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Ofgem Retail Price Regulation Team
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By email only

5 January 2023

Dear Retail Price Regulation Team,

OVO response to Ofgem's further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance

OVO exists to power human progress with clean affordable energy for everyone. We are committed to being a driving force in the UK's pursuit of net zero. Our role in this journey is outlined in our company manifesto, Plan Zero.

Delivery of Plan Zero, and the broader industry transition to net zero is dependent on creating an investable market. Without investment, the innovation required to achieve net zero, and broader consumer benefit, will not be possible. It is therefore critically important that any review of the supplier EBIT allowance is done so in an appropriately considered fashion.

We have included detailed responses to the questions raised in the consultation within the appendix to this letter. In addition, there are three primary matters which we believe warrant particular attention, these are set out below.

1. EBIT should not be reviewed until key outstanding Price Cap matters are resolved

We acknowledge Ofgem's proposed programme of work in relation to the Price Cap as published in November 2022. We note that there are certain key matters which are due to be addressed over the next 18 months, all of which will have a fundamental impact on the operating environment and level of risks in the sector. We suggest that the review of the EBIT allowance is postponed until the key outstanding matters concerning the Price Cap are resolved. Failure to delay this would likely result in inappropriate policy decisions being made in this area, as evidence will be gathered from a market which is still currently subject to a significant degree of regulatory uncertainty.

We are also aware that this consultation is being rushed through during a time of

resource challenges within Ofgem. Postponing this consultation would alleviate these challenges and would afford this consultation the full attention which it deserves.

2. Any modelled 'notional supplier' must be representative of an independent retail supply business

We believe that the notional supplier in the model must be representative of a fully independent supplier. Any policy which assumes that a notional supplier would have support of a wider group company is inappropriate and would lead to significant market distortion, favouring legacy incumbents over technology-driven innovative challenger companies.

3. Ofgem have significantly underestimated the true cost of capital

The consultation significantly underestimates the true cost of capital for an independent supplier. Theoretical comparisons are made with companies which are not true comparators, and other theoretical assumptions are made which do not reflect the reality of the operating environment of the energy retail sector.

We urge Ofgem to seek empirical evidence on the true cost of capital of an independent energy supplier, rather than relying on theoretical calculations. Empirical evidence should include reviewing the actual cost of capital of independent suppliers (without taking into account the impact of group company support, and adjusted for current market conditions), and interviews with equity and debt market participants. Failure to do so will result in a fundamental oversight of real world evidence on the regulator's part.

At the present time we are gravely concerned that the direction of travel of this consultation is erroneous, due to the matters outlined above, and for further detailed reasons as set out in the appendix to this letter.

We would welcome the opportunity to work collaboratively with you on this consultation process, in particular with regards to the sourcing of empirical evidence to support the true cost of capital of energy retailers.

In addition, we would be happy to discuss any elements of our response further through bilateral discussions.

Should you have any questions please contact policy@ovoenergy.com.

Kind regards,



Vincent Casey
Group CFO, OVO

Appendix A - OVO responses to Ofgem's consultation questions

Section 2 - Background

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

We note that the Ofgem proposed programme of work in relation to the Price Cap (published 25 November 2022) includes the review of a number of fundamental Price Cap matters over the next 12 - 18 months. Notably, a review of debt related costs is not due to take place until Winter 2023/24, and a review of additional wholesale allowances is not due to take place until Summer 2024.

We suggest that Ofgem should consider adjusting the timing of this consultation until after certain fundamental questions have been answered in relation to the underlying Price Cap calculations, such as: will the Price Cap allow suppliers to promptly and completely recover those costs which are necessarily incurred in efficiently serving customers.

Until the outstanding and significant uncertainties regarding the Price Cap have been addressed, rushing through adjustments in order to fine tune the EBIT allowance, based primarily on purely theoretical considerations, appears to be a misallocation of regulatory, stakeholder, and supplier bandwidth, and will likely lead to an inappropriate outcome.

The outcome reached if this review is expedited could be detrimental to customers, detrimental to market stability, or distortionary from a retail market structure perspective.

Section 3 - Case for change and wider policy considerations

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

We agree with many of the matters set out within this section of the consultation document, in particular with the fact that the risks that retailers are facing at present are greater than those in place when the Price Cap was initially set.

However, we consider the timing of the consultation to be inappropriate and suggest that there would be more logic in concluding this review once other more material questions regarding the future of the Price Cap have been addressed, as outlined above.

Section 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?

Yes, we agree with the proposal. However, we have not had time to reach a view on the suggested level, and would urge Ofgem to reconsider the timing of this consultation to allow for appropriate review and analysis following the conclusion of Ofgem's Price Cap programme of work.

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

Given the timescale involved with this consultation, and the parallel running of this consultation with several other Ofgem consultations, we have not had time to reach a conclusion on this question.

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?

Working capital model

We understand that a model to answer this question has been prepared by Ofgem in conjunction with a third party consultancy firm (Cambridge Economic Policy Associates, or "CEPA"). We would expect Ofgem to publish this model alongside the results of such a model, well in advance of any subsequent consultation on EBIT, so as to ensure that stakeholders have sufficient time to review and critique the model, and in turn the regulator has time to take such feedback on board.

We are concerned that paragraph 4.31 of the consultation states '**initial** results of that model would be shared with stakeholders as part of the **statutory** consultation'. This indicates instead that the regulator only plans to share initial results (rather than the full model), and also only intends to share them at the point of a statutory consultation (rather than allowing time for comment and feedback from industry parties). This was the same as the process followed for the recent statutory consultation on strengthening financial resilience (albeit the sharing of the model was delayed), and led to insufficient time for stakeholders to review and understand the model - the opposite of an open, transparent, and collaborative consultation process. Such an approach is likely to prevent robust scrutiny, and could imply that there is a predetermined outcome that will be implemented.

Based on recent past experience, we are concerned that there may well be errors or inconsistencies in the model which should be corrected, and therefore would urge Ofgem to share the full model well in advance of the statutory consultation.

Seasonality in working capital

We echo the view outlined in paragraph 4.34 of the consultation document regarding the seasonality of working capital. Suppliers must fund their businesses to ensure sufficient capital at the low point of the annual cycle.

Adopting an average level of working capital over a year (as implied paragraph 4.36) would simply mean that a business is not able to fund its capital requirement at the end of the winter. It should be noted that the drawdown and payback of funds is not fully liquid, and that suppliers typically have long term financing structures which are not able to be drawn and paid back in line with a seasonal working capital cycle. This means that the argument that suppliers may potentially be 'over compensated' during summer months is not valid.

Prudence in working capital

Furthermore, a prudent supplier will adopt a range of forward curves and weather scenarios when sizing the capital requirement for the winter ahead. We cannot simply finance to the minimum P50 working capital requirement, a business needs to be fully funded against a reasonable range of downside scenarios.

Methodology used to set working capital

In relation to Appendix A to the consultation, we note the following:

- **Paragraph A1.11** - it may be worth developing the model to assume that customers have joined on a staggered basis across a year, such that their join dates are equally distributed across the annual cycle
- **Paragraph A1.12** - using a three monthly average for commodity costs may understate the working capital low point. For example, at the end of winter a model which uses an average would overstate the accrued commodity liability, as the actual commodity liability for March consumption is likely to be at a lower unit rate than that for January consumption
- **Paragraph A1.13** - the projection of Q4 forward curves into Qs 5 - 8 may create a modelling issue if there's a formulaic link between the two. Forward curves in Qs 5 - 8 should be assumed to oscillate independently of Q4, which will create working capital and risk capital requirements which may not be picked up if these are assumed to move in tandem in the model
- **Paragraph A1.19** - a period of time is taken to generate and send a bill. DSO for standard credit customers is typically longer than 30 days. We would encourage Ofgem to consider extending this assumption based on data available from its regular supplier RFIs

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

It is of great concern to us that this question is being asked at this stage of the process

We would expect the model that has been developed to evaluate the notional efficient supplier to provide for a forward curve of energy prices as an input, and calculate monthly working capital requirements. A series of simulations should then be carried out to assess the impact of volatility in wholesale prices on the working capital cycle of a retailer.

As per our response to the previous question, we strongly recommend that Ofgem share the model ahead of the statutory consultation so that it can be properly and appropriately assessed.

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?

Yes, we agree. Furthermore, we believe that the capital requirement should be able to be determined by applying the relevant scenarios in the model which has been developed.

We also note that customer switching represents another key driver of volume risk.

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 including these within the capital employed section of the EBIT allowance calculation could lead to double counting if the Price Cap was set up to allow for complete and prompt recovery of all costs incurred by an efficient supplier. However, we note:

- **Backwardation costs** are not recovered promptly under the Price Cap. This means that suppliers are asked to bear the burden of a proportion of backwardation costs for an additional c.3 months after incurrence, thereby **adding to the capital employed figure**,
- **Bad debt costs** are not allowed to be recovered completely or promptly under the Price Cap. The lagged recovery of true bad debt costs means that suppliers are asked to bear the working capital burden of a proportion of bad debt costs for an unknown length of time after incurrence (until a regulatory review takes place), **thereby adding to the capital employed figure**. The completeness of recovery of bad debt costs is also not confirmed in the current Price Cap construct which also serves to **drive up the cost of capital (additional supplier risk)**, and
- **Shaping and imbalance costs** are also not recovered completely or promptly under the Price Cap, and hence they **drive up capital employed and the cost of capital**.

It is for reasons such as these that we would suggest that Ofgem pauses the current workstream on EBIT until such time as other more fundamental matters concerning the Price Cap have been resolved.

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 would suggest that the model must be subject to sensitivity analysis.

The narrative in Appendix 1 suggests that some sensitivity analysis has taken place, though it's not clear to what extent this informs the capital employed requirement. We would argue that risk capital is a fundamental part of a business' capital structure, and hence the theoretical model should be subject to a full suite of stress test scenarios, and risk capital should be assumed to represent delta between the central case and the compound impact of a minimum of two years of successive plausible downside cases.

The stress testing should take into account volume risk as well as bad debt and balancing & settlement risk.

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

Collateral should be included in the capital employed calculation.

We believe that the commentary in the consultation is confused between the relevance of LOCs/PCGs, trading arrangements and collateral posting. The approach adopted should be agnostic between the different means by which suppliers can satisfy collateral requirements. Our comments build on our headline view in the cover letter above that the notional supplier needs to be an independent domestic energy supplier. Defining this as a guiding principle of the consultation will allow for the resulting analysis to be simpler. Not adopting this principle would imply that a subsidy is required from a different business, typically generation or networks (although could be anything with a balance sheet) in order to operate in energy supply.

Hedging appropriately requires the forward purchase of commodity, which results in a requirement to post collateral. The capital required under this fundamental requirement to operate as an energy supplier therefore needs to be rewarded. Either collateral is simply posted, or suppliers have to create alternative structures to negate or limit the requirement to post collateral as below:

- **LOCs/PCGs:** these instruments are typically provided by generation and networks businesses to energy supply businesses. These guarantors have a large physical asset base, enjoy certain and stable returns and have a high credit rating, the

benefits of which are passed to energy suppliers. In effect, these instruments transfer credit support from one business to another. However, just because these arrangements are not on an arms' length basis it does not mean that there is not a real cost associated with them.

Footnote 47 states that these arrangements leverage the credit worthiness of the overall organisation. This is incorrect. The arrangements leverage the credit worthiness of only the non-energy supply parts of the organisation. The energy supply business is credit detracting and cannot support the collateral requirements without a structured commodity trading agreement on a standalone basis.

We do not consider that it would be possible for some of the large suppliers to utilise these arrangements if they were on a standalone basis. This is because many of the large energy suppliers are structurally loss making, have been for many years and there is not a clear pathway to profitability. No bank or finance institution would provide collateral support under these circumstances.

- **Structured commodity trading agreement:** an alternative approach favoured by independent suppliers who cannot leverage assets from another dimension of the energy system is to put in place a structured commodity trading agreement, which can limit or negate the requirement to post collateral. These arrangements include a fee, and also place other restrictions on companies – consistent with those found in debt agreements such as restrictions on dividend policy, acquisitions, hedging strategy, and many more, and include financial covenants. Alongside the trading agreement, a security package is included which provides for the counterpart to take control of the company in a downside scenario.

Each of these alternative options to posting collateral have real costs associated with them. In the case of the LOCs and PCGs, the cost is felt in a different business unit not involved in energy supply. However, using one company to subsidise another company should be a business decision, not a regulatory decision. For the structured commodity trading agreement, the placing of collateral is optimised, but with an associated fee which can be directly quantified and certain restrictions on the company.

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

Collateral is theoretically required to be posted for every pound for which a trading book is 'out of the money'. It should be simple to model this by assuming a hedged value and volume, and then applying certain sensitivities to the forward curve. By moving the forward curve downwards (compared with the curve in place at the point of hedging) a collateral posting requirement situation can be simulated. We would encourage Ofgem to undertake this type of simulated modelling in order to assess the collateral which should be included in the capital employed function of the EBIT calculation.

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

As discussed, our own model does not expose us to such differences. However, conceptually there should be no difference if each trading position is arms' length.

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

No. Collateral capital and risk capital should be considered to be separate.

Section 5 - Cost of Capital

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

*We include within this answer certain comments on the **cost of capital** in response to the narrative outlined within the consultation document.*

CAPM framework

The CAPM framework which is proposed in the consultation document works well for long term infrastructure style pricing frameworks.

However, we note that the CAPM is a framework which aims to represent the long term returns which a stakeholder would expect from capital employed. By its very nature, it takes a long term view - where cyclical risks will be abated over time. However, the energy retail Price Cap should be set with reference to more short term return requirements as (unlike network businesses and other generation assets where the regulatory precedent for using the CAPM model has been set), default tariff customers are free to switch tariffs at any point - creating the requirement for a more short term view of return on capital.

Whilst the CAPM framework is elegant in its intellectual rigour, it departs from the real returns which are required by financial stakeholders in the energy retail market. CEPA captured this within their paper: "we consider that Ofgem will need to take into consideration the significant uncertainty of retailer's cost of capital in the current market, and in particular short term evidence".

We note that this is picked up in paragraphs 5.11 and 5.12 of the consultation document. However, other than pointing to regulatory precedent for the use of CAPM, the concern that energy retail is fundamentally different from other regulated markets appears to be ignored. Whilst we agree that there is regulatory precedent for the use of CAPM, we reiterate the point that energy retail is a fundamentally different sector than the other sectors which are regulated using CAPM models, on the basis that the market is competitive, and does not enjoy the luxury of a monopoly structure.

As a minimum, Ofgem should ensure that their theoretical conclusions on cost of capital marry up with the real world cost of capital which pure play retailers experience. They could for example cross check their theoretical conclusions against a sample of pure-play retailers' costs of capital and interviews with analysts and financing institutions.

Ofgem must ensure that they seek out and consider empirical evidence, rather than solely relying on theoretical calculations alone.

Beta

As noted by CEPA in their cost of capital paper, there are a number of theoretical and practical challenges with determining the beta value for GB energy retailers. However, there are certain factors which should be considered.

First economics paper: Firstly, we note the paper prepared by First Economics on behalf of Energy UK entitled 'GB Energy Retail Businesses: Risk Profile and Cost of Capital'. This paper clearly sets out that the level of risks which the energy retail sector faces has significantly increased since the introduction of the Price Cap - the majority of these risks are idiosyncratic. **This should serve to increase Beta vs. the CMA view.**

Comparative betas - energy companies: Para 5.122 onwards of the consultation document continues to perpetuate the idea that large vertically integrated energy companies, Telecom Plus, and Just Energy are comparators which are worth considering when reviewing the beta of an independent energy retailer. Our views on each of these are as follows:

- Large vertically integrated - we outlined our views on the lack of reliability of these companies' betas as part of our previous consultation responses. The betas of these companies are impacted so severely by their generation and network businesses that the impact of their domestic supply divisions becomes impossible to decipher from the wider group betas.
- Telecom Plus - this company is highly diversified, with revenue arising from energy, broadband, mobile, and insurance. As such, this diversification would serve to naturally drive the beta of the company downwards. In addition, the commercial arrangements which the company has with regards to energy retail are not consistent with those which would apply to a standalone notional supplier.
- Just Energy - this company is based in a wholly different geographical location, is subject to a completely different competitive environment, and is also not regulated in the same way as UK retailers. As such, the comparison is completely unhelpful.

The inclusion of these asset beta estimates in the consultation document serves to perpetuate the idea that energy retailers have a low beta when compared with the average UK company. Whilst we acknowledge that these companies are not being used

as data points in a specific calculation of the intended beta range, they are used to support arguments against increasing the beta (para 5.129).

The references to these betas should be removed, and the consequence should be that the **beta should increase**, given the drag which these comparators would have had on beta in the regulator's mind when undertaking the consultation process.

To support this further, we have appended to this document some further supporting analysis regarding comparison companies, and on suppliers' ability to achieve BB credit ratings over time. This is shown in appendix B to this document.

Idiosyncratic risks: Para 5.129 appears to acknowledge that idiosyncratic risks may have increased since the CMA's previous review. Assuming that the 'empirical evidence' of non-comparable comparative companies is discounted (as outlined above), then there should be no reason not to increase the beta for these risks. The qualitative matters outlined within the various documents submitted to Ofgem clearly demonstrate that there has been an increase in risk (including idiosyncratic risk) - that increase in risk should be accounted for. **Not increasing beta where it's right to do so simply because it's difficult to quantify is a fundamental oversight and dereliction of a duty to conduct a comprehensive review on the regulator's part.** Further work should be undertaken by the regulator, including input from external parties if necessary in order to determine the likely impact of this increase in risk. The increase in risk is material, and so the impact on beta is likely to be material.

Reflecting risk in cost of capital and capital employed: Para 5.130 suggests that it wouldn't be appropriate to reflect risks for which a supplier already holds risk capital against on the balance sheet. We disagree with this suggestion: (i) a supplier must hold risk capital to ensure that it maintains liquidity and hence continues as a going concern under certain downside scenarios, (ii) that same risk capital is subject to the full suite of risks which the supplier faces, and hence a supplier of such capital (equity or debt) would expect to receive a return which accounted for the risk that such capital may be depleted (due to certain downside scenarios). The risk capital should be included within the capital employed calculation, and the risk to which all capital is exposed should be accounted for in the assumed cost of capital.

Reliance on views from UKRN guidance

The cost of capital approach is heavily influenced by the various papers commissioned by the UK Regulators Network (UKRN). However, the 'R' in the context of UKRN refers to monopolistic markets for which a Regulated return needs to be established through price controls.

The first paragraph in the introduction of the latest UKRN guidance for regulators on CoC methodology reads:

Economic regulators use price controls to protect consumers from excessive prices and to incentivise companies to invest, innovate, deliver cost efficiencies, and provide a

decent quality of service. In effect, regulators are trying to recreate incentives which are prevalent in competitive markets.

Energy retail features both a competitive market and a price control.

The references to UKRN guidance throughout the consultation are typically made in paragraphs or statements which serve to push down the cost of capital (compared with the absence of such references). They are also used to justify the use of CAPM as a framework itself.

With such a significant reliance based on research and analysis created for monopolistic markets we suggest that Ofgem disregard references to UKRN analysis throughout the consultation.

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 suggest that the risk-free rates used in the policy should match the risk free rates at the date of the implementation of the policy. That way, suppliers will be remunerated for the true cost of the capital employed.

As (i) the policy will need to be set a small number of months in advance of implementation, and (ii) the policy should endure for a period of time before requiring revision, we suggest that published forward rate data would be most appropriate for the purposes of the policy.

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

Updating periodically to reflect changes in the tax rate is likely to be a reasonably simple adjustment for Ofgem to make, and hence we would support updating the tax rate each quarter, based on the prevailing tax rate at the time.

Section 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?

Yes.

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?

Yes. We have not yet had time to conclude on which other components should be considered fixed, we intend to feed this into a subsequent consultation.

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 the EBIT calculation should reflect the true level of risks which retailers are exposed to. This should be reflected in the beta value in the cost of capital formula.

We don't believe that it is necessary to introduce a calculation that adjusts a component of the EBIT allowance based on market volatility. The CAPM model being used assumes a long term view, a timeframe over which returns are assumed to normalise. Wholesale market volatility should theoretically already be factored into the CAPM calculation, and hence should already be present in the allowed for cost of capital.

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?

Yes, we agree.

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 changes that should be included?

From a short review of the significant changes proposed by Ofgem, we do not disagree, however we have not had sufficient time to consider any further changes that may need to be included.

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.

Appendix B - comparable companies and credit rating methodology review

This review has been prepared in response to Ofgem's recent consultations on both Strengthening Financial Resilience and the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance, hereby referred to as the 'FR consultation' and the 'EBIT consultation' respectively. The purpose is to assess the validity of the comparable companies referenced within these documents in determining an appropriate credit rating and subsequent cost of capital for a theoretical 'efficient supplier'.

The analysis presented is split into the following sections:

1. Relevance of comparable companies
2. Moody's credit rating methodology
3. Conclusion

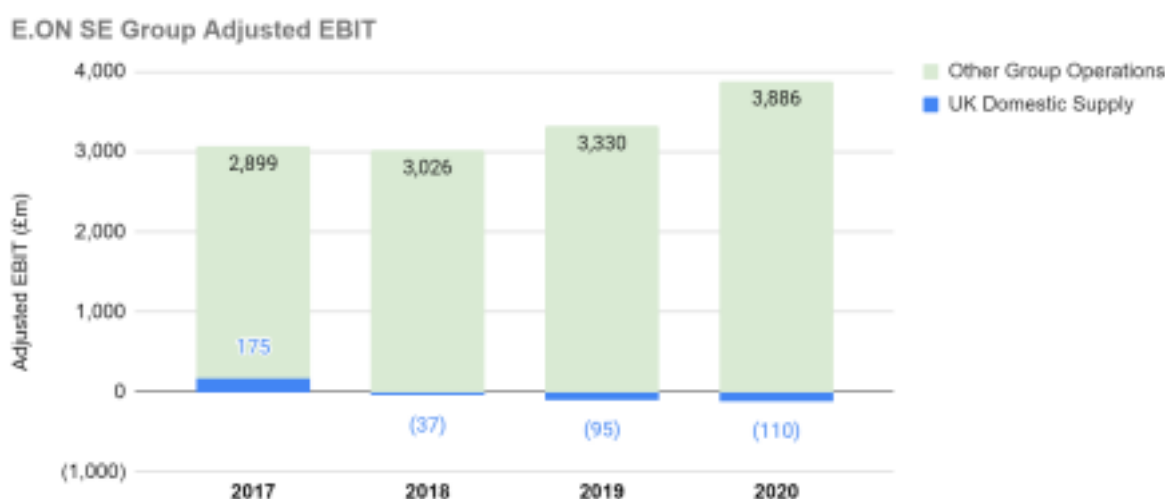
1. Relevance of comparable companies

The comparable companies referenced in the FR consultation are provided below:

Supplier	Moody's	S&P	Date
Centrica (CAN-BG)	Baa2	BBB	Both: Dec 2021
EDF (EDF-FR)	Baa1	BBB	Both: Feb 2022
Iberdrola SA (IBE-ES)	Baa1	BBB+	M: Apr 2016, S&P: Mar 2018
E.on SE (EOAN-DE)	Baa2	BBB	M: Mar 2020, S&P: Mar 2017
SSE plc (SSE-GB)	Baa1	BBB+	M: Nov 2021, S&P: Dec 2018

Source: Table 7 in the 'Revised impact assessment of Strengthening Financial Resilience proposals'

These legal entities, for which the associated credit ratings have been attained, all represent large vertically integrated companies for which UK domestic energy retail supply forms only a small proportion of their earnings. This is evidenced below by combining data from the Energy companies' Consolidated Segmental Statements (CSS) with annual reports published by the companies. See the example below for E.ON SE.



In the majority of cases, UK domestic energy retail results in a drag on earnings, offset by other profitable business divisions within the wider group. The profitable business units operate in generation and networks, parts of the energy value chain which benefit from stable positive earnings. Moreover, it is likely that the negative earnings supply divisions are viewed as credit detracting. As such, adopting the holding groups as comparable companies for standalone UK domestic energy retail is not a fair or appropriate comparison.

This technical error in approach significantly overestimates the benefits of the FR consultation proposals by overstating the reduction in risk post-policy. We welcome the aspiration of risk reduction for the energy retail sector, but structural changes beyond the scope of the current consultations would be required to achieve the credit rating improvements as set out in the consultation documents.

For the purposes of the FR consultation, we would recommend adopting pre and post policy credit ratings based on a bottom up assessment against a credit rating methodology.

2. Moody's credit rating methodology

The 'Revised impact assessment of Strengthening Financial Resilience proposals' references Moody's rating methodology for 'Unregulated Utilities and Unregulated Power Companies', hereby referred to as the 'Moody's paper'.

Within this document, Moody's themselves point out that their methodology *'factors in that unregulated utilities with an integrated model may derive a meaningful portion of their cash flows from regulated and quasi regulated activities. These businesses can exhibit a materially lower business risk profile compared with the predominant unregulated activities and thus enhance the resilience of a utility's earnings and cash flows in the face of economic and commodity cycle downturns'*.

This clearly states that, as one would expect, a vertically integrated company (such as those used by Ofgem as comparable companies) have a clear advantage from a credit rating perspective given their relative strength from both a balance sheet and diversification perspective - thus further discrediting the use of such companies as comparables for a standalone domestic supplier.

The Moody's paper further outlines each of the factors and sub-factors which contribute to a company's overall credit rating. Each of the sub-factors are assessed in turn here with respect to either a theoretical supplier or, where possible, the retail divisions of the comparable companies referenced above. In each case, the requirements to achieve a Baa rating are assessed.

Note: The credit ratings for the 5 'large suppliers' presented as comparable companies by Ofgem are all either Baa1 or Baa2.

For reference, the sub-factors and their associated weightings within the overall credit rating calculation for Unregulated Utilities are provided below:

Factor	Sub-Factor	Sub-Factor Weighting
Scale	1. Scale	10%
Business Profile	2. Market diversification	10%
	3. Hedging and integration impact on cash flow	5%
	4. Market framework and positioning	10%
	5. Capital requirements and operational performance	5%
	6. Business mix impact on cash flow predictability	10%
Financial Policy	7. Financial Policy	10%
Leverage and coverage	8. (CFO Pre-W/C + Interest) / Interest Expense	10%
	9. (CFO Pre-W/C) / Debt	15%
	10. RCF / Debt	15%
Total		100%

In the credit rating process, each sub-factor is given one of the following ratings (in descending order): Aaa, Aa, A, Baa, Ba, B, Caa. These ratings are referenced in the following sections.

2.1 Scale

Baa rating requirement: *'Total assets \$10-25 billion OR Total assets \$5-10 billion and entrenched position in substantial national/regional market'.*

Energy retailers can be seen to have an 'entrenched position in a substantial national/regional market', however they are typically asset light companies - particularly when compared with networks, generators and various other companies within the energy supply chain. As such, it is very difficult for a standalone energy supplier to compete when 'scale' is measured by total asset value.

Conclusion: Caa ('Total assets < \$2.5 billion').

2.2 Market diversification

Baa rating requirement: *'Expected to maintain material operations in more than one geographic or market regions with no one market accounting for > 75% of EBITDA'.*

A standalone UK energy retailer would be unable to achieve this without significant diversification into other markets. Over the coming years, it is expected that suppliers will be able to achieve such diversification by means of cross-selling and business expansion as part of the decarbonisation journey. However, any such diversification will require significant investment and shouldn't be an assumed characteristic of Ofgem's efficient notional supplier.

Conclusion: In the near term at least, the highest attainable rating for a standalone supplier would be Ba ('Expected to operate predominantly in a single well developed geographic region').

2.3 Hedging and integration impact on cash flow

Baa rating requirement: *'Forward hedges or other contractual/ market arrangements provide good visibility on 50% or more of expected cash flow for the next 3 years OR good visibility on > 30% expected cash flow for the next 2 years, if underpinned by sizeable high quality customer base'.*

The price cap mechanism itself prevents suppliers from meeting this criteria. In particular, the misalignment between the delivery period and the wholesale reference period (i.e. 3 months vs 12 months) causes significant working capital movements for suppliers. Despite the partial mitigation of this through the 6 monthly backwardation recovery allowance, this dynamic still creates uncertainty within the cash flow. These risks are heightened during periods of extreme wholesale market volatility.

Similarly, a 'high quality customer base' would likely be defined as one which is stable and predictable, such that the hedged volume can be reliably assumed to be delivered to customers. Domestic suppliers are instead exposed to both churn risk and other volume related risks including weather and consumer behaviour in relation to price elasticity and other factors. These risks suggest that the customer base wouldn't be considered high quality under the Moody's criteria. These risks are also exacerbated by both the volatile wholesale market conditions and the price cap environment within which suppliers are currently operating which drive further challenges with regards to surety over hedged vs. supplied volumes.

Conclusion: B ('Minimal reliable cash flow visibility OR Limited ability to hedge OR Portfolio of contracts/hedges very short term OR Substantial short generation position versus customer base').

2.4 Market framework and positioning

Baa rating requirement: *'Company operates within generation markets whose frameworks may be undergoing some change, Generation mix is expected to remain well aligned with market average and diversified portfolio (no fuel/ technology > 50% output)'.*

Conclusion: B - this sub-factor is heavily focused on generation rather than supply. We see no evidence to propose an alternative to the rating suggested by Ofgem in their Strengthening Financial Resilience impact assessment model.

2.5 Capital requirements and operational performance

Baa rating requirement: *'Manageable levels of capex needed for maintenance, environmental related expenditures or expansion of asset base (e.g. total annual future capex is typically 12% or less of net PP&E). Operational performance of the fleet is typically average relative to competitors'.*

Historically, capex requirements have been relatively low for domestic energy retailers. However, in recent years there has been growing momentum for regulatory change as we enter a transitional period towards a more sophisticated, tech enabled energy supply market. For example, the roll-out of smart meters and subsequent Market-wide Half-Hourly Settlement (MHHS), and the Faster Switching programme. On top of this, the drive for operational efficiency in a market with stiflingly low margins has seen many suppliers undertake significant re-platforming exercises to move to more tech-enabled, efficient billing systems. Such migrations are highly expensive and extremely complex, carrying high levels of execution risk.

Conclusion: B ('Significant capex program needed for maintenance, environmental related expenditures or expansion of asset base (e.g. total annual future capex is typically 20% or less of net PP&E) OR Capex program is challenging in scope and complexity and carries a high degree of execution risk').

2.6 Business mix impact on cash flow predictability

Baa rating requirement: *'Contribution from low/higher risk businesses limited as to scale or accessibility'.*

The rating scale applied by Moody's is based on the % of EBITDA generated by low risk businesses relative to that generated by higher risk businesses. Since the introduction of the SVT price cap in Jan 2019, UK domestic energy supply can only be viewed as a higher risk business. For example, earnings across the industry have been extremely low (negative in the vast majority of cases), the price cap design has introduced significant uncertainty relating to the timing of cash flows (predominantly due to the lagged recovery of a number of costs), bad debt risk has heightened significantly with the average consumer bills more than doubling, and many other high risk factors - as outlined in the paper prepared by First Economics on behalf of Energy UK entitled 'GB Energy Retail Businesses: Risk Profile and Cost of Capital'.

Even to achieve a B rating, Moody's stipulate that they would typically expect 20-35% of the company's EBITDA to be generated by higher risk businesses. For a standalone energy retail supplier, it would therefore be impossible to achieve a rating any higher than the lowest level of Caa.

Conclusion: Caa (*Very high contribution from high risk businesses/ markets (typically, higher than 35% of EBITDA)*).

2.7 Financial Policy

Baa rating requirement: *Track record and expected maintenance of a conservative financial policy; an average level of debt for the industry and a balance between shareholders and creditors; Some risk that shareholder distributions and/or acquisitions could lead to a weaker credit profile; Solid commitment to targeted metrics*'.

We do not see the Baa rating as unattainable for an energy retailer. Achieving a higher rating of A would require an 'extended' track record from a company that is 'not likely to make acquisitions which could lead to a weaker credit profile'. Given the number of Supplier of Last Resort (SoLR) events and high level of difficulty in achieving sustainable organic growth, it is not likely that a standalone energy retailer would be able to achieve this higher rating.

Conclusion: Baa

2.8 (CFO Pre-W/C + Interest) / Interest Expense

Baa rating requirement: *Coverage ratio of 4.2x - 8x*

It is clear from the financial results presented in Appendix C that, following the introduction of the SVT price cap in Jan 2019, domestic suppliers have not been achieving a positive return on investment. The total EBITDA across the large suppliers referenced by Ofgem as comparable companies (excluding British Gas due to reporting differences - see Appendix C) was £(309)m and £(89)m in 2019 and 2020 respectively. Applying EBITDA as a reasonable proxy for CFO Pre-W/C, this clearly indicates that these suppliers would not be able to support a positive coverage ratio and therefore would not be able to attain a rating higher than Caa.

Conclusion: Caa (*Coverage ratio < 1x*).

2.9 (CFO Pre-W/C) / Debt

Baa rating requirement: *Coverage ratio of 20% - 35%*

As outlined above, the negative earnings across the industry under the current price cap design have made it impossible to have a positive coverage ratio or to achieve a rating higher than Caa.

Conclusion: Caa (*Coverage ratio < 5%*)

2.10 RCF / Debt

Baa rating requirement: *Coverage ratio of 15% - 20%*

As outlined above, the negative earnings across the industry under the current price cap design have made it impossible to have a positive coverage ratio or to achieve a rating higher than Caa.

Conclusion: Caa (*Coverage ratio < 3%*).

2.11 Overall weighted rating

Sub-Factor	Rating given	Score*	Weighting	Weighted score
1. Scale	Caa	18	10%	1.8
2. Market diversification	Ba	12	10%	1.2
3. Hedging and integration impact on cash flow	B	15	5%	0.75
4. Market framework and positioning	B	15	10%	1.5
5. Capital requirements and operational performance	B	15	5%	0.75
6. Business mix impact on cash flow predictability	Caa	18	10%	1.8
7. Financial Policy	Baa	9	10%	0.9
8. (CFO Pre-W/C + Interest) / Interest Expense	Caa	18	10%	1.8
9. (CFO Pre-W/C) / Debt	Caa	18	15%	2.7
10. RCF / Debt	Caa	18	15%	2.7
Total			100%	15.9

*The Moody's paper specifies a mapping from ratings to a score from 1 to 20 for each sub-factor.

A factor-weighted score of 15.9 equates to a credit rating of B3. Moody's assign this rating for 'obligations considered speculative and subject to high credit risk'. It is difficult to contest this definition given the recent market failures, negative earnings and high levels of uncertainty introduced by both wholesale market volatility and the price cap design.

3. Conclusion

We believe that the analysis presented within the section above represents a fair reflection of the maximum credit ratings achievable by a standalone domestic retailer operating within the current environment.

Ofgem's proposal suggests an improvement in rating to BB by 2025, equating to a reduction in the cost of debt of 2.69% relative to a B rating (Source: Ofgem Strengthening Financial Resilience impact assessment model). An increase in rating from B3 (as presented in section 2) to BB (as presented by Ofgem) is wholly unattainable without significant market reform. Given the rating methodology and the design of the price cap, there is minimal scope for improvement in any of the criteria except for in the Leverage and Coverage ratios (i.e. 8, 9 & 10).

There are two potential options for improving these ratios:

1. Reduce debt and therefore interest expense (i.e. reduce the denominator)
2. Increase profitability and hence the stability of free cash flows (i.e. increase the numerator)

Suppliers are not in a position to simply reduce the level of debt on their balance sheet by either releasing excess cash or refinancing with equity investment. Similarly, the FR consultation itself is proposing to increase capital requirements for suppliers and therefore can only act to increase levels of debt rather than to reduce them.

As such, the only option for suppliers to improve these financial ratios is option 2 above, i.e. to increase profitability. Clearly there are some level of operational improvements that suppliers can make in order to achieve this, however a reversal of the downward trend and negative earnings seen in recent years will not be possible without sufficient intervention from the regulator by means of a more cost-reflective price cap offering a fairer rate of return on capital employed.

In any case, it will take a number of years for the sector to recover reputationally from the damage caused by the mass failures and negative earnings observed by the market in recent times. However, no such recovery will be possible at all without suppliers being fairly rewarded for both the risks inherent in the market and for those specifically introduced by the price cap and other Ofgem initiatives.

Appendix C: Consolidated Segmental Statements (CSS)

EBITDA

Retailer	Group	2017	2018	2019	2020
British Gas	Centrica	682	573	235	209
EDF	EDF	92	118	(127)	(44)
Scottish Power	Iberdrola SA	65	159	(8)	40
E.ON	E.ON SE	189	(17)	(65)	(85)
SSE*	SSE Plc	298	120	16	-
npower**	RWE	(50)	(73)	(126)	-
Total		1275	880	(74)	120
Total excluding British Gas***		593	307	(309)	(89)

EBIT

Retailer	Group	2017	2018	2019	2020
British Gas	Centrica	566	466	137	112
EDF	EDF	26	50	(183)	(69)
Scottish Power	Iberdrola SA	12	111	(81)	(53)
E.ON	E.ON SE	175	(37)	(95)	(110)
SSE*	SSE Plc	260	84	(24)	-
npower**	RWE	(116)	(105)	(155)	-
Total		924	571	(401)	(119)
Total excluding British Gas***		358	105	(537)	(231)

* SSE was acquired by OVO Energy in Jan 2020, hence the 2020 results are not included in the CSS published by Ofgem.

** npower was acquired by E.ON in Jan 2019. The 2020 results are included within the E.ON results presented above.

*** British Gas do not report standalone financial results for their domestic energy supply business within the CSS in a consistent manner with the other suppliers, hence this is a clear outlier in the above table. The results reported within the CSS include additional revenue (£585.1m across the 4 year period 2017-2020) generated from 'new housing connections and smart meter installations'. This is not revenue generated from the supply of kWh to domestic customers hence we feel it is most appropriate to use total values which exclude British Gas.

Source:

https://www.ofgem.gov.uk/sites/default/files/docs/2021/03/energy_companies_individual_consolidated_segmental_statements_css_2019-2020.pdf

END