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## **Ecotricity Response to Amending the Methodology for setting the EBIT Allowance**

Dear Colleague

### **Introduction**

Ecotricity were the world's first green energy company when we established in 1995 and we now have over 175k domestic and non-domestic supply accounts, alongside over 100MW of self-developed renewable generation capacity. We continue to invest in new sources of renewable generation, with two new solar parks recently commissioned and our first green gas mill and energy storage sites under construction.

We welcome the opportunity to respond to this consultation.

### **Executive Summary**

The recent market volatility and subsequent risk profile has created a shift in the outlook for suppliers. When reviewed against the EBIT methodology which was initially developed, it is important this is reflected in the review of the EBIT methodology. The current highly volatile market price environment is particularly impactful for near term trading and balancing, which is not accounted for fully in the cap calculation, as it often happens after the observation window has closed.

Capital requirements for small suppliers can differ considerably from larger players in the market and as such we would encourage that consideration is paid to how this methodology could be adapted to account for those differentiations to ensure that there is a level playing field and a continued competitive market.

Whilst we understand the logic proposed behind splitting the EBIT component of the cap calculation into a fixed element and a variable element, we are of the belief that this results in adding unnecessary complexity. Whilst also having the potential to reduce the transparency behind the calculation, which is not beneficial to consumers or suppliers and could lead to further mistrust of the industry.

Please find responses to the consultation questions below:

**Question 1: Are there any issues we should consider in relation to our proposed 1 July 2023 implementation?**

The level of capital required by smaller suppliers can differ from larger suppliers and we propose that you consider how you can vary the return and capital requirements for different suppliers or ensure that there is a level playing field to allow for a competitive market space.

**Question 2: Do you agree with our assessment on the case for change?**

Our view is that the current level of margin being offered doesn't adequately reflect the risks that energy suppliers are facing in a more volatile wholesale environment. We believe that this level of margin at times of stress is important to reflect the higher levels of risk and capital needed.

The methodology needs to be more reflective of the current trading environment. We would argue that some of the actions you outline in the paper as preferences would not be fair to suppliers who are facing a more challenging trading environment due to higher wholesale prices and the decreasing risk appetite of counterparties.

**Question 3: Do you agree with our proposal to include fixed assets as a component of capital employed and the suggested level?**

We agree with the proposal to include fixed assets. We would suggest this needs to be reviewed at a Group level for those suppliers that are vertically integrated or have service companies for a wider group. This should also include investments in buildings, fixtures, and fittings. This is increasingly important given the requirement under the Financial Resilience review which requires suppliers to have direct access to the infrastructure they require to continue to trade in a SOLR process. A level of £85 per meter is low and would suggest a figure closer to £110 per meter would be more realistic. This is based upon our internal analysis of our depreciation levels across the group.

**Question 4: Do you agree that our estimate of fixed assets for a notional supplier is representative of current market conditions?**

As per question 3 we believe the level is low and a cost of £110 per meter is more appropriate.

**Question 5: What do you see as the minimum level of working capital required for a supplier to be able to operate and which method should we use to set it?**

We believe that any working capital calculation has to take into account customer's propensity to pay and delays in payment. Our domestic DSO has sat between 70 to 100 days over the past 12 months and this needs to be factored in when taking account of the working capital cycle. We calculate this to be c£670 per meter of capital required (pre-application of the cost of capital).

We believe that the approach for DSO splitting direct debit and standard credit customers has merit but note that the average DSO for a direct debit customer can change dependent upon their quarterly review. This can lead to a customer either being in a net credit position or net debit position of 30 days respectively dependent upon when their cycles start.

Wholesale costs are payable within the next calendar month and generally fall on day 15, so in most cases, before any payment is due from customers. We would also point out that there is an amount of energy that is required to be bought on a short-term basis for shaping and balancing. This, therefore, also reduces the amount of credit to cover customer's working capital needs.

**Question 6: How can the relationship between wholesale prices and their volatility, and working capital be quantified?**

We do not yet have enough data to be able to quantify the relationship between wholesale prices (in their volatility) and working capital requirement. We believe that the working capital requirement will go up as prices go up due to customers propensity and speed of payment slowing down, coupled with an increased requirement for collateral and margin arrangements with trading counterparties. We will have a better indication of this relationship and the impact on our business in 12 months' time once we see the full effects of the recent price rises in October 22 and January 23.

**Question 7: Do you agree with our proposal to include wholesale cost volatility and unexpected demand shock as key drivers of volume risk when calculating suppliers' risk capital requirements?**

We agree this should be included and needs to be captured appropriately within the price cap calculation.

**Question 8: Do you agree with our assessment that backwardation, bad debt, and shaping and imbalances costs are accounted for in the existing cap allowances and that their inclusion within the EBIT allowance could lead to double counting?**

We agree that backwardation has its own cost component in the wholesale part of the price cap calculation.

We think that the price cap currently understates the cost of bad debt and imbalance costs having been set in 2017 before a price volatile environment. We would encourage you to review the price cap methodology components for these areas.

**Question 9: Do you propose an alternative approach for measuring risk capital which is preferable to the approach we describe in this section and Appendix 1? In your approach, how do you model the relationship between wholesale price volatility and risk capital under stress test scenarios?**

We do not have an alternative view at this stage.

**Question 10: Do you have a view on a preferred approach with regards to the treatment of collateral under the cap?**

Due to the high levels of volatility in the market, we are facing additional challenges from counterparties, and we have encountered a shift in behaviours to increase securitisation. This increase is leading to more requirements in terms of collateralisation (including margin calls when wholesale prices fall) and in turn will have an impact on our working capital and needs to be adequately captured in the price cap methodology.

**Question 11: How are the collateral requirements calculated? Is it possible to quantify the relationship between collateral, wholesale prices and volatility?**

It is difficult to quantify a relationship between collateral, wholesale prices and volatility given the nature of our counterparty agreements.

Typically, the collateral calculation is based on an exposure measurement in line with a credit limit. We do not foresee the market moving to a lower risk framework in the near or medium term given the recent market challenges.

Higher volatility and prices are having an impact on collateral requirement. We are already finding that increasing requirements from Trading Counterparties to implement margin call agreements for forward trading which potentially increases collateral requirement.

**Question 12: Do the wholesale collateral requirements mechanisms differ for trading on exchange vs trading over the counter?**

Each counterparty (irrespective of exchange vs over the counter) will have a different risk appetite and as such varied criteria for determining the securitisation parameters and levels.

**Question 13: Does posting collateral affect the level of risk capital employed? Consultation – Further consultation on amending the methodology for setting the EBIT allowance**

No, collateral simply offers a route to market with specific counterparties. It is part of the working capital requirement.

**Question 14: Should the cost of capital allowance compensate for inflation risk? If so, how?**

We believe that the current cost of capital formula you have outlined would result in a cost of capital at c6%. This seems low compared to expected rates of return we understand potential purchasers of an energy supply company would use.

We think that this is, in part, because there is a lack of compensation for inflation and the use of a long-term beta. We think that a short-term beta would be more appropriate if the cost of capital is going to be reviewed more often.

We also believe that inflation should be taken into account through an adjustment to market wide rate. The rates you quote have not factored into account any form of inflation expectation. We believe inflation should be included at a market indexed level.

We agree that the risk-free rate based on the long-term gilts market will have factored in inflation.

**Question 15: Do you have a strong preference between setting the risk-free rate using recent data, forward rates, or recent data but with indexation?**

We would use recent data to prepare the risk-free rate as we would propose that this is more transparent.

**Question 16: Should the tax rate be updated? If yes, how frequently?**

The rate should take account of tax. We would look to do this upon rates being changed in government policy.

**Question 17: Do you agree that a hybrid approach strikes an appropriate balance between cost reflectivity and simplicity? Do you agree that it is the most appropriate approach to implement in practice?**

There is a risk that this approach will overcomplicate the mechanism and make it less transparent. We believe that the simplest approach, would be to not fix any elements of the EBIT methodology.

We would highlight that overall, the cap methodology has become more complex, its components and structure are not as transparent as they once were when setting the original cap. We think an updated explanation of the cap methodology and a breakdown of the components is required following these consultations and policy changes. This is to help participants in the market ensure that the cap remains fit for purpose, both remaining cost effective for consumers and ensuring suppliers are properly reimbursed for their costs of operating and participating in the market.

**Question 18: Do you agree that fixed assets and potentially RO ringfencing should be considered as part of the fixed components? Which other components may be fixed?**

We disagree with fixing part of the calculation as this increases the complexity and in turn transparency.

**Question 19: Should the EBIT calculation include a component that adjusts based on market volatility? How could such an approach be quantified and implemented?**

We believe that by including (i) wholesale cost and imbalance allowances in the capital requirement, and (ii) moving to a shorter-term beta the cost of capital calculation would better serve a volatile market.

**Question 20: Do you agree that Ofgem should not schedule periodic reviews for the EBIT allowance methodology? If you disagree, how frequent should those reviews be?**

It is appropriate for Ofgem to undertake periodic reviews for the EBIT allowance methodology, to ensure that it is reflective of current market conditions. We would propose that anything more frequent than annually would be challenging from a business planning point of view.

**Question 21: Do you agree with the conditions we identified as constituting significant changes to the context in which suppliers operate? Are there any other conditions that should be included?**

Yes, we agree with the conditions that Ofgem have identified as constituting significant change.

**Question 22: Do you agree with our proposal to apply the EBIT allowance in a way that does not change the ratio of standing charges to unit charges?**

Yes, we agree with Ofgem's proposal. We would prefer option 1 to provide better cost reflectively and transparency to the calculation but we recognise the harm this could have on low consuming households.

**Ecotricity Team**