
EBIT consultation - Draft default tariff cap overview model guidance

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This document provides a detailed description of how the methodology proposed in the current statutory consultation on the Earnings Before Interest and Tax (EBIT) allowance is put into practice within the Default Tariff Cap Overview Model.

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1. Introduction

EBIT consultation

- 1.1 A statutory consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance was published on 25 May 2023.¹ It sets out a revised approach for calculating the level of capital employed and the cost of capital of a notional supplier.
- 1.2 Chapter 6 of the consultation document also sets out a revised approach to calculating an EBIT allowance using those capital employed and cost of capital figures. In particular it proposes introducing a fixed EBIT allowance, expressed in £'s per customer, and a variable EBIT allowance, expressed as a percentage of the other price cap allowances (minus EBIT, headroom and VAT).

Default tariff cap overview model

- 1.3 The default tariff cap (DTC) overview model is a spreadsheet model published alongside each price cap update. It takes the individual price cap allowances as inputs and calculates the overall cap level for each fuel, metering arrangement, payment type and region combination.
- 1.4 A draft update to the DTC overview model was published alongside the May 2023 EBIT consultation.² It provides an illustration of the proposed approach for calculating and implementing the revised EBIT methodology, as described in Chapter 6 of the consultation document.

This document

- 1.5 Appendix 2 of the May 2023 EBIT consultation provided a summary of the changes made to the DTC overview model to give effect to the proposed new EBIT methodology.

¹ Ofgem (2023), "Price Cap - Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance", <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance>

² Ofgem (2023), "Draft Overview model – Default tariff cap level", https://www.ofgem.gov.uk/sites/default/files/2023-05/Default_tariff_cap_level_v1.18.xlsx

1.6 This document repeats that summary but also provides a more detailed description of the changes made and the proposed approach to updating newly introduced inputs.

2. Draft DTC Overview model

Summary of changes

Table – Changes to the Default tariff cap overview model

Type	Change	Description
Input	Added new table to '3k EBIT' sheet above existing table with current EBIT values.	<p>Table provides a summary of the fixed and variable EBIT components for all price cap periods up to the end of 2030.</p> <p>Takes values from pre-existing EBIT table (rows 21-27) for all periods prior to October 2023 and from a new section (rows 29-66) for cap periods from October 2023 onwards.</p> <p>Values in this table are used as inputs within the calculation sheets of the model.</p>
Input	Added a new section to '3k EBIT' sheet below the existing table containing EBIT values.	<p>Section consists of three tables.</p> <p>The first table (rows 36-50) calculates the cost of capital given a set of parameter values. These parameters will be fixed for four quarters, with only the gilt yield, inflation wedge and tax rate inputs being updated annually.</p> <p>The second table (rows 54-59) contains the capital employed values. These values will remain the same for each cap period unless subjected to a future review supported by a consultation.</p> <p>The third table (rows 63-66) calculates the fixed and variable EBIT components using the cost of capital and capital employed values. These calculations follow those set out in Chapter 6 of this consultation document.</p>
Calculation	Amended the formulas in the EBIT rows of each "calculations" sheet	<p>The calculations sheets contain the total EBIT allowance value (fixed plus variable) for each fuel/metering arrangement, consumption level, payment type and region combination.</p> <p>For those calculations sheets assuming positive consumption the EBIT allowance is calculated by multiplying the variable EBIT percentage for the relevant period taken from sheet '3k EBIT' by the sum of the allowances excluding EBIT itself and headroom. Half the value of the fixed EBIT component for the relevant period, also taken from '3k EBIT', is then added. This reflects the proposal to split the value of the fixed component equally across electricity and gas.</p>

		For those sheets assuming 'Nil' consumption the EBIT allowance is calculated using the implied EBIT margin (EBIT allowance / All other allowances excluding EBIT and headroom) from the equivalent calculations sheet based on TDCV levels of consumption. This ensures the EBIT margin is the same at TDCV and Nil consumption.
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Description of sheet '3k EBIT'

EBIT allowances (row 6-15)

2.1 This is a summary table of the fixed and variable EBIT allowances for each cap period, both historic and future. It is the main output of the EBIT sheet and feeds into the overall cap calculations in the "2. Calculations =>" sheets.

EBIT allowance up to September 2023 (row 16-28)

2.2 This table is replica of the table in the EBIT sheet of the current DTC overview model. It is used as the source of the variable EBIT allowance for all cap periods prior to October 2023.

EBIT allowance from October 2023 (row 29-66)

2.3 This section calculates the fixed and variable EBIT allowance in line with the proposed methodology outlined in Chapter 6 of the May 2023 statutory EBIT consultation.

Cost of capital (row 34-50)

2.4 This section calculates the cost of capital component of the EBIT allowance and is based on the inputs detailed in the table below.

2.5 The table below lists the inputs and whether they are subject to change over time or not. Where inputs are static (ie do not change over time) the same value will be copied and pasted into the adjacent column ahead of each quarterly cap update.

Table 1 – Cost of capital inputs

Input	Source	Static or variable?
Real total market return	Value in line with RIIO-2 decisions.	Static
Asset beta	See paragraphs 5.92 to 5.135 of statutory consultation document.	Static
Gearing	Based on the assumption that the notional supplier is 100% equity financed, consistent with previous CMA analysis.	Static
Index-linked UK government gilt yields	One-month average of UK government index-linked gilts from Bank of England archive yield curve data. ¹ Current value averaged over March 2023, proposed decision value averaged over July 2023.	Variable – updated annually
RPI-CPI wedge	Difference between Office for Budget Responsibility (OBR) RPI and CPI 5-year ahead forecasts. ² Proposed decision value will be based on latest OBR forecasts published by 1 st August 2023.	Variable – updated annually
Nominal UK government gilt yields	One-month average of UK government index-linked gilts from Bank of England archive yield curve data. ³ Current value averaged over March 2023, proposed decision value averaged over July 2023.	Variable – updated annually
Tax rate	Headline rate of corporation tax. ⁴	Variable – updated annually

1. Bank Of England, "Daily government liability curve (real): archive data", sheet "4. spot curve", <https://www.bankofengland.co.uk/-/media/boe/files/statistics/yield-curves/glcrealddata.zip>
2. OBR (2023), "Historical official forecasts database", "CPI" and "RPI" sheets <https://obr.uk/download/historical-official-forecasts-database/>
3. Bank Of England, "Daily government liability curve (nominal): archive data", sheet "4. spot curve", <https://www.bankofengland.co.uk/-/media/boe/files/statistics/yield-curves/glcnominalddata.zip>
4. GOV.UK, "Guidance: Corporation Tax rates and allowances", <https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax>

Capital employed (row 52-59)

- 2.6 This section presents the values of the different components of the notional supplier's capital employed.
- 2.7 Chapter 4 of the May-23 EBIT consultation sets out in detail how these values were derived.

EBIT (row 61-66)

- 2.8 This section brings together the cost of capital and capital employed values to generate the fixed and variable EBIT allowances.
- 2.9 The fixed allowance is calculated by multiplying the sum of fixed assets and RO ringfencing components of capital employed by the cost of capital. For cap periods beyond October 2023 – December 2023 the fixed EBIT allowance is updated by CPIH inflation.
- 2.10 The variable allowance is calculated by multiplying the sum of the capital employed values excluding RO ringfencing by the cost of capital. The fixed allowance is then subtracted from this value. The resulting value is divided by a reference revenue level, transforming the £ value into a percentage.
- 2.11 Assuming the revised EBIT allowance is implemented as part of the October to December 2023 price cap period, then the reference revenue level will be the dual fuel price cap level at typical consumption for that period.

Description of changes to “calculation” sheets

- 2.12 Within the DTC overview model there are a series of sheets for each fuel, payment type and consumption level combination which bring together the relevant separate allowances and calculate the price cap level for each region and the GB average. We refer to these as the “calculation” sheets (shaded light green in the model).
- 2.13 In each of these calculation sheets, and for each region, there is a row for the EBIT allowance. The formulae in these cells have been modified to account for the changes in the “3k EBIT” sheet.
- 2.14 They also account for the proposed introduction of a fixed EBIT component. The fixed component is first halved before being added to the variable allowance. This reflects the fact that the EBIT allowance, as calculated in sheet “3k EBIT”, is a dual fuel allowance while each calculation sheet is for either electricity or gas. The fixed component is therefore split evenly between fuels.

- 2.15 For the calculation sheets which calculate the price cap at Nil consumption the EBIT allowance is implemented using the implied EBIT margin (EBIT allowance / All other allowances excluding EBIT and headroom) from the equivalent calculations sheet based on TDCV levels of consumption. This ensures the total EBIT margin (%) is the same at TDCV and Nil consumption.

3. Approach to updating inputs

- 3.1 The table in Appendix 1 illustrates how the inputs used to calculate the fixed and variable EBIT allowances would be updated over time, and the consequences for how often the allowances themselves would change.
- 3.2 It shows that the fixed EBIT allowance would change quarterly as a result of updating its value by CPIH each quarter. It would also change due to updates to the cost of capital value as part of each October price cap update.
- 3.3 The variable EBIT allowance would only change annually, also due to updates to the cost of capital as part of each October price cap update.
- 3.4 Any changes to the capital employed values or the fixed cost of capital inputs (Total Market Return, asset beta and gearing) would be subject to a consultation and would likely only be prompted in reaction to a material change in market conditions.

Appendix 1 – Illustrative inputs and allowances over time

The table below illustrates how the proposals set out in the May 2023 EBIT consultation could translate into EBIT allowances over time. The initial values presented are consistent with the draft values presented in the May 2023 consultation and are subject to change.

Orange shading indicates a change in value compared to the previous quarter.

Input	Oct-Dec 23	Jan-Mar 24	Apr-Jun 24	Jul-Sep 24	Oct-Dec 24	Jan-Mar 25	Apr-Jun 25	Jul-Sep 25
Cost of Capital								
Total Market Return	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%	6.50%
Asset beta	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
Gearing	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Index-linked UK government gilt yields	0.15%	0.15%	0.15%	0.15%	A%	A%	A%	A%
RPI-CPI wedge	1.21%	1.21%	1.21%	1.21%	B%	B%	B%	B%
Nominal UK government gilt yields	3.49%	3.49%	3.49%	3.49%	C%	C%	C%	C%
Tax rate	25%	25%	25%	25%	D%	D%	D%	D%
Capital Employed								
Working capital	£127	£127	£127	£127	£127	£127	£127	£127
Collateral	£165	£165	£165	£165	£165	£165	£165	£165
Fixed Assets	£90	£90	£90	£90	£90	£90	£90	£90
RO Ringfencing	£67	£67	£67	£67	£67	£67	£67	£67
Other								
CPIH ¹	1.00	1.00	1.01	1.02	1.02	1.03	1.03	1.04
Reference revenue level	£1940	£1940	£1940	£1940	£1940	£1940	£1940	£1940
EBIT allowances								
Fixed	£19.20	£19.30	£19.39	£19.49	£Y x 1.02	£Y x 1.03	£Y x 1.03	£Y x 1.04
Variable	1.4126%	1.4126%	1.4126%	1.4126%	X%	X%	X%	X%

1. Illustrative CPIH index assuming 2% annual inflation.