

5 January 2023

by email (cc Neil Kenward, Marzia Zafar & Shai Hassid, retailpriceregulation@ofgem.gov.uk)

Dear Dan,

Response to Ofgem's further consultation on amending the methodology for setting the EBIT allowance

Thank you for providing an opportunity to comment on the proposals to amend the methodology for setting the EBIT allowance in the default tariff cap. We do not support this review and have a number of concerns with the preliminary findings which Ofgem has set out for consultation. In particular:

- a) **Ofgem's time and energy would be much better spent in working with BEIS in its strategic review of energy retail**, than reviewing allowances in the Default Tariff Cap which is no longer fit for purpose. The BEIS review - which aims to introduce new arrangements in 2024 - provides the opportunity to find a significantly better approach to protecting customers (for example exploring options such as a relative price cap) while restoring stability to the retail market and re-establishing vibrant and fair competition.
- b) **Ofgem's consultation exposes the increasing unsuitability of the current "cost stack" price cap approach.** In particular, while the "notional" supplier approach may have just about been credible when the price cap was designed in 2018, the market is now no longer dominated by legacy suppliers. There is a diverse range of suppliers, including large scale challenger businesses alongside legacy businesses. Suppliers making up the majority of the market now have vastly different costs of capital and financing structures, investors with very different expected returns and with different ways of providing security. In this context a single EBIT allowance based on the idea of a "notional supplier" is not credible. It runs the risk of damaging competition, pushing all suppliers into a low innovation, low and steady return business model which is not compatible with the innovation needed for the energy market transformation.
- c) **Any robust review of the EBIT allowances would lead to an increase in the level of the cap which we do not think is in customer interests at this time** when Government is looking to cut back support and prices are at an all time high. It is also problematic given the new requirement on Ofgem to consider the impact of its decisions on public finances. Ofgem has not addressed this challenge. Its work so far disregards the significant increases in risk in the market since the CMA's analysis. This strongly suggests both the cost of capital and the amount of capital retailers need to hold has increased very substantially. Barring a return to pre-crisis wholesale market conditions (which we do not foresee for some time to come) only BEIS' holistic and strategic rethink of the retail market framework could address this situation. A change to the EBIT methodology is unlikely to do much to address these issues.
- d) We do think Ofgem urgently needs to address one area - the hugely disproportionate and extremely profitable premium for "standard credit" which has crept up in the price cap, with companies charging

these most sticky consumers over £200 more when a cost-reflective figure may be more like £80. **This needs urgent attention to avoid major backlash.**

In the short time available, we have also considered the specific questions in the consultation and, where relevant, provided additional comments in the Annex below. These should be read alongside the detailed response from Energy UK. [REDACTED]

We would be happy to discuss any elements of our response with you in more detail.

Your sincerely

Rachel Fletcher
Director of Regulation and Economics
Octopus Energy

Annex

Chapter 2: Background

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

As explained above, the logic of making adjustments to the price cap allowances in mid 2023 is called into question by the wider strategic review of retail regulation/customer protection which we understand Government and Ofgem are committed to undertaking for implementation in 2024. We would rather see Ofgem use its limited resources to work with BEIS on this review. It provides an opportunity to put the retail sector onto a new footing (including new price cap structures to replace the current cost stack) while changes to the EBIT allowance in the current cap could be short lived and are unlikely to do much to stabilise the retail market, protect customers or help the return to competition.

Chapter 3: Case for change and wider policy considerations

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

We do not agree there is a case for change or for the industry and Ofgem to expend time in the complex work that setting up a new EBIT methodology requires.

We are concerned that Ofgem might consider the predominant case for change is that the EBIT allowance has risen too quickly (in absolute £ terms) as wholesale costs have increased. While the EBIT cost in £/customer has increased very considerably, the evidence makes it clear that supplier returns have not scaled during the energy crisis. If anything (and as discussed below) the very significant increase in risks to retailers in recent years means there is a technical case for increasing rather than reducing the EBIT uplift as a percentage of other costs.

However, as explained in our covering letter, we would not support Ofgem making an upward adjustment to EBIT at this point as this is not in customer interests. Such a move would do very little to address the more fundamental problems with the regulatory framework which have been exposed during the energy crisis and a sustained period of high wholesale volatility. A more strategic and holistic set of measures are required to improve the financial resilience of the sector while protecting customers and helping the return to a vibrant competitive market.

Chapter 4: Capital employed

Question 3: Do you agree with our proposal to include fixed assets as a component of capital employed and the suggested level? Question 4: Do you agree that our estimate of fixed assets for a notional supplier is representative of current market conditions?

We agree that in principle, fixed assets should be included as a component of capital employed in the EBIT methodology. However, if Ofgem is to proceed with this review, it would be helpful to have more clarity on its definition of what it seeks to include in fixed assets.

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

We do not think it is possible to define a minimum level of working capital required, without reference to the price of energy on the wholesale market. Our working capital requirements are driven by a need to cover the following 3 risks:

- weather - extreme cold or warm conditions (especially over the winter) affect consumption and the additional volumes of energy we need to purchase (or sell). Where wholesale prices are high and volatile this can result in very significant extra costs beyond the cost of purchasing on the forward markets that is reflected in the price cap.
- collateral requirements - [REDACTED]
 [REDACTED]
 [REDACTED]
 [REDACTED]
- payments - a sudden drop in customer payments creates immediate cash stress which we need to cover for. Again the scale and likelihood of this risk is directly correlated with the overall size of energy bills (and by definition, wholesale prices).

[REDACTED]
 [REDACTED]
 [REDACTED]

It is not immediately evident how Ofgem would arrive at a general quantification of the relationship, but it may be possible to deduce this from the financial stress tests and financial RFIs suppliers have submitted over the last year. We would be happy to meet with Ofgem to talk through our own approach.

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?

Yes. In particular, wholesale cost volatility combined with volume shocks is a key driver of risk capital requirements. In current market conditions, where wholesale prices are both high and volatile, any deviation from expected demand (or the demand suppliers have hedged for) – because of the weather or other changes in consumer behaviour – leaves suppliers exposed to very significant potential losses. These are materially greater than the historical volume risk that suppliers managed pre-2021.

This volatility exacerbates suppliers' working capital requirements – particularly as there is uncertainty about whether suppliers will be able to recover losses associated with volume risk and, even if they are able to recover some of these losses, there is a lag (and therefore working capital strain) between when these costs are incurred and when suppliers are allowed to recover the costs under the price cap.

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?

No – we do not believe that the current price cap methodology fully reflects the risks and costs associated with backwardation, bad debt, and shaping and balancing within the existing allowances. While there has been a one off allowance, we also do not think the price cap adequately adjusts to account for the high proportion of customers rolling onto SVT that would previously have fixed.

In relation to backwardation, while Ofgem has introduced an ex-ante allowance for backwardation costs, there remains a delay in the recovery of these costs, and uncertainty about whether suppliers will be able to recover them in full.

In relation to bad debt, notwithstanding the introduction of the Energy Price Guarantee (EPG), energy costs are more than twice their normal level. The number of customers struggling to pay, especially when the EPG increases to £3000 and the EBSS is removed, is expected to increase very substantially. We are particularly concerned that there are no special arrangements for direct bill support in Winter 2023/24 and this could result in considerable default. While there is a separate allowance for bad debt within the cap, there is a risk that the upcoming level of bad debt in the market is underestimated, and these costs are therefore under-recovered by suppliers.

The shaping and balancing allowances are not sufficient to accommodate the very significant additional costs in a higher and more volatile price environment (and where, as Ofgem has acknowledged, there is illiquidity in the forward power markets). Potential losses associated with a deviation from expected consumption could be very significant and exceed the allowance in the price cap.

As per our comments above, we do not think the best solution is to adjust the EBIT allowance. Rather it is to design a new form of price protection which avoids the pitfalls associated with the current cost stack methodology, and which particularly avoids the need to impose a wholesale allowance and hedging methodology on suppliers.

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 are happy to talk Ofgem through how we calculate liquidity buffers, indeed would welcome the opportunity to do so as part of a wider discussion about capital and liquidity management and potential regulatory requirements.

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

If Ofgem is to proceed with its review of the EBIT methodology, then it must include collateral in its assessment of capital employed. Not to do so would penalise stand-alone retailers. Nonetheless, the issues Ofgem identifies with the treatment of wholesale collateral exposes the impossibility of arriving at a market wide EBIT

allowance (and the fault lines in the “notionally efficient supplier” approach) in the context of a competitive market with a variety of business models.

Ofgem is correct that many suppliers will provide security off balance sheet and for those retailers who can do so at low cost (for example because it is done through a related party or PCG), including a collateral allowance in capital employed could unnecessarily inflate their EBIT allowance. In other cases, these arrangements could represent a very significant cost which should, in principle, be reflected in the price cap. However, where suppliers have to post cash collateral, this capital is completely tied up. It is capital that cannot be “employed” elsewhere and should be considered as allowable capital in the EBIT allowance. Within the current price cap construct, the only way of solving this issue would be to introduce a levelisation fund which spreads the cost of collateralisation evenly across all retailers. While this could be deemed fair (the cost of providing security is not something that suppliers have direct control over) we imagine it would be very difficult to gain legacy company support.

The difficulty of finding one set of arrangements which is appropriate for all situations and which does not unintentionally skew competition underlines the importance of considering alternative customer protection mechanisms - such as a relative cap - as soon as possible.

Question 11: How are the collateral requirements calculated? Is it possible to quantify the relationship between collateral, wholesale prices and volatility? Question 12: Do the wholesale collateral requirements mechanisms differ for trading on exchange vs trading over-the-counter?

[REDACTED]

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

[REDACTED]

Chapter 5: Cost of capital

We have contributed to the work of Energy UK on sector-wide costs of capital, and their submission and the analysis they have commissioned should be read alongside our response. We do, however, want to emphasise two points from the EUK response.

Firstly, as noted in our cover letter, the risks that suppliers face has increased very significantly since the price cap EBIT methodology was set. Consequently, we would expect that a robust review of the EBIT methodology would arrive at a higher cost of capital in the allowance than at present.

Despite the welcome measures that the Government and Ofgem have introduced to stabilise the market, suppliers continue to face significant price volatility, liquidity issues (which constrain suppliers’ ability to hedge), demand risk, bad debt risk, and policy/regulatory risk. These risks are exacerbated by the operation of the current price cap, which heavily constrains suppliers’ ability to respond commercially to unforeseen events (e.g. a warm October). Similarly, the disruption to wholesale market stability from renewables combined with the more volatile weather conditions due to global warming means that it is not appropriate to rely on historic

data as a benchmark for future market conditions and risks. In this context, Ofgem's proposals to hold the equity beta and the market risk premium constant is not credible.

We further recommend that if Ofgem does go ahead with this review it conducts further analysis on the risk free rate, as recommended by CEPA in its August report. We would expect this to have moved significantly following the end of many years of quantitative easing. Equally, it would make sense to update the tax rate (up and down) in line with changes as post-tax returns are what interest investors.

Secondly, we consider it to be impossible and inappropriate to arrive at a single cost of capital for all suppliers. The retail market has changed considerably since the price cap was introduced, with challengers no longer accounting for only a very small (single digit) percentage of market share. The notional supplier approach embedded in the EBIT methodology is overly theoretical and its continuation puts this diversity at risk. This would be bad for customers, competition, and impede the innovation and transformation needed for net zero.

In particular, we note that the costs of capital vary very significantly across the sector, perhaps by as much as 300%. Ofgem is mistaken in its assumption that suppliers are typically fully equity funded - in practice incumbent suppliers do raise debt (though typically at Parent or Group level), meaning their cost of capital is depressed relative to other retailers. Conversely, while challenger businesses don't have the credit rating required to raise debt, they will have other financing arrangements [REDACTED]

[REDACTED] These arrangements often have costs that are complex to analyse and likely to be more than the assumed 10% cost of equity. These might include interest on credit when it is provided directly; enhanced trading fees; security rights and covenants. While rights and covenants are hard to put a price on, they present risk to shareholders and therefore a cost.

Similarly, in reality there are different types of investors engaged in retail energy, with different risk/reward profiles – from utility-style investors looking for stable returns, to tech-style investors looking for innovation that drives growth. This variety is an important source of dynamism in the market, and we urge Ofgem not to make the market attractive to utility-style investors only.

We also note that, particularly in the current market, the price at which different suppliers could raise additional capital varies enormously, and some would likely be unable to raise capital at all.

As per our comments on the treatment of wholesale collateral, this issue exposes the fault lines in the cost stack price cap approach, and underlines the importance of Ofgem working with BEIS to consider alternative forms of customer protection, such as a relative price cap, as soon as possible.

Chapter 6: Amending the EBIT allowance methodology

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? 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 agree with Ofgem that a fixed figure amount approach for EBIT would not be appropriate, as most elements of capital employed scale with changes in the overall cap level, as noted above. Including this in the EBIT

methodology would exacerbate the risks associated with periods of high volatility. If there was a fixed element of the EBIT allowance, it would make sense for the RO ringfenced amount to be included.

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

Ideally the price cap would be sufficiently flexible to allow retailers to recover their costs in periods of high volatility. However, designing this feature in the methodology would be complex and inevitably imperfect. We maintain that the last 15 months of high volatility have revealed the limits of a cost stack price cap and the difficulties caused by constraining the tools at retailers' disposal to manage this risk. A new approach to protecting customers should be implemented rather than investing time in designing a market volatility adjuster.

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? 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?

Our view is that the entire price cap structure needs to be reviewed as part of the BEIS/Ofgem strategic review. While the current structure stays in place, we favour minimising reviews of all elements of the allowance (including EBIT), to minimise regulatory uncertainty. Where individual elements become badly mis-calibrated they may need to be reviewed (e.g., bad debt if economic conditions worsen). But we do not see the case for regular review of the EBIT allowance.

It is important that Ofgem takes a predictable and consistent approach to its regulation of the retail energy market.

Ofgem's criteria for "significant changes" to the context in which suppliers operate are currently broadly drafted and could conceivably apply to a range of different scenarios. In order to maintain confidence in the GB retail energy market, there must be clarity about the returns suppliers can expect to make, and there should be a high bar to future reviews of the EBIT allowance.

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?

We would not support a proposal that resulted in an increase in standing charges relative to unit rates, as this would disproportionately affect low-use households and make it more difficult for households to save money through efficiency.

— end —