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“Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance” – So Energy Response

Dear Marzia and Shai,

So Energy is a leading energy supplier providing great value 100% renewable electricity to homes across England, Wales and Scotland. We have consistently been recognised by our customers and the wider industry for our outstanding customer service since we were founded in 2015, including being a Which? Recommended Provider in 2020. In August 2021, So Energy merged with ESB Energy and our combined business now supplies over 300,000 domestic customers. As one of the last challenger suppliers left in the market, and one that is backed by ESB’s resources and expertise, So Energy is able to provide a unique view on the energy market and future reform.

So Energy believes that the price cap exposes energy suppliers and consumers to uncontrollable risks and is therefore unsustainable in the long term. We welcome Ofgem’s decision to review the EBIT allowance in light of our improved understanding of managing price cap risk in a volatile wholesale market.

Our chief concern relates to Ofgem’s proposal that the asset beta should remain unchanged from where the CMA initially set it. There is no direct question concerning that proposal, so we will set out our position here. We retained Charles River Associates (CRA) to produce an independent opinion on the approach taken to asset beta - their report is provided alongside this response. The report concludes that:

1. In its initial assessment, the CMA’s exercised significant judgment and relied on multiple assumptions in setting a range for beta due to a lack of reliable data. The situation with a lack of data remains the same today, therefore, a similar burden of proof must be accepted in order to keep the model relevant. The standard to making a change to the recommended beta should also be to assess whether the observed systematic risk of the retail energy sector has changed.
2. CRA agrees with CEPA’s empirical analysis of other sectors, its cross checks with other market evidence, and their conclusion that retail energy is likely more on par with airlines is logical (suggesting a short-term beta of 1-1.2) and is in line with about a one third increase in asset beta, as observed for Centrica since 2016 (by both CRA and CEPA). Therefore, the range of 0.7-0.8 cannot hold.
3. In addition, CRA presents further evidence, through the increasing trend found in Centrica and Good Energy’s asset betas since 2016, that the retail energy sector has become riskier relative to the overall economy.
4. The financial crisis provides for a good comparator for assessing what the current crisis in the energy market might imply about perceived risk to investors today, and particularly:

- a. The financial crisis led to both an increase in banking equity beta (of 150% from pre-crisis levels), and a quadrupling of asset beta in European banks. Applying that range of increase to energy would lead to a beta of 1.75-3.2.
 - b. Where beta spikes in the context of a market crisis it can take years to normalise and may never return to pre-crisis levels. It took 6 years for the equity beta to normalise in banking following the crisis. The potential for a similar 'long tail' must be accounted for in the EBIT assessment.
- 5. There is a risk that by holding the beta of retail energy companies to the same level as observed in 2016 that Ofgem is, in fact, failing to allow for investors to recover for higher levels of systematic risk that exist today.

In addition to our concerns over the asset beta, we highlight other concerns within the responses to the questions:

- A. There are significant risks associated with the notional supplier under the price cap deviating from some or all suppliers' real world characteristics, given suppliers' dependency on price cap derived revenue in the current market:
 - The value of various allowances provided under the cap on a 'winners and losers' basis has grown very large. If a supplier happens to be a 'loser' too many times, they risk significant losses. Ofgem has not offered a sensitivity analysis on this.
 - Market volatility and lack of liquidity has led to much greater challenges in replicating the price cap index.
- B. Scope of risks and the mitigations outlined are too narrow. The stacking of allowances creates its own risks which are not accounted for. In addition, significant residual risk remains with regards to recovery of backwardation costs and forecasting of demand despite the mitigations that are already in place.
- C. There is clear evidence of profitability and working capital are low in the industry under the exiting price cap regime which highlights existing assumptions in CAPM model are not reflective of real world conditions. Real world capitalisation and profitability have both been consistently lower than what is assumed under the price cap. This contributed to a lack of resilience in the energy retail market, which was exposed during the current crisis.

Our answers to each of the consultation questions is set out below.

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

We are greatly concerned about the pace at which this review is being undertaken and the consequences in terms of interested parties having the time to properly consider and input into this work and the time available for Ofgem to properly consider the input that is provided. The period provided for the consultation is very short, especially given the consultation runs over the Christmas period, and alongside other important consultations.

Many of the proposals in this consultation, such as with regards to asset beta, are to make 'no change' due to what Ofgem considers an absence of evidence for change. However, as made clear in the CRA report, the CMA was heavily reliant on making assumptions in determining the original EBIT calculation and data on supplier profitability, capitalisation and subsequent supplier failures indicates some of these assumptions were materially incorrect. Ofgem is demanding a higher burden of proof to amend the EBIT calculation than what was used to derive it in the first place. This is especially concerning given Ofgem also thinks that the price cap design is in need of urgent review, which implies that original CMA design is flawed. The evidence we present in our response and the CRA report attached must be given full consideration ahead of any move to statutory consultation. The same can be said for the

Energy UK response, which we contributed to and the responses submitted by other interested parties. In response to questions on collateral, we also suggest Ofgem takes a more structured review with key wholesale trading partners within the UK energy wholesale market to assess the level of collateral requirements that would be required for the notional supplier Ofgem has proposed.

The consequences of compounding the CMA's flawed analysis by rolling it forward are especially severe given Ofgem proposes making no firm commitment on future reviews. If the analysis is rushed and the outcome flawed, this will likely remain the case for many years. In this context, we believe the likelihood of legal challenge is elevated.

Finally, we welcome that Ofgem elected to undertake a further policy consultation rather than proceed to statutory consultation. Given the timeline for July implementation, Ofgem has scope to delay for a further three summer months should they feel the need and the impact on customer bills would be relatively low.

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

We do not consider that the mitigations put forward in Table 1 fully mitigate the increase in risks summarised in Table 1. For example, the backwardation allowance and quarterly cap does not fully mitigate risks. There remains the risk that suppliers do not fully recover backwardation costs due to the deadband and the timing of cost recovery remain material. There are also new risks associated with the move to a quarterly price cap related to hedging and shaping to the price cap methodology, and these have been compounded by ongoing liquidity issues in the wholesale markets.

Our understanding of the risks suppliers manage under the price cap is much better than when the CMA made their original decision. The concept of the 'free option', that active switchers would jump from fixed tariffs to price capped tariffs and back with the cost of this action being socialised through SoLRs or price cap allowances was not conceived of in 2016. The 'free option', which is a key driver of volume risk, remains an enormous residual risk for suppliers to manage despite the move to a quarterly cap and the introduction of the MSC and BAT. Although ex-post allowances have been provided for exceptional unexpected SVT demand, it has been provided on an ex-post basis and based on data that excluded the impact on smaller suppliers. As things stand today, no one is in a position to accurately predict when active switchers may exercise the free option back to fixed tariffs. Uncertainty around the status of fixed tariffs within the EPG, the future of the MSC and the future of the BAT all contribute to these difficulties.

Many of the mitigations set out in Table 1 take the form of allowances or compensation. The allowances provided for in the existing price cap design and supporting elements do not fully account for the risks being borne by suppliers. Ofgem has continually said that each of these allowances are provided for 'in the round' with some suppliers being overcompensated for some allowances and undercompensated for others. The assumption by Ofgem is that these allowances will largely even out. However, no analysis has been presented by Ofgem to demonstrate that this is in fact the case. The materiality of these allowances has grown considerably since the crisis started and therefore the implications for suppliers should Ofgem's assumption that the allowances even out prove to be incorrect have grown more grave and consequential. The stacking of these large allowances on a 'winners and losers' basis, is in itself a risk that is not accounted for within the price cap framework.

As set out in the CRA report, Ofgem has made no attempt to determine the residual risk in the market following the implementation of the mitigations in Table 1 through detailed holistic

accounting. This calls into question the assumption that the residual risk is in any way low or manageable.

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

The fixed element of the price cap appears very small in comparison to the variable portion, which reflects a suppliers primary task of managing energy system risk on behalf of end consumers. If disaggregation of the components of EBIT is to be considered, then the management of non-linear risks (risks that scale in a greater than linear fashion) and the impact this has on suppliers should be investigated. Hedging, 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. These key risks items evidently scale in a fashion greater than on a linear one-for-one basis and therefore as the sector has experienced a sudden move towards a high and volatile wholesale cost position, the mitigations a supplier can and will need to take, such as raising capital, will become more expensive.

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

We note that Ofgem is due to review the operating cost allowance from which the estimate of fixed assets is derived. We consider the current operating cost allowance to be too low. The current energy crisis has led to a large increase in customer contact across the industry, necessitating investment in systems and additional personnel to mitigate the operational challenge. We look forward to Ofgem's review of operational expenditure.

Given the high and ever climbing proportion of customers on the price cap, considerations with the design of the price cap have essentially become considerations with the design of the market. Assumptions made about the notional supplier will define what business models are viable in the market. If a supplier is assumed to be vertically or horizontally integrated, it is difficult to see how an independent supplier can survive in the market given their greater exposure to risk. If a supplier is assumed to conduct wholesale trading activity through one of the limited number of available trading partners, then there is little chance alternative business models may develop, which adds an extra market risk around a reliance on a small number of wholesale trading partners. Whether Ofgem makes these decisions consciously or unconsciously, the adverse impact on competition by taking this approach will be the same. It is essential that Ofgem makes choices that allow for market entry and expansion and provide for a diverse supplier community. Therefore, the following features are essential for a notional supplier:

- The supplier must be an independent supplier – or as described in the CRA report a 'pure play energy retailer'. The price cap must allow for new entrant independent suppliers, which looking at what has happened historically, are generally private companies. If it does not, then new entrants will cease to be a feature in the market and effective competition will become impossible to achieve.
- The asset beta must be adjusted upwards in line with the CRAs recommendations in order to account for the level of risk an independent supplier must manage.
- The independent supplier must be capable of undertaking all supply activities, including posting their own collateral, even if commercial incentives at a given time point towards working through 3rd parties.

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

We note that the Oxera report cited low levels of working capital and insufficient profitability as key factor in the energy market's failure to weather the energy crisis. Taking these two issues in tandem, it is clear that revenue allowed under the price cap must grow in order to allow suppliers to recapitalise and make a sustainable return on investment. Otherwise, the industry will be even less well equipped to face the next energy crisis.

As noted in the CRA report, the CAPM framework is derived from a series of assumptions:

The price cap has an existing notional level of capital employed. However, this notional level is based on a series of assumptions derived from the CAPM framework that aren't necessarily reflective of real world market conditions.

The main assumptions underlying CAPM are that:

1. All investors are risk-averse, efficient and wish to maximise their own utility;
2. Investors have access to perfect information and a single period transaction horizon is assumed;
3. There is unlimited capital for investors to borrow and lend at the risk-free rate of return.
4. Investments are diversified such that unsystematic risk has been diversified;
5. There are no taxes, inflation, or transaction costs.
6. Risk and return are linearly related.

Many of these assumptions have been generally challenged and can appear unrealistic in the context of the retail utility market in the UK. Broadly speaking, the biggest implication of relevance to the calculation of Beta is that investors need only to be remunerated for the "systematic" risk their investment is exposed to because they are able to hedge "idiosyncratic" risks through a diversified portfolio. The CMA noted,

*"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."*¹

We agree with Ofgem and the CMA that idiosyncratic risk should be excluded in the calculation of Beta because that's technically how the CAPM model works. To the extent that industry participants feel that idiosyncratic risk needs to be remunerated, and that may be fair, it should be done outside of the Beta calculation. However, there is a broader question as to whether by choosing CAPM, the CMA and now Ofgem is, therefore, only allowing an appropriate return for investors who are able to hold diversified portfolios.

With private firms, this assumption may not hold. The owner is often the only investor (or one of a few) and may have much of its capital invested in the business and so does not have an opportunity to diversify. In such circumstances betas will understate the exposure to market risk. This applies to privately owned independent smaller retail utilities in the UK.

¹ CMA EMI 2016, Appendix 9.12: Cost of Capital to the CMA Energy Market Investigation, para 67, p. 25. See <https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf>

It could be construed that if suppliers were to increase their level of capitalisation to the notional allowance in the cap, then the issue with low levels of working capital would go away. However, that would imply that suppliers were historically making excess profits and as Oxera have pointed out, this clearly was not the case. The evidence points towards some or many of the assumptions made under the current CAPM framework being incorrect and as a consequence, the notional level of working capital and profitability provided for in the price cap was not reflective of real world market conditions. Given the historical lack of capitalisation and profitability in the market, it is clear that the notional level of capitalisation allowed for in the cap needs to increase and revenue allowed for under the cap must be increased to pay for this.

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

Given the high and ever climbing proportion of customers on the price cap, considerations with the design of the price cap have essentially become considerations with the design of the market. Assumptions made about the notional supplier will define what business models are viable in the market. If a supplier is assumed to be vertically or horizontally integrated, it is difficult to see how an independent supplier can survive in the market given their greater exposure to risk. If a supplier is assumed to conduct wholesale trading activity through one of the limited number of available trading partners, then there is little chance alternative business models may develop, which adds an extra market risk around a reliance on a small number of wholesale trading partners. Whether Ofgem makes these decisions consciously or unconsciously, the adverse impact on competition by taking this approach will be the same. It is essential that Ofgem makes choices that allow for market entry and expansion and provide for a diverse supplier community. Therefore, the following features are essential for a notional supplier:

- The supplier must be an independent supplier – or as described in the CRA report a ‘pure play energy retailer’. The price cap must allow for new entrant independent suppliers, which looking at what has happened historically, are generally private companies. If it does not, then new entrants will cease to be a feature in the market and effective competition will become impossible to achieve.
- The asset beta must be adjusted upwards in line with the CRAs recommendations in order to account for the level of risk an independent supplier must manage.
- The independent supplier must be capable of undertaking all supply activities, including posting their own collateral, even if commercial incentives at a given time point towards working through 3rd parties.

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?

These are both key drivers of volume risk. While steps have been taken to mitigate these risks in recent times, the overall level of residual risk is far higher than the real and perceived risks faced by suppliers at the time when the CMA made their original assessment in 2016. The concept of the ‘free option’ that active switchers would jump from fixed tariffs to price capped tariffs and back with the cost of this action being socialised through SoLRs or price cap allowances was not conceived of at the time. The ‘free option’, which is a key driver of volume risk, remains an enormous residual risk for suppliers to manage despite the move to a quarterly cap and the introduction of the MSC and BAT. Although ex-post allowances have been provided for exceptional unexpected SVT demand, it has been provided on an ex-post

basis and based on data that excluded the impact on smaller suppliers. As things stand today, no one is in a position to accurately predict when active switchers may exercise the free option back to fixed tariffs. Uncertainty around the status of fixed tariffs within the EPG, the future of the MSC and the future of the BAT all contribute to these difficulties.

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?

The allowances provided for in the existing price cap design do not fully account for the risks being borne by suppliers. Ofgem has continually said that each of these allowances are provided for 'in the round' with some suppliers being overcompensated for some allowances and undercompensated for others. The assumption by Ofgem is that these allowances will largely even out. However, no analysis has been presented by Ofgem to demonstrate that this is in fact the case. The materiality of these allowances has grown considerably since the crisis started, which means the implications for suppliers should Ofgem's assumption that the allowances even out prove incorrect have grown more grave and consequential. The stacking of these large allowances on a 'winners and losers' basis, is in itself a risk that is not accounted for within the price cap framework.

Instead of 'double counting', the current approach is under-accounting because the accumulation of risk brought about by multiple 'one size fits all' allowances is not currently factored within the EBIT allowance. Rather, it would account for the risks to which an increasingly complicated price cap exposes suppliers.

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

As set out in the CRA report, the use of the CAPM for this purpose requires significant amounts of judgement in light of both weaknesses in the model's representation of real-world processes and, particularly, the lack of directly relevant data for listed retail energy companies. The lack of data has consistently presented a challenge dating back to the original CMA assessment. Despite this, suppliers have been asked to furnish a higher burden of proof to amend the model than what underpinned the CMA's modelling. Suppliers are being asked to furnish "empirical evidence" where the CMA originally exercised judgment.

The evidence with regards to the level of capital employed in the industry versus the assumptions in the cap, the level of profitability in the industry versus the cap, the emergence of the 'free option' problem and the large number of supplier failures in the face of a wholesale market shock indicate a low ability to absorb shocks and point to a need for review of the CAPM to ensure it provides for a reasonable interpretation of investor incentives as they apply purely to retail energy. The out-turn does not align with the CMA's model.

This is how we find ourselves with a CMA model that never anticipated such an energy crisis and an Ofgem update that pretends it never happened. We have some reasonable suggestions to help address this issue:

1. Ofgem should consider empirical evidence where available. The asset beta of both Centrica and Good Energy have experienced an upward trend since 2016, pointing to increased systematic risk
2. Ofgem should look to markets that have faced crises periods reasonably analogous to the current crisis, but have better data, to see how they fared during and after their crisis. As set out in the CRA report, US equity banking Beta rose 150% from pre banking crisis level

to their peak. Further, while equity Beta subsided gradually by the end of 2014, it never returned to pre-crisis levels. Evidence also exists showing that the asset beta of the banking sector increased as a result of the financial crisis.

3. Ofgem should revisit the aviation industry as a comparator sector as identified by CEPA. The rationale for dismissing it, that the risks associated with changes in demand for aviation are greater than the risks associated with changes in demand for energy do not appear to stack up. If anything, energy suppliers are exposed to a greater volume risk than airlines:

Airlines	Energy
No duty of offer supply. Airlines can manage demand by adjusting supply. Flights can be cancelled (at a cost)	Duty to offer supply.
Demand can be managed by adjusting price, including price segmentation.	The price is capped.
Airlines demand payment in advance	Suppliers must offer payment in arrears as an option.
There is a cap in overall demand, when the plan is sold-out.	There is no practical cap in demand, the energy system is designed to function even in extreme demand scenarios.
Any revenue earned over fixed + variable costs will be profitable to the airline.	Suppliers can lose money if demand is higher or lower than forecast.
Impact of weather on demand is relatively low.	Impact on weather on demand high.
	'Free option' impact of price cap – hedging is per tariff and difficult to predict consumer behaviour & when SVT/Fix inversion might occur.

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

In working to a notional supplier, the price cap should assume that there is a requirement to post collateral. The CMA analysis of suppliers trading on a collateral free basis does not hold in the current market as wholesale volatility has fundamentally changed the nature of trading relationships across the market. Second, where independent suppliers have been able to trade on a collateral free basis, this is most often where they pay a trading fee and, importantly, ascribe certain rights of security over business assets. This does not appear to be factored into current analysis of responses provided by Ofgem. Further, new trading arrangements to be entered into on the basis of security over business assets is more unlikely given the regulatory changes made over the last 12 months which enforce greater control over material assets.

For those suppliers trading as part of a wider group, historically they may have been able to benefit from the group's trading relationships to trade in OTC markets on a more collateral

free basis, but essentially through a PCG/LOC. This collateral free arrangement is, in large part, due to the offsetting wholesale exposures within the wider group such that other parts of the business may benefit in certain wholesale scenarios where other parts do not. To therefore assume that a notional independent supplier can trade upon this basis does not hold.

In addition to this, the collateral free basis by which all market players have been impacted significantly by the elevated volatility levels in the wholesale markets. Limits of credit exposures are set between counterparties and collateral is required over and above these limits. With elevated wholesale volatility, combined with much larger notional values of energy being hedged, the requirement to post collateral in some form (whether OTC or on exchange) has increased significantly. Given the significance of this issue, we would recommend Ofgem takes a structured review with key trading partners within the UK energy wholesale market to assess the level of collateral requirements that would be required for the notional supplier Ofgem has proposed. The most transparent approach would be to assume collateral levels according to those published by exchanges, although we do recognise there are potentially material cost implications in this regard.

In 4.88 Ofgem has highlighted it has received little evidence regarding fees for LOCs/PCGs. Within this section, Ofgem has also suggested that the government EMFS scheme would likely represent the high end of the cost range and that suppliers' actual costs of trading would be lower. We would highlight that the credit rating required by the EMFS scheme (BB-/Ba3) is higher than the credit ratings Ofgem has associated with all challenger/smaller suppliers operating within the market today (Figure 10 of Revised impact assessment of Strengthening Financial Resilience proposals²).

We have also provided a separate confidential annex with further detail in response to this question.

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

The relationship between collateral, wholesale prices and volatility can clearly be analysed on the basis of collateral requirements published by exchanges. This does not cover OTC relationships which are more bespoke and unique to individual suppliers. We have suggested Ofgem undertakes a structured review with key trading partners within the UK energy wholesale market to assess the level of collateral requirements that would be required for the notional supplier Ofgem has proposed. This review would be a key element in further quantifying these relationships.

We have also provided a separate confidential annex with further detail in response to this question.

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

Yes, the mechanisms do differ but the level of volatility over the last couple of years has brought these closer together. As Ofgem have highlighted within the consultation, trading on a collateral free basis is now not possible in many circumstances and in the case of an

² <https://www.ofgem.gov.uk/sites/default/files/2022-11/Revised%20impact%20assessment%20of%20Strengthening%20Financial%20Resilience%20proposals.pdf>

independent notional supplier it would likely not be possible. As volatility has increased and higher wholesale prices have also increased the notional amount hedged at any time, this has exhausted existing collateral free facilities such that collateral is a requirement.

We have also provided a separate confidential annex with further detail in response to this question.

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

Yes, please see answers above.

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

In light of the large increases in inflation seen in the post-Covid economy, it is important that it is fully accounted for in the price cap. When the CMA conducted its 2016 assessment inflation had been in the range of 1-3% for the past 20 years, allowing for it to be taken for granted. The model needs to be reviewed to ensure it is suitable for high inflation scenarios.

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 believe the approach outlined by CEPA, which acknowledges the shorter investment horizon in the energy retail sector when compared to network companies is the most appropriate. The UKRN guidance quoted by Ofgem is in relation to price controls, which largely guarantees revenues and allows for long term investment decisions to be made, rather than price caps, which do not. The RIIO price control presents issues as a suitable point of reference for similar reasons.

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

We are not in a position to respond to this question owing to time constraints in the consultation process.

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?

Given the low level of fixed assets in retail suppliers, estimated at £85 per customer by Ofgem, we remain unconvinced that this is the most cost reflective adjustment that can be made.

Costs that can increase in a greater than linear manner, such as Bad Debt, shaping, balancing and collateral, are likely to have a far more material impact on energy costs in the context of continuing wholesale market volatility and the planned reduction in the level of energy bills planned from April 2023 onwards. The percentage of household incomes spent on energy bills has climbed to unprecedented levels, and at a certain threshold, consumers will cancel their direct debits and stop paying their bills. This leads to greater levels of non-payment and greater operational costs in managing non-payment of bills. As the steward of the energy market, it is incumbent on Ofgem to recognise this risk and allocate resource to addressing it.

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?

As acknowledged in the consultation on Strengthening Financial Resilience, RO ringfencing comes at a cost and a price cap uplift of £8 per year has been provided for, based on a 10% WACC. That consultation also acknowledged that although an allowance has been provided for it would not cover the cost of replacing lost capital for most suppliers, making them less financially resilient. The rationale for this position, that it provides 'a strong incentive for efficiency' is nonsensical and unjustifiable. The cost of raising capital bears little relationship to a given supplier's efficiency. Policies whose goal is to enhance the financial resilience of suppliers should actually enhance the financial resilience of suppliers. That means increasing the size of the uplift provided in the price cap. Whether the RO be treated as a fixed or a variable allowance, it must cover the cost borne by suppliers in order to strengthen the financial resilience of those suppliers.

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 price cap should account for the fact that some risk is non-linear in nature and may increase rapidly once certain thresholds are passed. An example of this is with regards to bad debt risk, households can only afford to bear a certain amount of energy cost before bills go unpaid and Direct Debits are cancelled. Given the end of the EBSS and the decrease in the value of the EPG, this should be a pressing concern for Ofgem in its role as a prudential regulator and chief determinant of how revenue is gathered to fund the operation of the energy system. Whether this and other non-linear risks are captured as part of the EBIT calculation or in discreet allowances, they need to be forecasted and accounted for.

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 disagree.

It is clear that the assumptions the CMA made when designing the original EBIT allowance did not account for the current energy crisis. By retaining Beta at the level set by the CMA, Ofgem is in effect pretending that the energy crisis is not happening. This is wholly inappropriate. As we have stated elsewhere, the allowances recently provided by Ofgem do not fully account for the risk faced by suppliers and the compounding of these 'one size fits all' allowances represents a risk in itself. The Beta must increase to account for the increase in the real and perceived risks associated with investment in the energy sector.

As set out in the CRA report, systematic risk can increase dramatically in times of crisis, it can take years to restabilise and it may never revert to pre-crisis levels. Based on the experience of the banking sector, we would recommend a review every 2 years over the next 6 years to track Beta volatility. After that period, it may be possible to revert to less frequent reviews.

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

Our preference is for a review of the EBIT allowance every two years in order to account for changes in Beta as the retail supply sector navigates its way out of this crisis.

As suggested by Ofgem, other risks can be addressed in the intervening period by adjusting allowances.

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?

The terminology used in the price cap is unhelpful in terms of explaining the price cap and its impacts to consumers, policy makers and the press. 'Cap allowance at nil consumption' should instead be stated as a pence per day standing charge. 'Cap allowance at [now outdated] TDCV' should be stated as a pence per kilowatt-hour unit rate (capped at 4 decimal places – we don't believe any supplier charges at a more granular level than this). This would also aid the pricing of price-capped products enormously in the context of the reduced notice period for the quarterly cap.

Yours Sincerely,

Paul Fuller
Head of Regulation

