

05 January 2023

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Dear Marzia,

Re: Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) Allowance

As Ofgem is aware, at present the level of the price cap precludes the generation of EBIT by an efficient supplier. The losses of major energy suppliers are published on Ofgem's website and have been for several years. The losses incurred by other significant suppliers can be found in their published financial statements at Companies House. Forcing supplier losses in this way is directly contrary to Ofgem's regulatory obligations as set out in the Domestic Gas and Electricity (Tariff Cap) Act 2018, S1(6) and more general obligations to ensure licensed entities can finance their regulated activities (for example Section 3A of the Electricity Act 1989). Ofgem is clearly failing on both counts and is consequently causing the lack of financial resilience in energy supply.

There is a disconnect between Ofgem's ambitions on consumer prices and its ambitions on financial resilience. Ofgem cannot impose extensive new rules on financial resilience in isolation without also allowing suppliers to recover their costs. There is no case for investment in energy supply at present. In fact, Dermot Nolan (Ofgem CEO) reported to the Parliamentary Select Committee that a conscious decision was made to reduce profitability within the sector¹. This ultimately meant that suppliers had to subsidise customers and made them (suppliers) vulnerable to shocks. While Ofgem refuses to allow price capped energy supply to be a profitable activity, this state of affairs will continue.

We have engaged with Ofgem on price caps since 2016, and we have set out clearly the fundamental problems with the specifics of the price caps time and again. We have also engaged specialist respected independent professional advisers to further support our arguments with expert advice and analysis. The reports delivered by Ofgem's advisers (OXERA), the Select Committee and the National Audit Office reached the same conclusions on Ofgem's failings. Our submissions, and these reports have been disregarded, this document and the paper on financial resilience do not address these shortcomings.

In the consultation, you imply that the financial stress in the energy market is entirely due to suppliers' unfettered choices - that is not the case. Suppliers have not had choices – they have had a price cap imposed after the fact on their businesses. The cap was – as set out by Dermot Nolan in his evidence – designed to be tough and has intentionally reduced profitability in the sector. Mr Nolan also explicitly accepted both supplier failure and significant mutualisation of costs as a natural consequence of Ofgem's approach to regulation.

Ofgem is now working to address gaps and issues in a number of areas – for example, supplier financial resilience, consumer protection and reviewing (elements) of the price cap. The effort is noted,

¹ <https://committees.parliament.uk/oralevidence/10330/html/> Dermot Nolan in answer to question 481, published 24 May 2022.

but the mindset remains flawed. Ofgem is still assuming that the problem is suppliers and the subtext in the document is that the expected outcome will be a reduction in EBIT. This is clearly at odds with the supplier exits and losses we have seen, the evidence of the previous Ofgem CEO and the newly stated requirement for improved financial resilience. The amounts under discussion in respect of EBIT are minimal at an individual customer level, but in aggregate are material to suppliers. This results in increased supplier risk and a further reduction to supplier revenue which is untenable.

We do not support implementation of new rules on financial resilience in isolation from the changes needed to the price cap. Suppliers need to rebuild balance sheets following years of underfunding, so the two must be done together. Equally, Ofgem's approach on resourcing is flawed, Ofgem has imposed more and more obligations and duties on suppliers without cost recovery. This cannot continue.

Ofgem is duty bound to reconsider its approach. It must be realistic about consumer prices – and accept that high prices are not down to supplier profits. The ingrained Ofgem mindset that energy retailers are profiteering is detrimental to consumers. In addition, the open and constructive approach required of suppliers under the new rules on financial resilience must be complemented by an equally open and constructive attitude by Ofgem. This will help rebuild industry trust and confidence.

Ofgem must now address its previous errors with an increase in the EBIT allowance for risk capital and margin, it cannot continue to be disjointed in its policy setting. By aligning the implementation of related policies and allowing the associated cost recovery, this will drive effective delivery for consumers and financial resilience.

Our submission comprises this cover letter, Appendix 1 (answers to consultation questions) and Appendix 2 - A copy of our previous EBIT response of 23 September 2022. The issues raised both in that submission and in our other price cap submissions remain valid. The issues have not been addressed by Ofgem and are restated. Please let us know if you need copies of our other submissions.

We state in the Appendix our view that a bilateral discussion of some questions would be more useful than a more restricted written submission. My colleague, Alison Russell will be happy to co-ordinate.

Yours sincerely

By email only

Ashley Milne
Chief Financial Officer

Appendix 1 - Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance

Utilita answers to consultation questions

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

The correct determination of an EBIT allowance in the manner Ofgem intends, i.e., a 'bottom up' calculation, is complex, and so Ofgem must ensure it gives itself enough time to be confident of the outcome it has determined.

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

Utilita agrees the market conditions at present are considerably different to when the price cap was formulated and that the extraordinary risks faced by energy suppliers at present are not currently fully accounted for in the price cap.

We have engaged with Ofgem since the introduction of the price cap and highlighted prior to the current crises that the cap did not allow suppliers to recover efficient costs or enable suppliers to be make a reasonable return to ensure balance sheets were resilient enough to withstand market shocks. Our predictions, as shared with Ofgem at the time have since come true.

As such, given how the cost of risk has increased by so much more than the absolute increase in EBIT allowance, Utilita's expectation is that the EBIT allowance will increase in absolute terms under the current market conditions.

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

Fixed assets are a component of capital employed and Ofgem is right to include them as such. £85 per customer is less than the capital employed per customer; the assumption of an average time on supply of six years is much more than the true average, which is likely the cause of the underestimation of the capital employed. A four-year average time on supply is much closer to reality and the subsequent capital employed number would therefore also be much more realistic.

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

As noted above, over the long term, average time on supply is much less than six years.

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?

Utilita agrees that the minimum level of working capital is, in fact, the maximum working capital requirement of a supplier over a year, especially where the requirement is unpredictable. Suppliers must have the capital to hand, and any bank interest on reserves available when the working capital is not required will be negligible compared with a supplier's cost of capital.

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

The relationship between wholesale prices and working capital is approximately linear.

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

These two factors are part of volume risk and should, therefore, be included. Without careful consideration, the degree of demand shock can be misjudged; it must align with Ofgem's opinion of the confidence of solvency of its efficient supplier. E.g., if Ofgem wishes an efficient supplier to have a 99% probability of remaining solvent over a one-year time horizon, it must consider a demand shock that represents a one-in-a-hundred-year event.

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?

These allowances are Ofgem's consideration of the expected value of cost. The allowances do not cover the capital requirement necessary to withstand the degree of uncertainty of these costs consistent with the risk appetite of the efficient supplier. As these costs are subject to uncertainty, and therefore a capital requirement, they ought to be included within the formulation of the EBIT allowance.

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?

Without examining the model, it is not possible to comment extensively. Utilita agrees stochastic process modelling of energy prices is appropriate. 5,000 simulations are fewer than typically performed for this sort of assessment. The stochastic process should also include, for example, Merton jump diffusion, which is appropriate to apply to energy prices, and treat volatility itself as a stochastic process (the simulations may already account for these points, but without having access to the model it is impossible to know if this is the case).

While Utilita does run scenario analysis, it does not estimate risk capital at a given confidence interval using scenarios, the selection of which is always arbitrary and can therefore produce biased results. A scenario analysis, testing as it does selected events, does not provide the probabilistic output required to estimate risk capital. Utilita uses stochastic process modelling to determine the risk capital requirement for a given level of confidence.

As a general note on risk capital, the price cap allowance must not consider risk capital to be less than the capital requirement determined by its financial resilience consultation; this capital adequacy set by the regulator is a form of risk capital, in that Ofgem requires suppliers hold a certain amount of capital to withstand shocks, and the servicing of this capital requirement must be provided for in the price cap.

We note the connection between this section and the associated RFI questions. We suggest that these matters would be better addressed in a bilateral discussion. If the team provides some suggested dates in week commencing 9 and 16 January, we will co-ordinate diaries at Utilita and revert.

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

Utilita believes collateral must be accounted for in the capital employed calculation. The price cap must allow a standalone efficient supplier to generate normal profit. A standalone efficient supplier would not have access to a parent company guarantee and would also struggle to be offered a letter of credit, if the CMA's view that an energy supplier could only finance itself through equity, is to be accepted.

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

It is possible to model such a relationship at a particular degree of confidence e.g., at a certain level of price and volatility, there will be x% confidence of collateral requirement for wholesale energy contracts not exceeding y.

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

Over-the-counter deals will be predicated on the existence of some sort of trading contract between the counter parties. The relationship between the counter parties will determine the nature of the capital requirement, and could be complicated by, for example, the level of trading fees, ownership stakes, or other ways in which the counter parties are partnering to offer services or products.

The over-the-counter relationship will be idiosyncratic and should not, therefore, be used to develop a view of the situation of a hypothetical efficient supplier, which ought to be assumed to be using exchanges that are open to any party than can meet the financial requirements of trading.

Question 13: Does posting collateral affect the level of risk capital employed?

The two are not related; posting collateral reduces a third party's exposure to an energy supplier, and is entirely unrelated to a supplier's risk capital, which covers the risk faced by the energy supplier itself.

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

The cost of capital allowance ought to compensate for inflation. As CEPA argues, suppliers ought to be remunerated for bearing inflation risk. Utilita agrees with CEPA's proposal for accounting for inflation in the cost of capital allowance.

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?

While the use of forward rates has been criticised in the past, this criticism has usually taken place in periods of relative stability of the risk-free rate. The rate of change of the risk-free rate is greater now than at any time since before the financial crisis, and as such the historical risk-free rate will be less good an indication of the future rate. Consequently, a forward-looking methodology ought to be considered.

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

Given the frequency of price cap changes, the allowance for corporation tax ought to be updated whenever a change in corporation tax rate is known to be taking effect.

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?

A properly constructed hybrid approach is best, although in practice this ought to differ little from fixed percentage approach as almost all a supplier's capital requirement scales with retail prices.

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?

If Ofgem sets a fixed capital adequacy requirement, this capital requirement ought to be subject to a fixed allowance. It will not be appropriate to subject the regulatory capital requirement to a fixed allowance if the capital requirement itself is set such that it is not fixed. As stated in our covering letter, we consider that the implementation of the financial resilience requirements should be aligned to appropriately increased EBIT allowances to ensure cost recovery.

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

If the allowance for risk capital is properly constructed, the allowance will naturally adjust to changing market conditions.

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?

Utilita agrees that scheduled reviews are unnecessary assuming the allowance is properly constructed in the first place. Ad hoc reviews when circumstances have materially changed ought to take place, and it will be obvious when such material changes to the environment have taken place.

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?

The conditions Ofgem lays out all seem reasonable. No other conditions seem obvious, but it is not possible to foresee all the ways in which material change could occur, so if Ofgem is pragmatic in allowing for material changes to conditions other than prescribed ones, the approach described is adequate.

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?

Ofgem's intention to avoid disadvantaging low usage households is admirable, but if suppliers are unable to recover efficient costs from a customer group, it will not, in fact, be to the benefit of that customer group in the long run as suppliers will either avoid competing for such customers, and consequently not innovate in a way that benefits that customer group, or even degrade the service offered to such customers.

If Ofgem intentionally departs from cost reflectivity in setting retail price limits, it must allow for mutualisation of over or under-recovered costs, as otherwise an efficient supplier would not be able to recover its costs and customers' interests would not be served.