, if it goes down to 1000.

Freshney, Mark (VQYB 1) 27:24
OK.
And secondly, holistically, I mean the focus has been on margin, but I mean what you're talking about here is an additional £10 when I talk to the suppliers, they're struggling with additional one-time costs, they're struggling massively with volume risk and the gamma risk on gas consumption in the final few days of the year, etcetera, etcetera.
I mean surely here and also, you know the operating costs which you addressing , surely here the biggest issue more than margin for the suppliers is cost recovery.
And if I could also clarify on the headroom, which may be thought of as additional marginal safety buffer, that headroom, the calculation, which gets to think 100 bips there or thereabout that that margin or that headroom is unchanged.

Dan Norton 28:25
I'll pick this one up.

Yes, headroom is unaffected, it's on a percentage basis and that's unchanged. We did signal in our program of work that we would look at headroom as a longer term thing, it's not something that we're immediately going to be looking at in terms of your general point around cost allowances for changing circumstances.

Freshney, Mark (VQYB 1) 28:49
Yes

Dan Norton 28:55
Yes, you know this is something all of you will know we have that programme of work in place to tackle any devices as they come up, both under allowances and over allowances are things that we're gonna continue looking at while the while the CAP is in is in operation but it you know it is a case of just you know prioritising our effort on to each of those issues as they come up and you know to try and do so in as transparent a way as possible which is why we publish that programme of work.

Steven Alcorn 29:37
Martin young.
I think you're next on next cab on the rank, Martin.

Martin Young 29:44
Yeah, and thank.
Thank you for the presentation.
Good afternoon to everybody.
I guess a couple of questions.

Martin Young 30:12
Can you sort of talk us through the mechanics of when things ultimately get set in stone, because presumably there could be some moving parts and it won't necessarily be 1.4% when you blow the final whistle on this, so to speak, and then beyond that. What about the frequency of updating both the fixed elements of the allowance and how often you will revisit the percentage scaleer just some clarity on that would be great.

And then the second question relates to, you know, the presentational issues that you've already alluded to whether you like it or not The headline number of the cap is used extremely widely.
Across all media, when you move to a lower level of TDCV, how are you going to head off that dislocation between where we are now and where we would be in the in the future? Any thoughts about moving this all to maybe, average unit charges that come out of the

cap rather than going with a headline number?
Just interested in the high level thinking of that communication challenge.

Rohan Churm 31:30
Thanks, Martin.
Let me go first and then I think others will pick up some of the details.
But in terms of the mechanics of it going in, I think you're exactly right that there will no longer be some fixed percentage for EBIT that will apply in every period and so the exact Pound number and that percentage number, you know when they come into play, it will depend on all of the other bits of the price cap formula and what's going in.

So I think we're accepting that today, but hopefully by explaining how the calculators are working on what we're assuming people will still you know I assume be able to forecast things quite accurately in advance and we're trying to strike a balance with when these things are reviewed to you know, review them when it's appropriate and material things have changed, but also to provide some consistency and certainty and not you know with things around from quarter to quarter.

Rohan Churm 32:39
So the team could talk more about those specifics, but that's the balance we're trying to strike here.

Martin Young 32:40
OK.

Martin Young 32:45
I was going to tell you on that and assumably you know you know the percentage you've outlined today.

It is based on the evidence that you have as well as we move through that statcon process and you get to the decision presumably that could potentially nudge, you know a little when you take that statcon decision.

Martin Young 33:03
Is that scaler then set in stone for a year and then gets updated?
You know annually with that, I think the I think the fixed element gets updated gets updated quarterly.
So when you model the price cap can you at least go, the starting scalar is there for a year, we've gotta review it a year down the line or does that move even more frequently?

Shai Hassid 33:29
Thanks Martin.
I guess some details.
So first on the first part of your question, whether our estimates are likely to change within now and the decision – there are a couple of things that could change our estimates.

First of all, if the forward curve will change and this is basically the estimates we have on working capital are affected by that, then this could change the result.
The other things that may change is the cost of capital, because we index it to the risk free rate.
Also we're gonna get responses on the consultation, people are gonna look into the model may, may, recommend suggestions or fix errors within the model, so that could also change the answer regarding the way when we go forward, how frequently we update it and which components.

Shai Hassid (4.41) 34:16
So the slope the 1.4% is unlikely to change.
This is likely to stay the same, at least at how we propose it now, but the fixed component, what's currently producing the 19 pounds we are proposing to link it to CPIH and that includes things related to fixed assets and RO ring fencing.

In terms of revising the methodology itself, we look at this as an enduring methodology, but we do acknowledge that could there could be significant changes in market conditions that basically could lead us to revise the allowance.
But would need to be quite significant And need to be high bar, and yeah and also a

colleague, peter also mentioned that in terms of the cost of capital, this is this will be updated annually Things related to the risk free rate or anything else that is indexed and influence at the cost of capital.

Martin Young 35:19
so cost of capital is updated annually.

Shai Hassid (4.41) 35:24
Yeah.

Martin Young 35:24
Then presumably the 1.4% scalar needs to be updated annually because this is effectively a backsolve between cost of capital times capital employed less the fixed component elevated by CPIH and the balance of all of that is effectively then backsolve to give you a percentage scaler. so presumably the scaler’s gotta move annually as well, then.

Shai Hassid (4.41) 35:52

Yes, you are correct.
What I'm saying is that the methodology would stay the same - there could be small changes in the index parts of the cost of capital that could slightly change this 1.4%, but really slightly.
And we have published, alongside the statutory consultation, the annex to the price cap that shows this calculation. So with that respect, yes, the cost of capital may change annually based on the index components and could impact very slightly the slope.

Martin Young 36:26
OK thank you
And the Great communication challenge that you've given yourself, given lower TDCVs?

Dan Norton 36:35
It's one of these things where TDCV is the worst form of communicating the price cap other than all of the other ways that we've that we've tried, there are challenges in terms of presenting it as standing charges in unit rates as well and certainly I think we've gained for positive or negative a certain amount of traction in terms of the single reference point.

Martin Young 37:05
OK.

Dan Norton 37:06
But the typical dual fuel customer bill level gives us, but yes, one of the big problems of using the TDC vs as typical consumption changes, we need to periodically update.
It is just an intrinsic uh problem with the way in which we present this data and you know all we can really do is in the in the October announcement will effectively do 2 parallel announcements one of the old TDCV, one of the new TDCV so that people can see the change from today but also you know understand that we're going to be using the new TDCV from now onwards. For commentators like yourself who you want to be able to calculate these we've actually added a new table into the price cap model. table 1C in the price cap model that allows you to manually adjust the TDCV levels and it spits out all of the CAP levels based on those different levels that's a useful little tool for to help make those things a little bit easier.

Martin Young 38:19
OK.
Thank you.

Steven Alcorn 38:21
Lovely.
Thank you, Martin.
Our next questioner I think is Pujarini Ghosh
you'll need to unmute yourself and then please ask your question.

Pujarini Ghosh - Bernstein (Guest) 38:31
Hi.
Thanks for taking my question.
So my question is around the capital employed and if you could, give us some more details about how you're thinking about calculating the working capital and collateral and the fixed assets you know so that it's a little bit easier for us to maybe forecast.

Rohan Churm 38:56
Let me just introduce that before passing over, so it's important to note that the capital employed number here for other purposes of the notional supplier and the notional, there's a diversity of suppliers in the retail market and the notional supplier probably looks different to almost all of the ones that practically exist.

And I just wanted to, repeat you know, because this came up on the April call that the capital employed for a notional supplier feeding into the EBIT is conceptually different to what we're thinking that sort of common minimum capital requirement would be for.

In particular, the capital employed here for the notional supplier, requires cash collateral to post into hedging contracts and other working capital that some in the market may not meet and you know that's why we're proposing to set a common minimum where we are. So I just wanted to be clear on what this concept relates to and how those two concepts are related but different.

Shai Hassid
Thank you, Rohan.
Yeah, I'll.
I'll explain to you about the three components of the capital employed, which are fixed assets, working capital and collateral starting with a fixed assets are estimated 90 pound.

This is based on the OpEx allowance, which has depreciation and it assumes 6 years of depreciation of assets.

And based on that, the derived those 90 pounds.
If we move on to the working capital, we have a working capital model that is available and everybody can access and play with it.
This one the main assumptions there it's notional supplier operating under the CAP, it's a medium sized supplier in.
In most cases, it matches the revenues of the allowances, but we also look at the effect of the cache low effects.
For example, looking at things like a one in 20 years scenario falser prices or A1 in 20 years scenario of volume risk and backwardation, and we thought of that together, we set a working capital level.
That means that this notional supplier never goes below 0 working capital and that is giving us an average working capital over a period of that is equivalent to that's essentially wanna then £27.00 for collateral.
We took a different approach.
We look at what happens in the market and we requested information from suppliers and in particular we focus on the notional supplier on what we think is closer to the notional supply, which is a non vertically integrated suppliers and we use this information they gave us to set.
It's just that the collateral level at the level that we believe that most notions suppliers, not basically the mask could achieve access to such level of collateral.

So those are essentially the components and really invited to if you want to go into more detail to also look at the package of applications we published today.

Pujarini Ghosh - Bernstein (Guest) 42:13
Thanks for that.
So just following up you know, I think what we are struggling with is probably I mean you've given us some details and we understand how you're thinking about it.

But how do we exactly forecast?
Now I understand that with the, you know the exhibit that you've given.
We probably can bypass that and then directly go to try to calculate ebit using the price

cap level but still I think what we are struggling with is how the capital employed moves with maybe inflation and things like that and then I mean maybe for your future periods if or future announcements, if there could be more details and more modules around these components that would be very useful, yeah.

Shai Hassid 43:08
Yeah, that that's a fair question.
I want I want to give a clarification that perhaps will make your life easier.
This working capital model, at least RFI of collateral and in the study of excess, it's a one off.

So we do that to set the methodology in 11A and from there, unless there's something significant, we don't touch it.

And if the price cap level changes any scales up and down according to what you see in the chart that we've shown.
So those models are just basically my starting point.
It's snapshot of where we are now.
So then it can stick here, up and down, so it wouldn't be using those models every quarter or even every year to establish what they're working capital should be, those are just proxy to establish the EBIT allowance that we use as a one off.

Steven Alcorn 43:59
Lovely.
Thank you very much.
I think our next question is coming from a Dominic Nash.
But only if you would, uh, mute yourself and ask your question.

Nash, Dominic : Research 44:08
Hi there.
Yeah.

Thank you very much.
A couple of questions from me.

Nash, Dominic : Research 44:12
One on the OpEx process that think you announced that you're gonna be kicking off and the second one is probably following up from the question about how you work out your hedging and collateral sort of numbers.

So firstly on the OpEx on the original price cap correct me if I'm wrong, but I believe that the you basically the benchmarking exercise where you took top quartile a supplier and use that as the sort of benchmark for the operating cost for the price cap.
And as you say that you're going to be looking at it again, it's been a number of years later.
Is it fair to say that you probably will be sort of almost revamping the new sort of baselines and should we begin looking at a move to a sort of top quartile, so OpEx number sort of a new a new target if you like for retailers?

And then the second question, that's £280 where you said that you got a bunch of working capital and a bit of collateral and the working capital was probably one that are more interested in conceptually, which is sort what sort of role calculations and VARs did you put in on that?

Nash, Dominic : Research 45:22
And you say that it's set in stone, but if we go through a period of very high or very low volatility is, is that likely to change?
And again on the collateral in a falling price world, surely the collateral posted by retailers collapses.
Indeed, it might even go negative.
You basically saying that They'll still get invested capital allowance for a collapsed or even when they're not actually posting any.
Thank you.

Dan Norton 45:52
I'll cover the first one the so.
So yes, What we're proposing in the in the OpEx allowances is to effectively benchmark a new operating allowance based on the world as it is today as opposed to when that allowance was originally set in sort of 2017, 2018 figures.

So the question about what level of benchmark we set, whether we go with lower quartile as we did previously or whether we go with weighted average which you know was one of the other options that we considered, you know you know both the both collecting the benchmarks and choosing you know what level to set that benchmark.
You know, those are all look for discussion in the in the call for input

Rohan Churm
on the second question, just before handing over on the detail, I think an important point is that a responsible supplier not knowing how wholesale prices will move and knowing they can be volatile has to be ready to post collateral against a plausible set in of moves.

So I do think it's right to sort of have a forward looking not backward looking cost in that regard. Clearly, some suppliers do achieve forward looking coverage via other arrangements than holding sort of working collateral capturing in cache as the notional supplier does.
But it's really important, I think, to be clear that if prices are rising and collateral must be posted at any point in time, they need to have it to be financially responsible.
So we need to then reflect that in how we expect suppliers to behave and what we compensate them for in the price CAP.
And I also think I'm sure we'll get periods of high volatility.
I'm sure we'll get periods of lower volatility, but it would be a more confident person than me that would and they see a few quarters where wholesale prices aren't volatile and say right, you know people no longer need to be ready for if they were, to shoot up again.

So I think you know we need to be quite consistent on this and not overreact to any of the

short term moves and make sure that the sector as a whole remains financially responsible and resilient to the potential future shocks that plausibly can occur.

Nash, Dominic : Research 48:23
Can I just put it up on that there?
I mean, you've mentioned volatility, but I think vast probably the bigger number and that will be very much linked to the length of the hedging that you put in place.
And how do you affect that behavior of retailers are then gonna clearly be affected by how much they should be putting up. It should be 3 months, six months, one year, two years.
Have you got what you actually think the hedged period should actually be for a reliable supply?

Rohan Churm (4.41) 49:00
We'll talk about what we assume the notional supplier does in hedging against the price CAP, which is 1 very clear strategy and you know we do not set out any single you know strategy in the enhanced financial responsibility principle that people have to follow.
We do expect them to hedge. We do expect them to have a well thought out strategy for their hedging factory and risks and if they choose to take more risks in that strategy then they should expect in due course to hold more capital resources.
Appropriately but for the notional supplier we are assuming a very specific hedging strategy and I'll let Shai talk to that.

Shai Hassid (4.41)
Yes.
Thank you Rohan. So on the volatility and the working capital, we assume a scenario of P-95 or full set prices and the way we derive this P-95 by observing past volatility in the market. So we basically use the parameters of past volatility in the market to establish a P-95 to an hour of power prices and then also what could be the volume risk based on that scenario. And that's basically saying that we do not expect every year to be a very volatile year but we expect suppliers to be able to hold enough cash to withstand a P-95 scenario even if there is a year where there's not that much volatility.

So this is essentially just to say that this is what we expect. The responsible notional supplier to be resilient and to be able to absorb in terms of the collateral, we use RFI data and we cannot disclose all the information there because there is some commercially sensitive information there.

But basically speaking is it's an enduring approach in a sense that the suppliers we use as a benchmark are non vertically integrated suppliers and almost overwhelmingly all the vertically integrated suppliers that we have use a trading intermediary for post surprises, which means that they are paying the fee and essentially they don't post collateral themseelf, they pay for a service that post collaterals for them as a trading intermediary. So the fact that wholesale prices jump up and down in the very immediate term doesn't change for them.
And lastly, I want to say that the allowance is dynamic.
So if we see high wholesale prices, the allowance increases as a whole.
If we see lower full surprises, the allowance decreases to reflect the fact that you are likely to need less working capital or even collateral. In many ways, when the prices are lower and the volatility are exposed is also likely to be lower and to conclude to say that there is a balance between having the perfect tool that captures the very immediate synthesis of the market, but also having something that provides enough certainty and regulatory first sites.
And that's is the balance and trying to strike you, you have something to be accurate enough the node to accurate that basically it wouldn't you wouldn't be able to actually be able to forecast it and build your business around it.

Dan Norton (4.41)
Just to add one of the things to that.

So obviously the EBIT calculation is very much based around a notional supplier operating under the price CAP and the price CAP has a clear price indexation strategy and we assume that that notional supplier is going to hedge in line with that with that indexation that's set out in the price CAP.

Obviously, any other tariffs that suppliers want to put out in the market and allowances they wanna make for any of those that are completely fair business.
this is particularly for the quarterly price cap as it's as it's set out.

Steven Alcorn 52:52
Lovely.
Thank you very much.
I think the next question is Jenny Ping, if Jenny if you wish to unmute yourself.

Jenny Ping 53:00
Hi.
Thanks very much.
A couple of questions from me please.
Firstly, just on following on from the OpEx question earlier, I just wondered and what your initial views are on the previous approach that had been taken, IE what had worked, what hasn't worked in the past and realistically have we actually seen an improvement in terms of the level of cost efficiencies in the sector given you went for the top quartile approach?
Second question, I got a little bit lost as to which component is indexed to inflation, which is updated annually?
Which one is quarterly?
If you can just sort of break that down, because I think there's a few comebacks that iterations of which bit is moving and which bit is set in stone, that would be really helpful.
And then very lastly.
Linked but not straight to the EBIT.
I just wondered where you got to on the segmental reporting outside of the Big 5 because at the moment the visibility for the sector is only limited to the large 5 suppliers.
And I know there had been plans to get more reporting structure for the others, but I just wondered whether you got to on that. Thanks.

Rohan Churm (4.41) 54:29
It's gonna be Dan for the first and third question and Shai for the middle one.

Dan Norton
The OpEx piece in terms of reflections from the previous one up until the gas price crisis, I think the OpEx benchmark was actually the biggest lever that we had in terms of measurable change in, in supplies, you know going all the way back to the CMA investigation.

But I think the principal finding that the CMA made was that was a lack of efficiency. Within suppliers rather than per say, a level of excess profit and be the absolute intention of the CAP at its outset was to try and drive efficiency in suppliers.
And we saw in those early years of the CAP, big drive for suppliers to improve their efficiency.
And I think in about point that the count was proven to be very successful in driving those outcomes.
This is why we've opened the OpEx consultation back up again.
You know about well still be something that we that we still want to continue pushing on, but actually that's why we're working that question as to what level of benchmark would be appropriate

I'll just pick up on the last question as well around segmental reporting.
So and we, you know, we still have the existing consolidated segmental reporting requirements and you write it's only a small number of suppliers that are now covered by that.
We're gonna be coming forward later this year with some policy proposals in terms of how we move that forward. Basically setting out two options, one around expanding it to cover more players or the other in terms of removing it.
I think what we have now is clearly not, you know, satisfactory driver one one way or the other.

Shai Hassid

Thank you.

OK.

I'll go from the less granular to the more granular updates so the less granular ones are cost of capital.

Cost of capital has one component risk free rate which is updated based on yields and this is done annually. on the fixed component, which affects the slope

this one includes the value of RO ring fencing and fix and fix us.

And this is based.

This is updated quarterly based on CPU IH the overall CAP skills.

The overall Italian scales up and down, also quarterly based on the overall cap level, so I hope this answers the question.

Jenny Ping 57:23

Brilliant.

Thank you very much.

Steven Alcorn 57:25

Thank you very much, Jenny.

OK.

So our next questioner is Ruisi Liu

Ruisi Liu (BofA) (Guest) 57:38

Two questions from me if I may.

The first one actually follows on from Jenny's question earlier.

Can I just clarify that cost of capital update annually -

You're only updating the risk free rate, so you're not touching.

For example, the beta and everything else in that calculation.

That's my first question and the inflation linking to the 382 - I think the capital employed - that's done quarterly, if you can clarify that, that would be helpful.

My second question is on the margin.

So if I look at the kind of price cap level today at around 2.5% with the headroom of 1, as Mark was saying 100 basis point 3.5%, that's probably still below the four to 6%.
Some of the companies out there are mentioning they're seeing other markets and given that your stated goal of avoiding volatility and more kind of what I've seen what we have seen in 2021. Do you think that's a sufficient level to avoid such a scenario, especially because we now even at higher prices.
The margin actually comes down when you can probably argue there's higher probability of tracking error in hedging in line with your indexation, but you're actually giving them a lower margin.
So I'm just trying to get your thoughts around that if that's OK.

Ruisi Liu (BofA) (Guest) 58:55
Thank you.

Rohan Churm 58:57
So just to come in with a with a headline and then Shai or Marzia will pick up.
You know we are trying to, you know, have the Goldilocks number here, right?

Rohan Churm 59:11
In terms of the reasonable profit we want to, we want to have a number that makes the market attractive to investment meets the cost of capital.
We want to be no higher than that because that's a cost on consumers and so it’s a delicate balance.

Rohan Churm 59:33
You know, we were definitely getting intelligence, including from some of you that the UK market looked unattractive to others.
I think this change will put it in a more attractive place.
I think the return to you know, profitability that people are seeing will also help there and some of the other certainty that comes in, I think I think we need to keep that under

review.
But if the UK had the highest, you know, returns out there, I mean, in developed economies, you know, we'd also be a bit bit worried and asleep at that.
We are and not protecting consumers so.
So we've gotta get that balance right.

And just to you, just to reiterate on things as material as the, the cost of capital, you know I think we would need to have a reconsult station where we to change it after putting this decision in this talk.
So, that's that sort of perspective on a high bar to those material changes like that, but comment,

Shai Hassid
yeah, we're not proposing any updates to the asset bit down and ongoing basis.
This is an enduring and a long term month.
Unless there is really significant changes to the market conditions in which suppliers operate in terms of which part of the index out of the 380 capital employed, there are two bits we index quarterly.
This is the 90 pounds of excess and the £70 of arrow ring ring fatty those.
This is a fixed component.
This is what we based on the fixed component to be on, so those are ones will be updated on a quarterly basis and may result in.
So once we consider very small changes to the slope that we see in the line that in the in the chart that you see there.

Ruisi Liu (BofA) (Guest) 1:01:14
That's very clear.
Thank you.

Steven Alcorn 1:01:17

Thank you very much.
OK, noticed we're getting quite tight on time.
That's not a reflection on you, Sam, and your question.
I'm sure I'll be very good and we'll answer as full as we can.
So if you press add it.
There you go.
Please ask question.

Arie, Sam 1:01:28
Yeah.
OK, excellent.
Well, I don't.
I don't promise to my question would be very good, but I just wanted to ask two things and the first is regarding the figure that Mark asked about earlier and which is in your slides on page 5.
And so this shows that the allowance would be 37 pounds.
Current bills current method, but you're saying we'll go up to 47 with the new method and can I can you confirm cause a bit hard to read off exactly what Bill level would give you the same 37 pound EBIT allowance, but under the new method and the reason for asking is just to I suppose check that I've got this right, that's suppliers would only see the £10 increase in EBIT allowance that we've talked about.
If bills are stable at the current level and if bills are going down, which is what Jonathan talked about, of course I'm Radio 4 this morning because of, you know, just the unwinding of the hedge dynamic that's already there.
Then, yes, suppliers may avoid a reduction of the allowance, but they won't see a £10 increase in absolute terms.
So that's my first question.
Then the second one maybe a bit easier, but there was a question earlier.
I think it was Jenny on the CSS, but I wonder if you could just talk to us about what you've seen over the years since the CAP was introduced in the CSS in terms of how achieved EBIT margins compared to what the allowed EBIT margin is theoretically.
And I know that the the consolidated statements include everything, not just the CAP

tariffs.
So it's a little bit of a average way of looking at things, but you know Centrica last year I think they're aborted more like couple of quid of EBIT per customer, not anything close to 37 and the year before that I think it was more like a tenor.
So it seems to me like over the years, suppliers have got nowhere close to the allowed margin, but I'm wondering if you've looked at that more closely and considerable us through the difference to what's allowed and what in practice is being achieved.

Rohan Churm 1:03:34
So I'm conscious we've got a minute left and some work left to convey before we're actually going to be removed from this this room for Jonathan Brierley to hold another event.

So, you know, let me be very brief. we could probably send you the number of where the Orange Line on the model cost is 37 pounds or we think 1270 pounds but a point I would make is relative to the counterfactual. The gap is actually more than £10 at that point, so it is supporting EBIT more at those lower prices and pulling down at the higher prices and to your second question, yes of course we have looked at that data.

Rohan Churm 1:04:20
and we recognise that the price cap for the number the notional supplier is not the number that all suppliers will make all the time and there are things that may change, but I can't do that answer full justice in the time today I'm afraid.

7. Conclusion – Rohan Churm & Steven Alcorn

Rohan Churm 1:04:38
Let me let me wrap up with just a couple of points on time frame.
So EBIT as mentioned earlier, we're anticipating our final decision in August and an implementation period in October for FRC, which we talked about in April and the enhanced financial responsibility principle version live on the 31st of May.

November is the first deadline for allowing fencing credit cover, and we're planning to have a decision on common minimal capital requirements in this summer, so I look forward to continuing these conversations and speaking to you again in the not too distant future.

Thank you.

Steven Alcorn 1:05:19
Thank you.
And lastly, Mark Freshney I know you had your hand up
If you email the investor Relations box then mailbox, we will answer that and everybody else.
Any other further questions that wish to be asked, please do it.
Email the Investor Relations email box and we will come back to you.

Steven Alcorn 1:05:33
Thank you very much.
Sorry we couldn't answer all of your questions.

Rohan Churm 1:05:36
Thank you.

Freshney, Mark (VQYB 1) 1:05:36
Thank you, Steven.