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Dear Marzia and Shai

### Further consultation on EBIT allowance

I am writing to you in response to Ofgem's "Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance".

We warmly welcome Ofgem's approach to setting out this second policy consultation before putting forward a statutory consultation later in 2023.

It is critical that Ofgem ensures a regulatory regime that provides value to consumers, through allowing reasonable returns for a diverse range of suppliers in a competitive market. BEIS and Ofgem have supported the continued viability of the energy retail market by limiting suppliers' risk exposure through a number of ad hoc allowances and schemes. We recommend that Ofgem ensures that the regulatory framework reflects the level of risk that energy suppliers are exposed to now and in the coming years. An appropriate margin in the short term appears to be needed to ensure investment in a retail market that will drive the customer services, innovation and net zero solutions that deliver value for consumers.

To summarise, the key points in our response are:

- We encourage Ofgem to re-examine their equity beta estimation in their cost of cost of capital calculation to reflect the higher relative risk of suppliers to the wider economy since the Competition and Markets Authority's (CMA's) 2016 Energy Market Investigation. We think it is important that the regulatory framework reflects the cost of raising capital in a market with higher systemic risks than in 2016.
- The proposed scope of risks considered by Ofgem in the consultation are too narrow. We recommend that the EBIT allowance accounts for risks that are not otherwise accounted for through the application of other Ofgem price cap schemes, or in the interaction between schemes.
- There appears to be a strong case that the EBIT margin needs to appropriately reflect the insufficiency of current supplier returns under the price cap, the limited scope of suppliers for diversification of risk under the price cap and the implications of market volatility.

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- There are significant risks to consumers of Ofgem's proposed application of the notional supplier model if it does not actively support funding energy suppliers operating in a fast-moving and competitive retail market.

### **Ofgem's approach to retailer returns**

Ofgem is proposing these changes to EBIT at a time when the energy retail market is facing significant challenges. These include:

- volatile and very high wholesale costs;
- growing consumer debt;
- the socialisation of costs and customer issues from supplier failure;
- persistent low and negative margins of return<sup>1</sup>; and
- delivering government market interventions such as the Energy Price Guarantee (EPG).

In the last 12 months, energy suppliers have broadly welcomed interventions by Ofgem and the government such as the Energy Price Guarantee (EPG), Market Stabilisation Charge, Ban on Acquisition-Only Tariffs (BATs), reforms to backwardation and improving financial resilience. These changes attempt to stabilise the way the current retail market and price cap design are linked to an extremely volatile market that it was not designed for.

A case for change on EBIT that is in the interests of customers should provide evidence that an updated EBIT margin will more accurately reflect the efficient returns that suppliers require to engage in purposeful and sustainable competition that benefits consumers. Particularly over the coming years of anticipated continued wholesale volatility. This will mean providing a sufficient EBIT margin that reflects current returns, the form of regulatory intervention, the impact of price support schemes and the level of supplier dependency on the continued operation and potential expansion of stabilisation measures.

The strength of the case for change will be determined by the additional value provided to consumers through enabling the efficient funding of critical energy supplier services. We urge Ofgem to publicly reflect why a sufficient margin for suppliers is vital for delivering a retail market that will:

1. help customers navigate significantly higher bills in the short term and
2. have a key role in consumer engagement with net zero.

As with network price controls decisions, price cap changes are an opportunity to reflect on the valued work and future deliverables of regulated entities, such as delivering vital support schemes and services.

### **Case for change**

We see several issues with Ofgem's proposed case for change. We set these out alongside providing a table from First Economics on the recent, current and forward-looking factors

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<sup>1</sup> Ofgem (2021) [Aggregate profits in %: supply segment](#)

that create a case for change in the cost of capital allowance under a price cap methodology that continues to evolve<sup>2</sup>.

Based on the First Economics report we propose that the systematic risk suppliers experience has significantly exceeded the wider economy and is likely to have fallen slightly due to policy and regulatory interventions. There is also scope for systematic risk to continue to fall if the risks to suppliers are mitigated effectively through other elements of price control design. We think this situation requires an enduringly higher equity beta. However, additional allowances for the temporary increases in systematic risk might be reflected by Ofgem in multiple ways to support a stable model, as the government and regulator continue to help the market stabilise.

### **Approach to the EBIT margin**

Given these findings, the benefit for consumers of these reforms will likely be from ensuring the current cost stack allows efficient retailers to make a fair return in the short term. This is particularly the case given Ofgem's wider concerns about financial resilience and the need for further review following forthcoming development of the role of retailers and regulated pricing through changes to market design.

We recommend that Ofgem sets an EBIT allowance that adequately reflects the short- and medium-term risks faced by suppliers. For the longer-term, Ofgem needs to signal an approach to delivering an enduring solution to fair returns, particularly about how to define price regulation allowances that support a competitive market in periods of extreme volatility. This needs to provide energy suppliers and their investors with the necessary confidence about the direction of the cost of capital and EBIT methodologies.

Supplier exposure to the impacts of external volatility will likely cause the requisite EBIT margin to be significantly above a linear correlation with a consumers energy bill. This is due to the potential for systematic risks to potentially present an existential threat to retailers. Even with assumed government and regulatory support, the nature of interventions increases supplier dependency on both the current and enduring landscape of regulatory and government interventions.

Hedging, load shaping and consumer debt, for example, were assumed to scale largely linearly with the bill in normal circumstances as part of the current fixed EBIT margin. However, if the sector experiences a sudden move towards a high and volatile wholesale cost position, the processes a supplier can and will need to take, such as raising capital, will become more expensive. Managing wholesale cost volatility and anticipating complex load shaping requirements will become more expensive and riskier. This is particularly the case when there is lower scope for potential idiosyncratic opportunities for a supplier for commercial advantage.

We recommend a closer examination of supplier risk revealed by COVID-19, the gas crisis and the impacts of consumer energy and switching habits. We also expect that Ofgem will also be in a better place to set a more enduring approach to EBIT once there is clarity on the direction of electricity market and retail market reform.

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<sup>2</sup> First Economics, GB Energy Retail Businesses: Risk Profile and Cost of Capital, December 2022

## Relative supplier risk

The price cap has changed suppliers' ability to define their approaches to pricing, financing and therefore investment since the CMA's 2016 Energy Market Investigation (EMI).

As the CMA recognised in 2016 *"there can be significant volatility in the profits of a retail supply business due to weather-related demand fluctuations, government scheme costs and input price changes"*. However, the scale of these issues mean they required interventions from the government and Ofgem. These new policies and regulations mitigated risk exposure but also restricted suppliers' ability to define their commercial strategies to asymmetrically navigate and manage risk.

Previously, there have been debates about whether risks faced by retailers are systematic risks that affected a supplier's cost of capital under the Capital Asset Pricing Model (CAPM) framework. This is not nearly so relevant in the current market circumstances. The level of energy costs and prices have exerted and continue to exert a very sizeable influence on the inflation rate, household disposable income, interest rate policy, the government's fiscal position, the rate of change in GDP, the profits earned by firms in general and the performance of the stock market. It follows that any risk which can impact suppliers' costs and prices, by virtue of its direct and indirect knock-on effects on the aforementioned measures, is relevant and matters to all firms in the wider economy and, hence, should be thought of as a systematic risk.

We disagree with Ofgem's position that the relative risk of energy retailers to the wider economy is unchanged since 2016. We think Ofgem need to better acknowledge the challenges and limitations of the EBIT margin for retailers since the Competition and Market Authority's (CMA's) Energy Market Investigation in assessing cost of capital. The anticipated level of fair return anticipated by the CMA has not been achieved as expected, with suppliers on average being loss-making since the price cap was introduced.

## Recommendations

We expect a higher EBIT margin to be necessary where suppliers face the systematic risks caused or revealed by extreme market volatility that is not accounted for elsewhere under the price cap. The recent degree of external volatility on suppliers has shaped the necessity of an enhanced EBIT margin, which appears to not reflect the risk in the sector and is too low for suppliers to make fair returns. There seems to be evidence of clear covariance and interdependency between energy suppliers and the wider economy which Ofgem have not yet clearly considered.

There needs to be a clear signal to the retail market that, in instances where it is required, such as following a period of underfunding and facing increased volatility and risk, Ofgem will offer allowable returns that supports purposeful and sustainable competition that will benefit consumers.

Please do get in contact if we can be of assistance in supporting your work on this key issue. You can reach me on [ed.rees@energy-uk.org.uk](mailto:ed.rees@energy-uk.org.uk)

Kind regards

Ed Rees

Senior Policy Manager, Energy UK

## **Appendix 1**

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

We recommend that Ofgem sets an EBIT allowance that adequately reflects the short-term risks faced by suppliers. For the longer-term, Ofgem needs to signal an approach to delivering an enduring solution to fair returns. This should provide suppliers and their investors with the necessary confidence about the direction of the cost of capital and EBIT methodologies. The chosen methodology should also be considerate of the cumulative pressure on suppliers' regulatory teams and minimise the supplier input needed to deliver a new approach, particularly in the short term.

To arrive at an accurate figure, a holistic and robust assessment is needed of the underlying exposure of suppliers to risk revealed by COVID-19, the gas crisis, statutory changes, and the impacts of consumer energy consumption behaviours and switching habits.

Ofgem should also reconsider the EBIT margin when the retail market is operating more normally and once there is clarity on the direction of electricity market and retail market reform.

#### **Risks in data choices when defining an “efficient theoretical supplier”**

We welcome that Ofgem appears open to considering alternative options, but we are concerned about the risks to consumers of potential data choices in the proposed approach.

If Ofgem pursues an efficient theoretical supplier approach by 1<sup>st</sup> July 2023, we think that it should support the diversity in the energy retail market that will provide purposeful and sustainable competition that will benefit consumers.

Making unrealistic assumptions about the cumulative efficiency across a supply business will cause both short term and longer-term issues for consumers. Firstly, it will inhibit supplier stability and risk of exposure to additional costs to stabilise a supplier or cause costs from supplier failure. A focus purely on efficiency may reduce the ability of suppliers to build resilience and invest to offer a high-quality service to all customers through all channels.

Setting a theoretical supplier cost too tightly will also restrict access of new entrants to the market, limit scope for suppliers to compete and impact the overall market returns in the sector. This will reduce competition and innovation, forcing up costs and reducing service quality. It could also significantly make it more costly for suppliers to attract investment into the sector.

We think there should be explicit recognition that suppliers seeking competitiveness do not require each element of a business to operate independently. Otherwise, it risks overestimating the potential cumulative efficiency that can be achieved through siloed assumptions about different elements of a business. So, because one area of a company's business is lean it should not be seen to be a marker for efficiency. Interdependencies of suppliers' business are a key opportunity to find competitive positions, where this opportunity is removed it will likely impact suppliers' ability to raise investment.

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

We set out our concerns about Ofgem's proposed case for change. We consider the theory behind a case for change and draw on a table of recent, current and future risks from the First Economics report. The First Economics report provides what we think is a case for change that will benefit consumers.

### **The proposed case for change**

Ofgem have yet to make a case for change that provides evidence that it will benefit consumers. Or yet "*formed a view on whether the existing allowance over or underestimates a normal profit in the retail market*" which is the way a change to EBIT can impact consumers. We recognise the sense in reviewing the methodology and that there is a case for this to understand if there is a case for change. However, we have yet to see evidence that the current allowance overestimates a normal profit and requires the apparent focus on a margin that would scale to a lesser extent with market volatility for suppliers or that these methods will more accurately define a fair return.

A case for change on EBIT that is in the interests of customers should provide evidence that an updated EBIT margin will more accurately reflect the efficient returns that suppliers require to engage in purposeful and sustainable competition that benefits consumers. Particularly over the coming years of anticipated wholesale volatility where there is a risk of defining too tightly an "*efficient theoretical supplier*" set out in response to Question 1. This will mean providing a sufficient EBIT margin that reflects the approach to regulatory intervention, the impact of price support schemes and the level of supplier dependency and exposure to the removal of stabilisation measures.

### **EBIT margin methodology**

Supplier exposure to the impacts of external volatility will likely cause the requisite EBIT margin to be significantly above a linear correlation with a consumers energy bill. This is due to the potential for systematic risks to potentially present an existential threat to retailers. Even with assumed government and regulatory support, the nature of interventions increases supplier dependency on both the current and enduring landscape of regulatory and government interventions.

Hedging, load shaping and consumer debt, for example, was assumed to scale largely linearly with the bill in normal circumstances as part of the current fixed EBIT margin. However, if the sector experiences a sudden move towards a high and volatile wholesale cost position, the processes a supplier can and will need to take, such as raising capital, will become more expensive. Managing wholesale cost volatility and anticipating complex load shaping requirements will become more expensive and riskier. This is particularly the case when there is lower scope for potential idiosyncratic opportunities for commercial advantage.

We recommend a closer examination of supplier risk revealed by COVID-19, the gas crisis and the impacts of consumer energy and switching habits. We also expect that Ofgem will also be in a better place to set a more enduring approach to EBIT once there is clarity on the direction of electricity market and retail market reform.

### **Issues with the current approach to systematic risk**

We think there is a requirement for a broadly inclusive assessment of the factors in price cap that reflect supplier risk and which haven't been mitigated elsewhere.

We do not agree with CEPA and Ofgem's approach to estimating beta, in particular their apparent reliance on the CMA position from 2016 as applicable to the current retail market. The CMA stated:

*"we accept [suppliers'] argument that there can be significant volatility in the profits of a retail supply business due to weather-related demand fluctuations, government scheme costs and input price changes, we note that these would only have an effect on beta to the extent that the volatility is correlated with overall market returns. Neither volumetric risk arising from fluctuations in the weather, nor changes in government scheme costs, exhibit this correlation."*

Setting aside the accuracy of this assumption at the time it was made, we do not think that the CEPA position that *"0.7 to 0.8 can still be considered plausible and supportable as a long-term, forward-looking view of the relative (market) risk of an energy retailer"* is credible. While accepting the factors outlined above *"contribute, with a forward-looking view, to a perception of greater market risk and covariance of returns from GB energy retail and the wider market portfolio"* there is no evidence or credible reason provided why these factors do not impact suppliers systematic risk and enduring return expectations.

We also support the concerns set out in the First Economics report about the comparator evidence that CEPA and Ofgem have used<sup>3</sup>.

Since 2016, we have seen the introduction of the price cap and the significant impacts on the economy of COVID-19, the gas crisis and the extraordinary steps by governments and regulators in the UK and Europe to seek to mitigate their impacts on the energy market and consumers. It needs to be reasonably established to what extent the combination of input price change, consumers financial positions, volumetric risk and government intervention under a new and fast-evolving model of price regulation are impacting the risk of energy supply businesses relative to the wider economy. Periods of exceptional market volatility are highly revealing for accessing the correlation between a business and the wider economy. While extended periods of no profit or loss making are possible, even with significant redevelopment of the price cap and massive government bill support, is new evidence. The ongoing planned changes to the price cap design is also likely to shape how supply businesses seek to be competitive and make a profit. Also, there is no evidence that consumer elasticity through current exposure to volatile prices is temporary (as argued by CEPA). Particularly if energy efficiency and low carbon technology increase elasticity with slow uptake of consumer devices and industry arrangements to help suppliers manage demand.

### **Supplier risk under the price cap**

Ofgem state that *"recent cap developments have reduced suppliers' risks in comparison to a pre-price cap counterfactual"*. This position appears to assume that the CMA's proposed cost of capital and EBIT margin accurately defined supplier risk under the price cap and there was a net neutral risk position to before the price cap. We do not think this can be substantiated. For example, without the price cap, more customers are also likely to be on fixed tariffs and so switching and hedging risks have changed. Also, Ofgem claim there is

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<sup>3</sup> *Ibid* pp 1-9

evidence they “*step in and protect against systematic market risks*”, yet interventions cannot fully protect against systematic risks without, firstly being enduring or permanent, or without impacting supplier dependence on these interventions and the remaining scope for idiosyncratic approaches to mitigating risks and generating returns.

CEPA and Ofgem make several further statements that appear to misrepresent current relative risk of suppliers verse a counterfactual without the price cap. First, “*the level of price risk a retailer is exposed to can be considerably reduced through effective hedging strategies*”. While hedging strategy has an impact under the price cap now updated quarterly, under the EPG most customers are on SVTs and so the scope for suppliers to reduce their exposure to price risk is clearly significantly weaker than in 2016. This will significantly impact the scope for supplier hedging to improve a supplier’s performance relative to the overall market portfolio.

Similarly, on churn and volume risk the current demand levels that suppliers are far greater as most customers are on SVTs. The risks, in numerous ways, are that suppliers are exposed to the movement in wholesale costs and to a lack of consumers contracted positions and cost recovery options under direct debit. This has partly been accounted for by the MSC and BAT, however, the movement to a market largely on SVT is a hugely important increased risk for suppliers. Intervention mechanisms with protections that have scope for methodologies to change or for mechanisms to be removed at short notice are unlikely to fully account for these risks.

As the CMA recognised in 2016 “*there can be significant volatility in the profits of a retail supply business due to weather-related demand fluctuations, government scheme costs and input price changes*”. However, the scale of these issues mean they required interventions from the government and Ofgem. These new policies and regulations mitigated risk exposure but also restricted suppliers’ ability to define their commercial strategies to asymmetrically navigate and manage risk.

The Ofgem price cap and the government’s EPG influence how a supplier is funded and strongly encourages domestic consumers on to SVTs (because the EPG does not apply to new fixed rate tariff offers). We recommend Ofgem reflect the risks to suppliers not being incentivised to offer fixed contracts to consumers due to the EPG and the likely market challenges when competitive fixed rates emerge.

The price cap and further changes to the price cap have changed suppliers’ ability to define their approaches to pricing, financing and therefore investment since the CMA’s 2016 Energy Market Investigation (EMI).

### **Recent, present and forward-looking risk for suppliers**

Below is the collated recent, present and forward-looking risks set out in the First Economics report that we think are highly relevant to systematic risk<sup>4</sup>. The table sets out the extent to which they are mitigated under the price cap.

### **First Economics Risk Overview**

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<sup>4</sup> *ibid*

<b>Risk category</b>	<b>Risks facing retailers as at H2 2021</b>	<b>Risks facing retailers as at Q4 2022</b>	<b>Risks facing retailers in the coming 12 months</b>
<b>Wholesale price risk</b>	<p><i>As intermediaries between customers and wholesalers, suppliers have continued to face the risk that the prices of the electricity and gas that they purchase on customers' behalf will change in an unpredictable manner.</i></p> <p><i>This risk crystallised in an extreme way during the recovery from the global COVID pandemic and then again following Russia's aggression towards Ukraine. These events, in turn, then brought forth a period of very high volatility in wholesale prices caused by:</i></p> <ul style="list-style-type: none"> <li><i>- short-term dislocations in markets; and</i></li> <li><i>- the sheer level of uncertainty that there has been about the extent to which the macroeconomic and geopolitical factors that have moved prices higher might exacerbate, stabilise or resolve themselves.</i></li> </ul> <p><i>All other things being equal, the higher short-term volatility and heightened</i></p>	<p><i>The underlying risks in the wholesale market do not look to us to have changed materially in the last 12 months.</i></p> <p><i>Suppliers are still facing significant short-term price volatility. And there remains considerable uncertainty about the path of wholesale prices in the coming weeks, months and years.</i></p>	<p><i>... we do not feel qualified to opine on the level of wholesale price volatility/uncertainty that suppliers will be exposed to one year from now.</i></p> <p><i>We do feel confident in saying that the events of the last 18 months will give rise in most quarters to a lasting mental recalibration of the degree of risk that supply companies are unavoidably exposed to.</i></p>

	<i>uncertainty about the path of prices in medium term both straight away meant higher risks around suppliers' future profits.</i>		
<b>Incomplete hedging risk</b>	<p><i>Suppliers can, in principle, limit their exposure to wholesale price risk by locking into fixed prices for future electricity and gas purchases and aligning customer tariffs to those hedged prices. However, suppliers' ability to hedge wholesale prices can be impacted by trading counterparties' willingness to enter into forward contracts and/or energy suppliers' ability to meet collateral requirements and margin calls.</i></p> <p><i>Our understanding, based on the conversations that we have had with suppliers, is that some established trading partners last year started to step away from the market after deciding that the risks they were being asked to bear exceeded their willingness and/or ability to absorb losses. At the same</i></p>	<p><i>Our understanding is that liquidity issues continued to grow during 2022 to the point where HM Treasury and the Bank of England were forced in September 2022 to step in with a backstop Energy Market Financing Scheme (EMFS).</i></p> <p><i>The express purpose of the EMFS is to ensure that energy market participants can continue to hedge wholesale price exposure. In practice, the scheme has not to date been used by suppliers.</i></p>	<p><i>The expiry of the EMFS will remove the backstop protection that suppliers have against liquidity risks.</i></p> <p><i>This in and of itself constitutes a small increase in exposure to risk.</i></p>

	<p>time, those counterparties that stayed in the market increased collateral requirements significantly.</p> <p>This meant that suppliers faced a heightened risk of unwanted exposure to spot prices.</p>		
<b>Hedging mismatch risk</b>	<p>Previously hedging strategy and hedging risk was strictly a commercial matter. However, following the introduction of the tariff cap, there is now a regulatory dimension. Specifically, the price cap regime provides for customers to pay an Ofgem-calculated price for their electricity and gas based on the costs that a notionally efficient supplier would incur if it adopted a particular purchasing strategy that is devised and costed by the regulator.</p> <p>From the outset, this introduced a risk that real-life supplier would make money or lose money if, for whatever reason, it was unable exactly replicate the regulator-determined hedging strategy. Following the sudden changes in the level</p>	<p>In the previous table, we noted that there is a potential mismatch between: (a) the prices that suppliers pay for the purchase of energy over the course of a particular day and the single daily price reading that Ofgem takes into its price cap calculation; and (b) short-duration price cap periods and Ofgem's cap on annual p/kWh prices.</p> <p>In February 2022, Ofgem amended its price cap with effect from April 2022 to include an explicit allowance for backwardation costs that emerged in winter 2021/22. In August 2022, Ofgem made another amendment to provide from January 2023 for an ex ante allowance for expected backwardation costs in winter 2022/23.</p> <p>The revised methodology remunerates suppliers for the expected cost of (b), but still leaves suppliers exposed to the risk that backwardation costs may be higher or lower than anticipated. In addition,</p>	<p>Suppliers' exposure to hedging mismatch risk caused by the basic design of Ofgem's tariff cap will continue.</p> <p>The scale of this risk will be closely related to the degree of enduring wholesale price risk in the market.</p>

	<p><i>and volatility of wholesale prices, suppliers encountered even greater difficulties especially due to mismatches arising from:</i></p> <ul style="list-style-type: none"> <li><i>- intraday price variation vs the reference that Ofgem makes in its calculations to a single daily price reading at a specific point in the day; and</i></li> <li><i>- the six-month periodicity of the price cap vs Ofgem's setting of a cap on annual p/kWh prices.</i></li> </ul> <p><i>This meant that the scope to make or lose money as a result of hedging mismatches increased substantially.</i></p>	<p><i>suppliers continue to face risk (a).</i></p>	
<p><b>Tariff switching risk</b></p>	<p><i>The introduction of the tariff cap inserted a regulated price into an otherwise competitive market. This regulated tariff was originally fixed by Ofgem in month <math>t</math> for a period covering month <math>t+3</math> to month <math>t+8</math>. This design meant suppliers faced a risk that the regulated price would turn out to be more attractive to customers than any other new tariff that</i></p>	<p><i>In August 2022, Ofgem decided that it would adjust the level of the tariff cap every three months rather than every six months. Ofgem also decided that it would fix the level of the gap 25 working days before each reset, rather than ~2 months beforehand as was the case previously. By reducing the amount of time that a regulator-determined tariff set in month <math>t</math> remains in the market from ~8 months to ~4 months, Ofgem has reduced the risk that the</i></p>	<p><i>Ofgem has been clear that its MSC and its ban on acquisition-only tariffs are temporary, time-limited measures. Formally speaking, suppliers will one year from now bear the full risk of costs caused by customers switching back and forth between the regulated tariff in periods characterised by sharp changes in wholesale costs.</i></p>

	<p><i>suppliers could realistically offer to customers. Specifically, the risk was that wholesale prices would rise at some point after month t and that customers switch to the regulated SVT in preference to any of the competitive tariffs in the market.</i></p> <p><i>This ‘unexpected SVT volume’ risk was a problem in that by the time a customer switches to the regulated tariff it is generally too late for the supplier to enter into the purchases that it would need to make in order to buy energy for consumer at the cost assumed by Ofgem when fixing the regulated tariff.</i></p>	<p><i>regulated SVT will come to sit out of line with prevailing competitive tariffs and drive unforeseen levels of switching.</i></p> <p><i>Where one year ago the main risk faced by suppliers was that the regulated tariff would turn out to be cheaper than a supplier’s competitive offerings, the main risk that suppliers currently face is now the opposite problem – i.e. the risk that wholesale prices will fall and customers will switch away from the Ofgem-set SVT to a lower, cost-reflective tariff. This exposes suppliers to potential losses on energy already bought.</i></p> <p><i>Recognising this risk, in February 2022 Ofgem suppliers’ licence to include a market stabilisation charge (MSC) with effect from 14 April 2022. The MSC provides for suppliers acquiring a domestic customer to pay a charge to the losing supplier when wholesale costs fall more than 10% lower than the wholesale element of Ofgem’s price cap. The charge has been calibrated in such a way as to enable the losing supplier to recover most, but not all, of the losses it can suffer.</i></p>	
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<b><i>Demand risk</i></b>	<p><i>Suppliers have continued to face the risk that a customer might use more or less energy than the supplier forecasts.</i></p> <p><i>The level of demand risk grew both directly and indirectly as prices moved higher for at least two reasons:</i></p> <ul style="list-style-type: none"> <li><i>- first, all other things being equal, the elasticity of demand for energy with respect to prices is higher at elevated price levels; and</i></li> <li><i>- second, higher energy bills had a significant knock-on effects on inflation, household purchasing power, interest rates, and GDP, making for a less stable economy and greater uncertainty about future patterns of consumption.</i></li> </ul> <p><i>In a market with rising and volatile prices, and direct and indirect feed-through into customer usage, suppliers found themselves in a position where:</i></p> <ul style="list-style-type: none"> <li><i>- over-forecasting volumes is costly because the supplier</i></li> </ul>	<p><i>Suppliers continue to face the risk that customers will use more or less energy than the supplier forecasts.</i></p> <p><i>This risk has almost certainly increased due to:</i></p> <ul style="list-style-type: none"> <li><i>- the impossibility of knowing how customers will adjust usage in the face of unprecedentedly high prices; and</i></li> <li><i>- uncertainty around the indirect effects that higher inflation, higher interest rates, etc. will have on household spending and economic activity.</i></li> </ul>	<p><i>Forecasts from the Bank of England and the Office for Budget Responsibility suggest that Britain could be in for a long period of economic recession.</i></p> <p><i>This, coupled with the formal expiry of the Energy Price Guarantee in April 2023, creates a very uncertain backdrop for suppliers to forecast future volumes and suggests that volume risks will remain elevated for the foreseeable future.</i></p>

	<p><i>finds that it has purchased electricity or gas that it does not need; and</i></p> <p><i>- under-forecasting is also costly because the supplier has to purchase additional gas and electricity at prevailing, unhedged prices.</i></p>		
<b>Bad debt risk</b>	<p><i>Suppliers face the risk that the number of customers who are unable or choose not to pay their bills will change unexpectedly. As the absolute value of energy bills increased last year, default rates became harder to predict both among:</i></p> <p><i>- domestic customers whose bills were increasing much more quickly than household incomes; and</i></p> <p><i>- non-domestic customers, insofar as not all businesses have the pricing power to pass higher costs on in full to their customers.</i></p>	<p><i>On seeing the strain that higher energy prices have been putting on households and businesses, the government stepped in with a series of subsidy schemes: the Energy Bills Support Scheme; the Energy Price Guarantee (EPG); and the Energy Bill Relief Scheme.</i></p> <p><i>This support has helped to contain, but not eliminate bad debt risks. Suppliers still face elevated uncertainty in this area due to the level of prices customers are paying even after the application of the various support scheme and the wider economic pressures that households and businesses are experiencing.</i></p>	<p><i>A long recession, combined with the expiry of government support schemes, will increase the scale of the risks that suppliers face around the amount of bad debt.</i></p>
<b>Policy risk</b>	<p><i>Finally, all of the above risks have to be considered in conjunction with the keen interest that policymakers have had in the impacts on consumers.</i></p>	<p><i>Policy risks at present are rooted mainly in the uncertainties that there are about Ofgem's and government's willingness to retain many of the policy interventions mentioned under previous</i></p>	<p><i>All of the above risks have to be considered alongside the impossibility of knowing what policy initiative Ofgem and the government may pursue in the face of the new 'normal' level of energy prices.</i></p>

	<p><i>Regulatory risk and government policy risk is ever-present in energy markets. But the level of policy risk in a market with low and stable prices is not comparable to the level of policy risk in a market with high and volatile prices. In the next table, we identify a number of ways in which Ofgem and government have sought to support the market and contain the risks facing suppliers. But a supplier in H2 2021 would have found it very difficult to foresee what form policy interventions would take, what level of support they would provide, and when new measures would take effect, thus making policy risk an additional form of risk in itself.</i></p>	<p><i>headings. As examples of this:</i></p> <ul style="list-style-type: none"> <li><i>- the EMFS is open only until 27 January 2023;</i></li> <li><i>- the MSC is formally in place only until the end of March 2023; and</i></li> <li><i>- the EPG formally expires in April 2024.</i></li> </ul> <p><i>Insofar as we noted above that these interventions have helped to contain risks, it follows that the risks faced by suppliers are directly affected by uncertainties over whether the above sorts of measures will be extended or replaced with new schemes if the need arises.</i></p>	
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## Case for change

Previously, there have been debates about whether risks faced by retailers are systematic risks that affected a supplier's cost of capital under the Capital Asset Pricing Model (CAPM) framework. This is not nearly so relevant in the current market circumstances. The level of energy costs and prices have exerted and continue to exert a very sizeable influence on the inflation rate, household disposable income, interest rate policy, the government's fiscal position, the rate of change in GDP, the profits earned by firms in general and the performance of the stock market. It follows that any risk which can impact suppliers' costs and prices, by virtue of its direct and indirect knock-on effects on the aforementioned measures, is relevant and matters to all firms in the wider economy and, hence, should be thought of as a systematic risk.

Based on the table and the commissioned report we propose that the systematic risk suppliers experience has significantly exceeded the wider market and is likely to have fallen to some extent due to policy and regulatory interventions. There is also scope for systematic risk to continue to fall if the risks to suppliers are mitigated effectively through other elements of price control design. We think this situation requires an enduringly higher equity beta. However, additional allowances for the temporary increases in systematic risk might be reflected by Ofgem in multiple ways to support a stable model, as the government and regulator continue to help the market stabilise.

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

No response provided

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

No response provided

**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?**

No response provided

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

No response provided

**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?**

No response provided

**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 do not agree for the reasons set out in Question 2.

**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?**

No response provided

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

No response provided

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

No response provided

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

No response provided

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

No response provided

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

No response provided

**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?**

No response provided

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

No response provided

**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?**

As set out in response to Question 2 we do not think the value case for consumers for a change to a hybrid approach has been made. As set out in Question 1 there are clear risks to consumers of attempting to define too closely a notionally or theoretically efficient supplier.

**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?**

No response provided

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

The First Economics report suggests an approach to scaling the level of return to reflect the broad trends is market volatility which we encourage Ofgem to consider.

**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?**

We agree with this approach as long as the enduring EBIT methodology makes allowances for periods of significant market volatility as outlined in Question 19.

**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?**

We think this is the correct approach.

**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.