Decision

Price Cap - Decision on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance

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Contact:	Dan Norton and Shai Hassid
Team:	Retail Price Regulation
Telephone:	020 7901 7000
Email:	priceprotectionpolicy@ofgem.gov.uk

The default tariff cap ("the cap") protects customers under a standard variable tariff (SVT) by ensuring that customers pay no more than is necessary for an efficient supplier to recover its costs and earn a reasonable level of profit. The level of profit allowance under the cap can affect customers in the short term (via near-term prices) and in the longer term (via investment in the sector or likelihood of supplier failure).

We consulted in May 2023 on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance. We have decided to proceed with implementing the amended EBIT allowance from 1 October 2023, including introducing a new approach for how the EBIT allowance scales with the cap, so that its share of bill falls as cap levels increase.

This document sets out our rationale for the decisions we have made and our consideration of stakeholder responses to our May 2023 consultation.

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Contents

Executive Summary 4
1. Introduction 7
2. Case for change and wider considerations 11
3. Capital Employed 16
4. Cost of capital 41
5. Amending the EBIT allowance and methodology 59
Appendix 1 Impact assessment 72
Appendix 2 – Summary of individual responses and considerations 79
Appendix 3 – Numbers and parameters updated between the statutory consultation and decision (at Benchmark Consumption) 82
Appendix 4 – EBIT working capital model update 83

Executive Summary

The cap, as set out in law and introduced in January 2019, reflects what it costs to supply energy to our homes, by setting a maximum price suppliers can charge consumers for each kilowatt hour (kWh) of energy they use, and sets the profit margin an efficient supplier can make by supplying default tariff customers in the GB energy market. By doing so, it aims to protect customers who do not engage in the market, those placed under the cap in the aftermath of the energy crisis, and vulnerable groups.

This decision concerns the profit margin allowed for in the price cap, known as the Earnings Before Interest and Tax (EBIT) allowance. Our decision sets an EBIT allowance that we consider is high enough for a notional supplier to finance its activities, but where customers pay no more than necessary to ensure this financeability and promote market stability. Setting the allowance in such a way ensures a supply sector that ultimately benefits consumers, as it enhances suppliers' resilience and supports competition to participate in the market, encouraging investment and innovation to improve quality of services.

We include an impact assessment exploring the costs and benefits to consumers of our decision. We note that the EBIT allowance is a single component of the price cap, and our review of other allowances (as set out in our price cap programme of work)[1] and our work on strengthening financial resilience are instrumental to ensuring that the cap is appropriately cost reflective, enhancing the resilience of the sector and achieving an appropriate balance of risks. We are also mindful that we are required in our decisions to have regard to impacts on public spending. In accordance with that duty, we consider our decision on the EBIT allowance protects the interests of UK taxpayers, in addition to the interests of energy consumers.

In making the decision, we build on three policy consultations. The most recent one was published in May 2023 (‘the May consultation’) and as part of it we published the underlying model for calculating the working capital level. We set out our approach and resultant EBIT allowance level for price cap period 11a (October-December 2023) as part of this decision. We have considered stakeholder responses to the May consultation and made necessary changes where we deem it to be justified. However, our approach is largely the same as proposed in the May consultation. We have also made updates to

[1] Ofgem (2023), “Price Cap – Programme of Work: Update”, https://www.ofgem.gov.uk/publications/price-cap-programme-work-update

the estimates in our May consultation due to changes in wholesale prices and collateral data collected since then.

The enhanced financial resilience responsibility principle and the EBIT allowance go in tandem as they both address financial resilience – one through requesting suppliers to adhere to recently introduced requirements, and the other through sending a signal to attract needed investment. While the two are consistent, we note each uses a definition of Capital relevant to its purpose – we elaborate on this as part of this decision.

In setting the EBIT allowance we aim to allow for reasonable underlying/medium-term profitability. Our monitoring shows higher than usual profits recorded by some suppliers in the first half of this year. We can account for those by one-off deferred cap allowances that offset some of the losses experienced by the sector in previous years. We anticipate sector profits to settle down during the second part of the year and in 2024. In the nearer term, we take action to ensure turn-out sector profitability is reasonable and balanced against financial resilience, as set out in our CEO's recent open letter.[2]

Overall, we consider our decision represents an improvement to the previous EBIT allowance approach, as it better reflects current and prospective market conditions, while also being more reflective of a fair return on capital employed upon changes to price cap levels.

Our decision

The revised EBIT allowance is calculated based on the multiplication of two components: capital employed and cost of capital. We have set capital employed at £358 per customer for the upcoming cap, for a household with typical consumption. This is the sum of fixed assets, working capital[3] and collateral. We have set cost of capital at 12.3%, reflecting an increase to the asset beta[4] in recognition that systematic risks faced by energy suppliers are higher than those estimated in 2018 when the cap was developed. In combination, this leads to an indicative EBIT allowance of £44 per customer (annualised) for cap period 11a. This compares with a £34 for the same period under the previous methodology. We note that the EBIT allowance replaces the £8 temporary RO ringfencing allowance included in the July to September (Q3) cap, so the

[2] Ofgem (2023), 'Ofgem sets out clear expectations for energy suppliers on financial resilience and supporting consumers', https://www.ofgem.gov.uk/publications/ofgem-sets-out-clear-expectations-energy-suppliers-financial-resilience-and-supporting-consumers

[3] We estimate the working capital level needed to withstand 1-in-20 years risks that are uncovered by other cap allowances.

[4] Asset beta measures the systematic risks supplier equity holders are exposed to.

net impact on bills from Q3 to Q4 is an additional £2. The financial resilience requirements including to hold appropriate loss absorbing capital and liquidity/collateral arrangements are now incorporated into the capital employed estimate.

This decision confirms our proposal for altering the EBIT allowance methodology such that is has a fixed component, that does not change when the cap is updated, and a variable component that scales with the overall cap level.[5] This better reflects that some parts of a supplier's capital base need to change when prices change, but other elements are more constant, resulting in the share of the EBIT allowance within the cap falling as prices increase, better protecting consumers in the event of extreme price levels.

Stakeholders widely agreed this represents an improvement on the current fully scalable EBIT allowance. We will continue to update price cap elements as needed to ensure the price cap is set at a level that is fair and reflects suppliers' efficient costs, a plan for upcoming reviews of those is set out in our price cap programme of work. We acknowledge that the retail market is evolving and therefore include the option to review the EBIT allowance in the event of significant changes in the market, policy or regulatory conditions.

[5] We note this is different to the setting of unit and standing charges within the cap and is only used for calculating the overall EBIT allowance level. After the overall level of the allowance is calculated, the split between unit and standing charges is calculated in a way that mimics the ratio of those charges within the cap.

1. Introduction

This chapter provides context to this decision, its scope, the structure of this document, the decision-making process, and the statutory framework.

Context

1.1 The EBIT allowance was introduced as part of the price cap to deliver a normal rate of return for an efficient supplier serving standard variable tariff (SVT) customers. It was based on the Competition and Markets Authority's (CMA) 2016 analysis of what a normal rate of return should be in the retail market.

1.2 When the cap was developed in 2018, Ofgem incorporated the CMA's 1.9% EBIT estimate as a separate allowance within the cap. This percentage is applied to the sum of the cap allowances for wholesale costs, network costs, policy costs, operating costs, payment method uplift, and an adjustment allowance. This broadly means that the allowance scales with overall cap levels (excluding headroom, VAT and the EBIT allowance itself). The EBIT allowance level is updated quarterly when changes to the cap are announced.

Scope of this decision

1.3 The scope of decision includes setting the methodology for calculating the EBIT allowance in the cap, which is used for calculating the allowance from 1 October 2023 onwards.

1.4 For the purpose of setting the allowance, we estimate 3 components:

Capital employed – including fixed assets, working capital and collateral
Cost of capital (CoC)
The approach for adjusting and reviewing the EBIT allowance over time

1.5 The reasoning behind our decisions on those is explained throughout the document.

Structure of this document

1.6 This document is split into five chapters:

- Chapter 1: Introduction
- Chapter 2: Case for change and wider policy considerations
- Chapter 3: Capital Employed

- Chapter 4: Cost of Capital
- Chapter 5: Amending the EBIT allowance and methodology

The document also includes appendices with our impact assessment, summary of responses made by individuals, and description of the changes we made to our estimates since the May consultation.

1.7 Alongside this decision document we also publish:

- The updated working capital model
- Changes to standard licence conditions

These can all be accessed at: https://www.ofgem.gov.uk/publications/changes-methodology-price-cap-earnings-tax-ebit-allowance-decision

Our decision-making process

1.8 We have conducted three consultations ahead of reaching our decision:

- August 2022 policy consultation – consulting on a high-level approach
- November 2022 policy consultation – consulting on a detailed approach
- May 2023 statutory consultation – consulting on our minded-to position alongside publishing the working capital model and its documentation.

1.9 In parallel to the consultations, we conducted several meetings and workshops with stakeholders regarding our approach to setting capital employed.

Related publications

1.10 Key publications with relevance to the EBIT allowance decision include:

- May 2023: 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
- November 2022: Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance: https://www.ofgem.gov.uk/publications/further-consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance
- August 2022: Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance:
- https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance

- November 2018: Default Tariff Cap: Decision – Appendix 9 – EBIT: https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_9_-_ebit.pdf
- July 2023: Decision on introducing a minimum capital requirement and ringfencing customer credit balances by direction: https://www.ofgem.gov.uk/publications/decision-introducing-minimum-capital-requirement-and-ringfencing-customer-credit-balances-direction
- April 2023: Decision on Strengthening Financial Resilience – ringfencing Renewable Obligation and enhancing Financial Responsibility Principle: https://www.ofgem.gov.uk/publications/decision-strengthening-financial-resilience
- April 2023: Price Cap - Programme of Work: Update: https://www.ofgem.gov.uk/publications/price-cap-programme-work-update
- August 2023: Default tariff cap level: 1 October 2023 to 31 December 2023: https://www.ofgem.gov.uk/publications/energy-price-cap-default-tariff-1-october-31-december-2023

Statutory framework

1.11 We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act ("the Act").[6] The Act requires us to put in place and maintain the licence conditions which give effect to the cap. We must exercise our functions under the Act with a view to protecting current and future domestic default tariff customers. We must have regard to five matters, set out in section 1(6) of the Act, when setting the cap:

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and

[6] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). https://www.legislation.gov.uk/ukpga/2018/21/section/1

- the need to set the cap at a level that takes account of the impact of the cap on public spending.

1.12 The statutory requirement to have regard to the five matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future domestic consumers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations. Throughout this document we explain the various considerations and analysis which we have weighed up.

1.13 Following the introduction of the Energy Prices Act 2022, those specified considerations to be taken into account include *"the need to set the cap at a level that takes account of the impact of the cap on public spending"*. This new consideration reflects the fact that, while the government's Energy Price Guarantee is in force, the cap level affects the levels of payments by the government to energy suppliers. As part of the decision, we have had regard to the full set of statutory considerations set out in in section 1(6) of the Act.

General feedback

1.14 We are keen to receive your comments about this decision document. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Any further comments

Please send any general feedback comments to stakeholders@ofgem.gov.uk

2. Case for change and wider considerations

Stakeholders are generally in agreement for the need to review the EBIT allowance, noting the risks suppliers face have changed since the introduction of the cap. Consumer groups express the view that changes to the cap over recent years have de-risked the sector, while suppliers argue that risks have increased even after mitigations were put in place. We have analysed the different components of the EBIT allowance to take a fresh view of capital employed requirements, its costs and how those may change over time. Ultimately, we consider that alongside the enhanced financial resilience policies, a revised EBIT allowance strikes a better balance between minimising near-term costs to consumers and a resilient and investible sector.

Context

2.1 In previous consultations we set out our reasons for reviewing the EBIT allowance. These reasons rested on the observation that the underlying market and regulatory conditions had changed since the allowance was first set. We noted that developments since 2019 had moved risks faced by suppliers in both directions.

2.2 We did not set out a prior position on whether developments such as higher wholesale price volatility or increased volume risk had been offset by mitigations such as the move to a quarterly cap or introduction of backwardation allowance for example. However, in the May consultation, following the results of our analysis, we proposed an EBIT allowance that was higher than the current allowance at price cap levels below around £4,000.

2.3 In proposing to amend the EBIT allowance the policy intent remained unchanged. This is to deliver a fair return which protects consumers against both the risks of higher-than-normal profits and the excessive costs of supplier failures. The May consultation impact assessment demonstrated the value to customers of the higher allowance through a reduction in the cost of failures.

2.4 We also acknowledged the role a higher EBIT allowance could play in supporting a financeable and investible retail sector which would help ensure better quality of service and attract the investment needed for the transition to net zero. However, we stressed that changes to the EBIT allowance would only be one part of what is needed to ensure the sector is financially resilient and investible. The parallel financial resilience work and the review of other price cap allowances, as set out in our programme of work, are also important.

Overview of responses

Consumer groups and individual responses

2.5 Two consumer groups responded to the consultation. Consumer groups tended to agree with the need to review the EBIT allowance in the face of changed circumstances but, in contrast to suppliers, conclude that changes such as the Market Stabilisation Charge (MSC), quarterly price cap updates and backwardation allowance have lowered the risks suppliers face and therefore a lower EBIT is justified. We respond to the specific concerns these respondents express with regards to our methodological approach in the relevant sections.

2.6 The response of one consumer group was supported by an ongoing online petition as well as an email campaign. The petition, which also calls for the removal of the Headroom allowance, and which has been ongoing across multiple consultation periods, has now received just under 350,000 signatures. As part of the May consultation, we received approximately 1,200 emails from individuals either referencing or re-sending the consumer group's response.

2.7 In responding to our case for change this consumer group, and associated individual respondents and petitioners, told us that the notion a higher EBIT was needed to protect consumers from the cost of supplier failures was misleading. They told us that supplier failures at the end of 2021 and beginning of 2022 had only cost consumers around £0.20 per month per household per failure. They said that these costs had subsequently been used to justify a series of changes that were beneficial to suppliers and costly to consumers.

2.8 Some of the associated responses included wider themes that are not directly in scope of the EBIT decision. We have summarised those and our considerations in an appendix to this document.

Supplier responses

2.9 Ten suppliers responded to our consultation. Beyond those, we received a response from Energy UK which also included a report conducted by consulting firm Charles Rivers Associates (CRA).

2.10 In line with the responses to the earlier policy consultation, suppliers tended to support the principle that the EBIT allowance needed to be reviewed in light of market and regulatory changes.

2.11 However suppliers also highlighted concerns about our specific approach which they told us meant that our proposals did not sufficiently or accurately take

account of these developments. We respond in detail to these specific points in the relevant subsequent chapters and in the wider considerations section below.

2.12 Beyond specific methodology issues several suppliers told us that, after accounting for the inclusion of RO ringfencing, the level of capital employed proposed was lower than that implied by the current EBIT allowance. They noted that this almost entirely offset any increase from a higher cost of capital. One supplier said that this meant that our approach was inconsistent with the case for change. While not explicitly stating why, this is presumably because, from this supplier's point of view, the change in the allowance is not large enough to contribute to attracting investment into the sector or reducing the likelihood of future supplier failures.

2.13 Two suppliers pointed out that the case for change used to justify the review of the EBIT allowance could equally be applied to most other price cap allowances. One of these suppliers noted that the EBIT allowance, as it is applied as a percentage of other allowances, relies on other allowances functioning correctly. These suppliers therefore suggested that a wider review of all the constituent components of the cap was needed in order to achieve the stated policy aim.

2.14 One supplier expressed concern that in considering the case for change we had not given sufficient regard to all five matters set out in section 1(6) of the Act. Our analysis of these statutory matters is set out in the impact assessment found in an appendix to this decision document.

Considerations

2.15 We did not start the review of the EBIT allowance with a prior position as to whether the existing allowance over or under compensated suppliers. The case for reviewing the allowance was that circumstances had changed, without predetermining the outcome.

2.16 We have pointed to the importance of ensuring a resilient and investible sector. The EBIT allowance is one part of a wider set of changes to achieve this purpose. It relies on other cap allowances reflecting the cost faced by the notional supplier. Where this is not the case, it is most appropriately addressed through the relevant allowances rather than the EBIT allowance. We have committed through our Programme of Work to review allowances which we think may lead to disparity between the cap and supplier costs – either when they are set at higher or lower levels than they should be.

2.17 The observation that the proposed allowance results in a like-for-like capital employed estimate below the level implied by the current allowance is true at some cap levels but not at others.[7] Even at cap levels where this is the case, the increase in the cost of capital results in a higher overall EBIT allowance compared to the status quo at current cap levels on a like-for-like basis.[8]

2.18 Ultimately the value of the allowance reflects the outputs of the modelling and analysis we have conducted. We respond to concerns expressed about the detail of methodological choices in later sections of this document. Our overall justification of the resultant revised EBIT allowance is based on our analysis of individual components of the EBIT allowance.

2.19 The case for change also aligns with our statutory duty to protect existing and future domestic customers who pay standard variable and default rates, and has regard to the five needs set out in section 1(6) of the Act. We assess our proposal against those needs in the impact assessment found in the appendices of this document. The impact assessment demonstrates net benefits to consumers from the changes we have decided to make.

2.20 We do not accept that the justifications for recent changes to price cap methodology have been misleading or overly reliant on exaggerated claims of the cost of supplier failures, as one response claimed. The stakeholder correctly identified that consented to Supplier of Last Resort (SoLR) claims in December 2021 totalled around £1.8bn. However, a further approximately £0.5bn SoLR claims were consented to by December 2022. In total supplier failures during the gas crisis cost each household an average of £83, which is significant.[9] In considering the impact of EBIT on the cost of failure we apply the approach used in the impact assessments accompanying recent decisions on strengthening financial resilience.

2.21 Moreover, we consider that each change to the price cap methodology is justified in its own terms and assessed against the five needs set out in the Act. Beyond the five needs, the revised EBIT allowance contributes to an investible sector,

[7] For dual fuel price cap levels below about £1,100 (excluding EBIT, HAP and VAT) the implied capital employed is higher under the new EBIT allowance, even after removing the capital assumed to be held for RO ringfencing.
[8] Due to the higher cost of capital the overall level of the allowance, even after excluding RO ringfencing capital, is higher than the current allowance at all price cap levels below about £2,000 (excluding EBIT, HAP and VAT).
[9] Ofgem (2023), 'Customers to pay less for energy bills from summer' https://www.ofgem.gov.uk/publications/customers-pay-less-energy-bills-summer

which as consequence results in better quality of services and increased levels of innovation.

2.22 We are confident that our decision represents an improvement compared to the current EBIT allowance. At the same time, we set out the conditions which could trigger another review of the EBIT allowance methodology and parameters in the future should it be needed in Chapter 5.

3. Capital Employed

This chapter details our approach to estimate the three main sources of capital employed by the notional supplier: fixed assets, working capital, and collateral capital.

We have used existing price cap's depreciation and amortisation allowance information to estimate fixed assets owned by the notional supplier. We have used a separate model to assess working capital requirements for the notional supplier to operate in a 1-out-of-20-years price environment. Finally, we explain why we have used RFI data and based our collateral capital on the trading costs of independent suppliers trading with an intermediary.

The total capital employed by the notional supplier amounts to £368 per consumer (at benchmark consumption).[10]

3.1 Capital employed reflects the resources a supplier mobilises to undertake its operations, and for which investors expect to receive a return. In our May 2023 consultation, we proposed approaches for estimating three components of capital employed:

- fixed assets;
- working capital;
- collateral capital.

3.2 After considering stakeholder responses we have decided to broadly maintain the approaches to estimating these three components of capital employed as set out in the May consultation.

3.3 However, as a result of updated data and minor methodological changes, the final values of two of these components have evolved. The table below details the final values, the earlier consultation values, and briefly describes the cause of the change (further detail provided in later sections).

[10] Values are expressed in Benchmark consumption in the body of this decision document for consistency with the calculation used in the Price Cap Overview Model to calculate the allowance. Current TDCVs are used in the executive summary and impact assessment for consistency with other price cap calculation. This is different to the price cap calculations and the working capital model output which are based on benchmark. We note that in the May consultation numbers were presented using current TDCVs.

Table 1: Capital employed values at Benchmark consumption

Capital Employed	Consultation	Decision	Description
Fixed assets	£90	£90	Unchanged
Working capital	£125.80[11]	£102	Updated data and small changes to methodology
Collateral capital	£165	£176	More granular supplier data
Total	**£380.80**	**£368**	

3.4 In response to the total amount of capital employed indicated in the May consultation, suppliers told us that this was lower on a like-for-like basis than the capital employed under the current allowance and that this therefore undermined our case for change. Summaries of these responses alongside our considerations can be found in Chapter 2.

3.5 In the rest of this chapter, we discuss each of the three elements of capital employed separately.

Fixed assets

Context

3.6 In our November 2022 and May 2023 consultations, we proposed to include fixed assets as a component of capital employed. This is to reflect that the notional supplier is assumed to hold some level of fixed assets under the cap.

3.7 We asked suppliers whether they would agree with our proposals and whether our estimate of fixed assets of £90 for a notional supplier would be representative of current market conditions.

Our decision

3.8 We have decided to include fixed assets as a component of capital employed and include it in the capital employed calculation.

3.9 We have kept the figure of £90 per customer per year as proposed in the May 2023 consultation.

[11] Working capital was stated in the May consultation using typical consumption values – this has been restated at Benchmark consumption now.

Summary of stakeholder responses

3.10 No supplier disagreed with the inclusion of fixed assets in the capital employed calculation. One highlighted that the £90 figure was internally consistent with the depreciation and amortisation charges in the price cap's operating cost allowance.

3.11 Another supplier mentioned that Ofgem is in the process of reviewing the operating cost allowance. While agreeing that it would be disproportionate to pause the EBIT review until other reviews conclude, they advocated that we should already consider the impact of a potential change to the operating costs allowance on the EBIT calculation.

3.12 We got a range of views on the level set on fixed assets. One supplier agreed that fixed assets have not significantly changed over the past few years, inferring that the CMA's assessment was still valid. Another supplier argued that the amount remains on the low side compared to their own fixed assets. Another supplier eluded that the amount should lower due to another recent trends towards asset-light business models, including with the renting of IT equipment. They also maintained that If IT is included in capex, the depreciation schedule is closer to three years compared to six years assumed in the EBIT calculation.

Consideration

3.13 The variety of responses confirm that suppliers have very different models when it comes to fixed assets. We compared our proposed fixed assets amount against the stress-testing RFI, which suggested that the industry average is broadly in line with the £90 benchmark.

3.14 We recognise that renting equipment and software would likely reduce the level of required fixed assets and increase suppliers' operating costs instead. We will review the prominence of this practice across the sector as part of our review of the operational cost allowance. However, we consider the allocation of costs between allowances matters less than the total amount provided by the cap. For example, the cap design does not constrain suppliers to operate in a particular way.

3.15 We consider the EBIT review as separate to other work on reviewing existing allowance, and agree that it would be disproportionate to pause it pending the results of other workflows. Should other reviews lead to material change to the EBIT estimates, we will consider making changes to the EBIT allowance.

3.16 Our estimate of the notional supplier's depreciation & amortisation allowance is derived from the operating costs allowance. Initial analysis in 2018 estimated that depreciation and amortisation represented 8% of operating costs for gas and 7% of operating costs for electricity. We take those estimates over a year and multiply them by six – representing our average assumed lifetime of fixed assets. This translates into £90 per customer when accounting for inflation as measured by Consumer Prices Index with Housing (CPIH).

3.17 Our assumed lifetime of six years is in line with the CMA's approach to amortising customer acquisition costs in the Energy Market Investigation (EMI) model. In addition, this is consistent with our recent decision on the Smart Metering Net Cost Change (SMNCC) allowance, in which we have used a six-year amortisation period for IT costs.

Working capital

Context

3.18 In the May 2023 consultation, we proposed the use of a model for the purpose of estimating working capital. This is calculated as the difference between current assets and current liabilities, which is a part measure of liquidity, and is also observed as part of the enhanced Financial Responsibility Principle[12]

3.19 We published the working capital model and associated documentation as part of the consultation.

Our decision

3.20 We have decided to use the working capital model, setting a resilience level of 1-in-20-years as defined by that model, for setting the working capital required by the notional supplier.

3.21 We include within our working capital calculation the effects of high wholesale prices, volume risk, and recovery of backwardation costs over 6 months. We anticipate that other costs will be covered by the existing cap allowances, which are kept under constant review.

[12] Ofgem (2023), 'Guidance on the Operational Capability and Financial Responsibility Principles', https://www.ofgem.gov.uk/sites/default/files/2023-07/FRP%20Guidance%20for%20decision%20-%20JULY%202023%20%281%29.pdf

3.22 We include a modelled level of working capital of around £102[13] per customer in the capital employed figure for the notional supplier when setting the EBIT allowance. This is based on the output of our working capital model shared alongside this decision.[14]

Summary of stakeholder responses

Other risks

3.23 A majority of suppliers expressed concerns that our definition of a 1-in-20-year shock, which is applied to the notional supplier's balance sheet to generate an estimate of working capital, was too narrow in scope.

3.24 Several risks were highlighted as being omitted under the proposed approach. Most notable was the impact of weather on volume risk, but the risk of increased bad debt and shaping and balancing costs under a high price scenario, as well as the potential for shocks to operational expenses.

Weather risk

3.25 Weather risk refers to the impact unexpected weather events can have on the amount of energy demanded by consumers and the consequences that has for the amount and the price of energy suppliers need to buy. A majority of supplier responses highlighted this as a risk not covered by the proposed EBIT approach.

3.26 One supplier illustrated this risk by noting that SVT customers have two free options. The first is the ability to join and leave at will with no exit costs while the second is the option to use as little or as much energy as they choose without penalty. The supplier argued that the proposed approach to working capital ignored the impact of this second option and therefore underestimated the capital needed to remain resilient in the face of weather driven volume risk.

3.27 Another supplier argued that weather and energy prices are correlated. By not accounting for unexpected weather events, the wholesale price level used in the working capital model is understated, resulting in lower estimated working capital.

[13] The figure has decreased in comparison to the £127 in the may consultations. The drivers behind that decrease are outlined in the consideration part to this subsection.
[14] The figure is expressed in Benchmark consumption as this is how the allowance is calculated; it is scaled to TDCV for presentational purposes in the executive summary and impact assessment.

3.28 One supplier also noted that we identified weather driven volume risk as a driver of risk capital in our November 2022 consultation.[15] Another pointed to the stress testing scenarios Ofgem asks suppliers to consider and model, which include short-term demand shocks akin to weather shocks. This supplier also told us the requirement to hold cash to cover such risks was real because the only alternative - weather insurance - tended to be uneconomical and illiquid. They also noted there was no allowance in the price cap for such insurance costs.

3.29 One supplier submitted that while the impact of weather may average out at zero over a long enough time period, significant risk capital is still required to manage volatility due to weather. They acknowledged that in the original 2018 price cap decision this net cost was recognised and Ofgem had stated that regard had been given to these costs in the wholesale additional risk allowance (then referred to as the uncertainty allowance) and the headroom allowance.[16]

3.30 The supplier however expressed the view that it was not transparent what level of weather driven demand volatility was factored into these allowances. They advocated in favour of recalculating any such costs currently recovered through these allowances and reallocating them to the EBIT allowance.

Bad debt

3.31 One supplier submitted that the working capital model ignores the relationship between high prices and the rate of non-collection (ie bad debt). This supplier told us that the assumption that any realised bad debt would be covered by the bad debt allowance was an uncertain one. They noted that they had experienced an incidence of bad debt higher than the allowance in 2022.

3.32 Another supplier mentioned that even if an increase in bad debt could be recovered through the bad debt allowance there would nonetheless be working capital implications.

[15] Ofgem (2022), "Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance", paragraph 4.43 and Table 2 https://www.ofgem.gov.uk/publications/further-consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance

[16] Ofgem (2018), "Default tariff cap: decision – overview", "Appendix 4 – Wholesale", paragraph 3.115 https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

Shaping and balancing

3.33 One supplier submitted that suppliers face the risk that shaping and balancing costs fall outside of the percentages implied by the cap, resulting in unrecoverable costs. As a result, the supplier said that risk capital is needed to cover this potentiality.

3.34 The supplier additionally noted that we had previously recognised the existence of liquidity issues in the power forward markets- which could contribute to higher shaping and balancing costs - but had not addressed this. Furthermore, they made the case that a higher cost of capital, driven by an assessment of greater systematic risk, was not sufficient to cover this element of risk. They argued that in practice it was the case both that investors require higher returns and that suppliers need to hold greater capital.

Operational expenditure and minimum cash levels

3.35 The Energy UK commissioned CRA report identified potential shocks to operating costs as having been omitted from the consideration of capital employed. The report stated that suppliers are subject to basic business risks like any other firm, including risk to staff, systems, plant and machinery. The report suggests that this could be reflected in the working capital model by adjusting the current assumption that around how low cash balances can go.[17] Six suppliers supported this idea.

3.36 The working capital model optimises cash flow for the notional supplier, resulting in cash reserves reaching zero at the minimum point. The CRA report and some suppliers argued that this assumption is unrealistic, and that suppliers will ensure they always hold a minimum level of cash to cope with financial difficulties.

3.37 The CRA report suggested the use of the minimum quick ratio of one (cash divided by current liabilities). This is not the case in the model, meaning that the described supplier would be insolvent and need additional capital to stay afloat.

3.38 One supplier highlighted that the assumption contradicts the enhanced Financial Responsibility Trigger Points, which require suppliers to have enough cash to cover at least 20% of gross credit balances from fixed domestic direct debit

[17] The model calculates the notional suppliers opening balance equity so that its cash balance (net of ringfenced ROs) is zero or above.

customers, net of unbilled consumption. To buttress resilience, some suggested minimum cash reserves to cover between one and two months of operating costs.

Peak vs average capital

3.39 Four suppliers added that we should consider peak rather than average annual capital requirements, given that suppliers need to plan their finances based on the maximum capital projection.

Modelling period

3.40 A few respondents commented that the two-year period doesn't match suppliers' planning in practice. For instance, suppliers do not plan their cash requirements two years ahead.

3.41 Six suppliers questioned the discrepancy between the model coverage of a two-year period but the working capital calculation being based on a single year. This, in their view, understates capital requirements, which are higher during the last six months of the model (the "lead out" period).

Price input

3.42 Three suppliers expressed concern that we chose not to publish the Stochastic Wholesale Prices Model (SWPM), from which some outputs are use as inputs to the working capital model. They maintained that the release of the model would have helped them to test our wholesale prices assumptions and volume risk calculations, as well as underlying elasticity assumptions.

3.43 One respondent highlighted that the model should consider different price scenario and test resilience against a wide range of conditions including falling wholesale prices.

3.44 Some questioned that the input price forecasts underestimated a P95 scenario. One highlighted that wholesale prices in 2022 resulted in a 400% increase in the wholesale component of the DTC, and that prices used in our model are lower than the highs recorded that year.

Choice of resilience level

3.45 While most stakeholders agreed with the P95 approach, the CRA report commissioned by Energy UK suggested using a P99 approach similar to financial sector practice.

3.46 Ten suppliers stated that while they agreed with the use of a P95 scenario, they did not think that the wholesale prices used in the model were reflective of such a

scenario given that they were lower than actual prices seen over the past two years

3.47 While most stakeholders agreed with the P95 approach, ten suppliers argued that our model is misrepresentative of such market conditions.

3.48 On the other hand, a consumer advocate highlighted a discrepancy between the level of resilience proposed to estimate working capital vs the common minimum capital requirement. They added that the P95 level was too high considering that many risks have been transferred to consumers through recent market interventions. They view the working capital model as reflective of how Ofgem would expect suppliers to behave, not how Ofgem requires them to behave or how they act in reality, risking overcompensation to the detriment of consumers.[18]

Direct debit

3.49 Three suppliers flagged as unrealistic the model's assumption that direct debit (DD) payments are immediately updated in line with changes to the price cap. One stakeholder estimated that it would take between 14 and 28 weeks to amend DD payments for 1.4m customers –(the size of the notional supplier assumed in our model). This would be at least 10 weeks after the go-live date of a new price cap.

3.50 One respondent objected that, in practice, customers credit balances are positive, providing de facto suppliers with free working capital. They believe this should be reflected in the model to mirror actual supplier behaviour.

Dividend payments

3.51 One supplier commented on the absence of paid dividends in the model. They infer that Ofgem expects suppliers not to be able to make any profit during 1 in every 20 years, meaning that they only achieve 95% of profits Ofgem deems sustainable.

Market Stabilisation Charge (MSC)

3.52 Two suppliers noted that the working capital model assumed that the MSC will continue past its current March 2024 expiry date.

[18] For instance the model assumes an average a zero average customer credit balances over the period, while in reality customers are systematically owned money by suppliers.

Considerations

Other risks

3.53 Stakeholders' responses raised two related but distinct issues regarding additional risks that may not be accounted for in our approach to estimating working capital.

3.54 The first relates to specific risks that may materialise under the P95 wholesale price scenario. The risks raised were an increase in bad debt and growth in shaping and balancing costs.

3.55 The concern expressed is that under a high wholesale price scenario, these costs may exceed their respective allowances under existing price cap methodology, resulting in unrecoverable costs. The suggestion is that to remain resilient in the face of a wholesale price shock, a supplier would need to hold additional capital to absorb these costs.

3.56 Suppliers similarly suggested that even if these allowances were to be subsequently reviewed and increased to reflect the higher costs, this would come at a lag to when the cost were incurred and also generate greater working capital requirements.

3.57 The second issue relates to risks that do not necessarily occur under a high wholesale price scenario but nonetheless which a prudent supplier may consider holding additional capital to remain resilient against. Risks of this kind that suppliers highlighted include unexpected weather events and shocks to operational expenses.

3.58 While both issues relate to risks not explicitly accounted for in the working capital methodology, they describe two distinct concerns. The first is that we do not comprehensively account for the implications of a P95 wholesale price scenario on working capital. The second is that a high wholesale price scenario is an insufficiently stretching scenario to use on its own. We consider each of these issues separately below.

Wholesale price linked risks

3.59 Where possible, price cap allowances are set in a way that reflects whether the costs they account for are likely to scale with the overall price cap or not. In the case of the costs highlighted by suppliers, bad debt and shaping and balancing, both scale with the wholesale allowance or overall cap level. In the case of shaping and balancing, the allowance is set as a percentage of the wholesale

allowance. In the case of bad debt, the relevant allowances - with the exception of that relating to debt administration costs (and any amounts included in the core operating cost allowance) - scale linearly with the price cap level.

3.60 As a result, while we would expect bad debt and shaping and balancing costs to increase under the P95 wholesale price scenario, we would also expect the relevant allowance to increase as well.

3.61 We acknowledge that actual costs may fluctuate and differ from allowances at any point in time. However, we consider that the scaling of allowances with wholesale prices provides sufficient mitigation against a key driver of cost changes. Providing further working capital to account for adverse fluctuations in costs compared to allowances risks over-compensating suppliers, with a consequential impact on the degree of consumer protection.

Working capital implications of deferred allowances following price shocks

3.62 If, as a result of a high price scenario, costs like bad debt or shaping and balancing are systematically and materially increased, it would be our aim to reflect this through either a one-off or an on-going adjustment to the cap.

3.63 Such an adjustment or update to allowance methodologies would come at a lag to when costs had been incurred. We accept that this may temporarily require more working capital over limited time periods. We consider that estimating in advance the additional working capital that may arise as a result of the deferred cap allowances is unlikely to be credible as deferred allowances vary significantly. Hence estimating any additional working capital that arises from deferred cap allowances would be more appropriately done on a case-by-case basis and symmetrically, ie, also considering the case for refunding where a deferred allowance seeks to refund an initial allowance.

3.64 Considering how to account for these is complex, and therefore the cap has taken a cost neutral approach to date – instead accounting for changes in inflation between when costs were incurred and when the allowance is paid, eg COVID-19 debt deferred allowance.

Additional stress scenarios

3.65 The working capital model considers the working capital impact of high wholesale prices, tariff switching driven volume risk, and delayed recovery of backwardation.

3.66 This is because we only consider material risks that are not covered by other allowances (eg the wholesale debt allowance). It is unlikely to be possible to reasonably capture or anticipate in advance all potential shocks and their working capital implication. Neither would it be appropriate to assume all risks would materialise concurrently. We allow a margin of error through the inclusion of a headroom allowance within the cap.

3.67 The SWPM uses a Monte-Carlo approach to simulate a range of possible outcomes. As part of this, it runs 25,000 simulations based on sampled standard deviations. Layering a scenario-based approach on top of this, as suggested by some respondents, is likely to result in double-counting of risk and lead to over-compensation as a consequence.

3.68 While arguments can be made for modelling a notional supplier resilient to a wider range of risks, we must consider the trade-offs involved. While we believe increased levels of financial resilience compared to current levels would benefit consumers, this impact diminishes above a certain point. For example, in the context of the stress scenario we do consider and discuss later in this section the P95 level wholesale price scenario that achieves a better balance in that perspective compared to a P99 or P75 level.

3.69 Furthermore, our approach to EBIT already makes a key conservative assumption: namely, that all capital held is in the form of equity, and that only equity is used to respond to the working capital implications of shocks. This assumption reflects the view in the CMA's Energy Market Investigation that an independent GB energy supplier would be unlikely to be able to access long-term debt financing.

3.70 We note that there is uncertainty whether short-term credit facilities are accessible to all suppliers at this point of time, and therefore maintained our full equity financing assumption. However, we do expect access to such facilities to become more common as the creditworthiness of suppliers increases following the implementation of financial resilience policies. Those could make working capital more accessible and cheaper over time.

3.71 Ultimately, the scope of the shocks we assume our notional supplier is resilient to is subject to regulatory judgement. We consider the scenario we have used to be one that balances the need for the cap to reflect the costs of prudent business practice while also protecting customers from excessive prices.

3.72 Among supplier responses two additional risk scenarios were highlighted in particular. These were weather risk and the risk of shocks to operating expenses. We consider the specifics of those risks below.

Weather risk

3.73 The SWPM samples data from the previous years as inputs into its forecasts. The relationship between weather related demand and wholesale prices over that period will have influenced the SWPM forecasts. The impact of weather on wholesale prices is therefore implicitly incorporated into our estimation of working capital. The associated volume risk costs from customer movements between fixed and SVT tariffs generated by that price volatility are also incorporated as these are also estimated by the SWPM.

3.74 We acknowledge that volatility in consumption by SVT customers generated by unexpected weather shocks is not explicitly accounted for with the EBIT allowance that we have decided to implement. However, as set out in the considerations above we do not believe this undermines the validity of our approach.

3.75 We believe the appropriate place to capture this is the wholesale risk allowance and headroom. We will consider whether a review of the enduring additional wholesale allowances would be appropriate as set out in our Programme of Work update.

Notional supplier solvency, minimum cash levels, and operating costs

3.76 The working capital model aims to solve for the level of capital/cash injection that would give a notional efficient supplier the level of resilience it would aim for in order to be able to withstand a potential P95 of wholesale, backwardation, and volume risks associated with SVT customers switching tariffs. Adding cash above this level would imply a level of resilience which is higher than a P95 one. Furthermore, the amount of any such addition is likely to be arbitrary.

3.77 With regards to some respondents' comments that the notional supplier may not be adhering to capital requirements and enhanced FRP requirements, and may be insolvent, we note that:

- The notional supplier would have one month (April 2024) during which the modelled P95 cash net of RO ringfencing reaches zero. During this month the supplier would be able to operate.
- We've tested notional supplier's cash against the customer credit balances 20% trigger and found the notional supplier to running its cash flow

appropriately. We note that during the stress month of April, the credit balance net of unbilled is in fact negative (customers owe suppliers money)[19].

- The notional supplier remains above the common minimum capital target in all modelled months.[20]
- Having consulted with financial industry experts, the 'quick ratio' metric is one of many used by investors and lenders and not the definitive financing or insolvency test. We note that many current suppliers have historically published results indicating a quick ratio of less than 1.

We are therefore confident that the notional supplier is solvent and represents responsible and prudent financial behaviour.

3.78 Some suppliers pointed out the risk of higher operating costs and their working capital implications. We note risks like inflation are already covered by indexation of allowances. However, those respondents have not clearly articulated what may be the drivers of those costs, their magnitude, or how they could be credibly estimated.

Peak vs average capital

3.79 We use the average working capital metric to avoid overcompensation. Suppliers may be able to take advantage of periods when working capital requirements are below the average by building up more liquidity and earning interests, which could contribute towards meeting peak requirements.

3.80 We also note the difference between peak and average requirements for the notional supplier is limited during the 12-month estimation period in the working capital model.

Modelling period

3.81 We average working capital over a single year period as we consider it too uncertain to estimate working capital beyond a one-year forward curve horizon,

[19] To note, any decision on whether to ringfence CCBs by direction will also be subject to a consumer interest test. For instance, as stated in our June decision where a supplier has very limited liquidity and ringfencing CCBs may precipitate failure, we may decide that it is not in the consumer interest to do so.
[20] The Capital Target is £115 of Adjusted Net Assets per domestic dual fuel customer equivalent. Adjusted Net Assets is (Tangible fixed assets + current assets) – (current liabilities + non-current liabilities) plus approved Alternative Sources of Capital. As the notional supplier is fully equity financed we do not account for Alternative Sources of Capital in the model.

in particular given the uncertainty around how the recent energy crisis will unfold. However, we use a two-year period, with six-month lead-in and lead-out periods for model calibration purposes and to allow for the full recovery of backwardation costs incurred during the price rise. The lead-in and lead-out periods are not reflective of P95 conditions.

3.82 In the model, the notional supplier's capital increases during the lead out period. This is because volume risk is no longer factored in. In the absence of dividend payments, and with the EBIT allowance generating revenue, this leads to cash accumulation. Including the lead out period within the calculation would therefore artificially inflate the working capital calculation.

3.83 We also note some respondents commented that the price pattern of the lead out period affect the average working capital within the 12-month estimation period. This is due to the optimisation of opening customer credit balances. We have now introduced a declining prices pattern in the lead-out period[21] to offset the effect of the lead-out period on the working capital of the 12-month estimation period. This added £3 to the working capital.

Price input

3.84 The model generates a P95 scenario based on known forward prices at the start of the 11a cap period observation window. Rather than representing the absolute level of P95 wholesale prices, it represents a P95 level using baseline prices at the point of time mentioned. We deem this approach to be appropriate given the allowance scales with overall cap levels, and wholesale prices as consequence. Combining both an absolute P95 price environment alongside scaling would lead to unrealistically high capital employed. Evidently, when scaling the allowance to the historical high of the price cap level of £4,400 for a dual-fuel direct debit customer, the implicit capital employed level increases to £617 – a 71% increase to capital employed calculated for cap period 11a.

3.85 Some respondents wished us to test a falling price environment to account for the resultant volume risk. We note that our P95 picks the 5th highest percentile of volume risk across all simulations rather than the one associated with a particular

[21] We do so by mirroring the increase during the P95 in the estimation period.

simulation of wholesale prices. In doing so, the model takes account of both falling and rising price scenarios.[22]

3.86 We published the working capital model as part of the May consultation, recognising the need for enhanced transparency. Alongside it, we published documentation also describing the SWPM. Furthermore, we engaged in a question-and-answers session on 8 June during which we also answered queries regarding the SWPM. The structure of the working capital model also allowed stakeholders to test it with wholesale prices, volume risk and backwardation inputs. As such, we believe our approach provided sufficient avenues to meaningfully engage with the way we proposed setting working capital.

Choice of resilience level

3.87 Our view of working capital already factors in high levels of resilience by accounting for a P95 scenario of wholesale prices, price driven volume risk, and backwardation. However we have concluded that without some recognition of this additional risk faced by investors, that our allowance would understate required EBIT and therefore that despite this uncertainty we have to make an assumption about the level of additional risk taken.

3.88 Higher capital employed increases consumer bills but reduces expected cost of failures by making failure less likely. We have estimated both of these costs for the P75, P95, and P99 resilience levels of working capital and found that the P95 level of working capital gives the lowest overall cost to consumers when applied in the notional suppliers' context.[23] We note that as the allowance we provide

[22] At the same time we note that a rising price environment also exposes suppliers to volume risk in the event customers switch to an SVT tariff when prices are increasing. This is also taken into account in our modelling.

[23] This analysis assessed the cost of failure and cost of working capital of a notional supplier with 3 levels of working capital, to withstand modelled shocks of 1 in 4, 1 in 20, and 1 in 100. Higher capital employed has lower probability of failure, but higher cost to consumers to hold the added capital. In this analysis, the supplier with P75 working capital had the highest expected cost of failure, and the lowest cost of working capital. The supplier with P99 working capital had the highest cost of working capital, and the lowest expected cost of failure. The supplier with P95 working capital had both costs in between the p75 and p95, and the total of the two was the lowest of the three notional suppliers. The cost of failure is the capital employed which is lost in insolvency (working capital + intangible fixed assets), plus the administration and customer onboarding costs incurred. We multiply it by the probability of failure (eg. 5% in the case of a P95 working capital). As we assume that the notional suppliers hedges according to the cap, we do not include lost value of hedges. We consider the acquiring supplier could directly use those to serve SVT customers, and working capital already reflects volume risk driven losses. We likewise assume that tangible fixed assets retain their value in insolvency.

scales with prices, should upward price shocks materialise, the implied capital employed of the notional supplier will increase.

3.89 The P99 more commonly used in regulating large financial institutions in part reflects the greater systemic impact of a bank failure, so this stress level is less relevant to the energy sector.[24] For example, contagion risks and wider economic impacts are likely to be significantly higher for the financial sector than they are for energy retail. We therefore consider a P95 level of resilience for the notional supplier to be aligned with our expectations that a financially responsible supplier that maintains the common minimum capital target requirement and meets our financial responsibility requirements should be able to absorb losses in the event of a 'severe but plausible' shock.

3.90 We are cognisant that the notional supplier currently has a higher working capital than many actual suppliers. We expect suppliers' capital positions to improve as a result of the common minimum capital target requirement and the enhanced Financial Responsibility requirements.

3.91 There are important distinctions between the capital employed in the EBIT allowance and the common minimum capital target requirement. The first set for a notional supplier, whereas the latter reflects the minimum that we expect a financially responsible supplier to have, complemented by the enhanced Financial Responsibility Principle requirements to have sufficient capital and liquidity to manage business specific risks.

3.92 The common minimum capital target requirement and notional supplier capital employed differ in the risks they address or are aiming to measure. The former is intended to be a general loss-absorbing capital buffer to improve resilience in the event of a severe but plausible financial shock. The EBIT allowance is designed to ensure suppliers have a reasonable return to serve their SVT customers covered by the cap, while accounting for liquidity related residual risks not covered by other cap allowances.

3.93 Due to the different purposes the EBIT allowance and the common minimum capital target requirement serve, they use different definitions. First, the EBIT allowances capitalises collateral costs within capital employed in order for a firm to be able to access wholesale markets to secure hedges – this is since those are

[24] Bank of England (2020), 'Stress tests: a policymaker's perspective', https://www.bankofengland.co.uk/-/media/boe/files/speech/2020/stress-tests-a-policymakers-perspective.pdf

not captured by other cap allowances. Conversely, the common minimum capital target requirement does not account those as loss absorbing capital – we further expand on collateral in the next sub section. Second, the EBIT allowance captures both tangible and intangible fixed assets, acknowledging that investors will expect to earn a return on both. The common minimum capital target requirement on the other hand only considers tangible assets, as those are more easily liquidated in the case of need.

Direct debit

3.94 Suppliers receive a five week notice with the exact level of each new price cap and prior to this can still forecast the expected level with a good degree of accuracy, which means they have time to start adjusting direct debit levels before the go-live date. Hence, we believe that our assumption of no lag between new cap levels and updated direct debits in a P95 scenario is acceptable.

3.95 While positive CCBs have been a source of interest-free working capital for some suppliers, we have introduced requirements for suppliers not to excessively rely on them to finance their development. For example, suppliers who are below the Capital Target and/or the Cash Coverage Trigger, may need to ringfence a portion of their CCBs if we consider it to be in the consumer interest to do so[25]. This is why we assume that the notional supplier will not unduly use CCBs to build liquidity, but instead sets net CCBs at a level that are averaged at zero when seasonality is accounted.

Dividend payments

3.96 Our modelling assumes no dividend payments are made during the estimation period. We would not consider it prudent to pay dividends in financial stress circumstances, although shareholders still gain from the retained earnings. In turn, in years where profitability is higher, and resilience has been restored higher levels of dividend payments could well be possible.

Market Stabilisation Charge (MSC)

[25] Ofgem (2023), Decision on introducing a minimum capital requirement and ringfencing customer credit balances by direction: https://www.ofgem.gov.uk/publications/decision-introducing-minimum-capital-requirement-and-ringfencing-customer-credit-balances-direction

3.97 We are not accounting for the inclusion of the MSC anymore when calculating working capital. This is to acknowledge the uncertainty around when the MSC might be removed or around its future parametrisation. Please refer to the Appendix 4 for more information on changes to the model since the May 2023 consultation.

Collateral capital

Context

3.98 Collateral is the money a supplier, or an intermediary on its behalf, may be required to post to cover certain activities such as network, balancing and wholesale liabilities. Suppliers procuring energy via an intermediary – as opposed to trading directly – can have some or all their collateral requirements covered in exchange for a trading fee.

3.99 In our November 2022 consultation, we sought additional information on collateral posted by suppliers, including a breakdown between the different types of collateral. We also asked about the quantitative link between collateral, wholesale prices and volatility.

3.100 In parallel to the November 2022 consultation, we issued a request for information (RFI) which asked suppliers for collateral posted per consumer per month. The RFI covered the October 2020 to October 2022 period. We asked suppliers trading via an intermediary to provide additional information on their trading arrangements and associated fees.

3.101 In our May 2023 consultation, we set out our minded-to decision to include collateral in the capital employed calculation. This amounted to £165 of capital employed per SVT customer in cap period 11a.

Our decision

3.102 We have updated our collateral capital figure to £176, including a £3 increase for other types of collateral (LCCC and capacity market) not previously included in our calculation. The remaining £4 increase are a result of updates to RFI numbers previously shared with us.

3.103 The figure is derived from the RFI data and is based on the highest average annual amount of collateral and trading fees posted by a non-vertically integrated supplier in 2022.

Summary of stakeholder responses

Overall collateral levels

3.104 No stakeholder disagreed with the inclusion of collateral in the EBIT capital employed calculation. However, four suppliers argued that our assessment understates actual requirements.

3.105 This is in part because the RFI covered the October 2020 to November 2022 period, while collateral requirements peaked in late Q4 2022 and Q1 2023. A couple of respondents suggested the collection of additional data and extension of the period under consideration to build a more comprehensive view.

3.106 Four suppliers reiterated that there is no linear correlation between wholesale price and collateral, with variation margins increasing when commodity prices decline. They highlighted that the fall in initial margins did not compensate for the increase in variation margins, and that net collateral positions increased in early 2023. Likewise, while variation and initial margins may offset each other from an accounting perspective, they are independent in practice with distinct capital required to meet both obligations.

3.107 However, another supplier acknowledged that their collateral requirements did not materially change in 2023, with figures shared during the November 2022 consultation being still reflective of their current positions. As a result, they agreed with the approach taken in the consultation.

3.108 Many respondents suggested the allowance should be based on peak collateral requirements given that suppliers must plan for maximum capital employed. This would contribute to strengthened resilience across the UK retail energy sector. Consumer advocates stakeholders contested this, highlighting that it would be unfair to consumers and may overcompensate suppliers.

3.109 One supplier flagged that other types of collateral (LCCC and capacity markets) were omitted from our calculation and should be included. They specified that LCCC collateral is expected to triple in the coming years.

3.110 Two suppliers procuring wholesale volumes over-the-counter (OTC) mentioned that credit risks should also be accounted for in trading costs.

Use of RFI

3.111 Three suppliers disagreed with the use of RFI to estimate collateral requirements. They argued that building a model replicating initial and variation margins faced

by a supplier trading on exchange – notably the Intercontinental Exchange (ICE) – would be more methodologically sound and robust.

3.112 They said this would align with the modelling approach taken to measure working capital and allow for cross comparisons of collateral requirements in a P95 price environment.

Notional supplier and not accounting for vertically integrated (VI) suppliers within cost benchmarking

3.113 Five suppliers argued that VI suppliers are de facto excluded from the costs benchmarking exercise and that insufficient or inconclusive explanation is provided for the rationale. One supplier acknowledged the difficulty in estimated collateral for VI utilities given the wide variety of arrangements, but believed they should still be included to assess sector wise costs.

3.114 These suppliers claim the decision implies the notional supplier trades with an intermediary, which is inconsistent with the 2016 EMI by the CMA and previous iterations of the DTC determinations. Only looking at costs of independent suppliers would favour a specific business model, which would in turn reduce competition.

Trading arrangements

3.115 Four suppliers contested the use of trading fees as proxy to measure collateral costs. They highlighted the difficulty in finding "pure" trading fees that measure trading costs only. This is because trading agreements often cover a range of services and covenants – such as short-term credit facilities and claims over the supplier's business as trade guarantees – whose individual costs are difficult to unbundle.

Three suppliers added that the impact of these arrangements is not neutral with obligations outweighing benefits to suppliers, meaning that trading fees tend to underestimate actual trading costs.

3.116 A few participants mentioned that existing fees were agreed prior to the energy crisis, and do not reflect current market conditions. New contracts would likely feature higher fees, including because of the small number of intermediaries willing to provide trading services. They indicated that our approach provides an excessive clout to these intermediaries, including their ability to influence the caps cost benchmarking in case fees were to be reviewed.

3.117 One supplier stated VI suppliers may pay a fee to their parent company to use its trading arm. Fees can be below market value, with residual costs supported at the parent company level. The respondent believes that it us up to each business to decide where to allocate these costs, but that these costs should be accounted for in the cap.

3.118 One supplier agreed with our approach, especially given the difficulty to assess the relationship between wholesale prices and collateral.

Considerations

Overall collateral levels

3.119 We have continued to engage with suppliers and collected additional data since publication of both the November 2022 and May 2023 consultations.

3.120 We acknowledge that collateral requirements increased in Q4 2022 and Q1 2023, largely because of growing variation margins on wholesale contracts. However, we re-iterate that the impact was somehow downplayed – not nullified – by declining initial margins. Beyond this, as further elaborated, we chose to use a trading fee as a proxy, which does not establish such a direct link between wholesale price level and collateral.

3.121 We have updated our collateral capital figures from £165 to £176 per customer to take into account for the cost increase in late 2022 and which were not reflected in our previous RFI ending in October 2022. The new figure corresponds to the average trading fees and collateral requirements for a supplier trading with an intermediary in 2022.

3.122 However, we have also seen evidence that collateral requirements started to decline in Q2 2023, with both VI and independent suppliers having trading costs below the £176 per customer cost benchmark. As a result, we believe that using the 2022 average better reflects the variety of costs faced by suppliers.

3.123 We disagree with selecting peak requirements as a benchmark as it may lead to overcompensation on an annual basis – in particular given the allowance scales with the overall cap level. Hence at higher cap levels the implied value of collateral is higher. Furthermore, we have not seen concrete evidence that suppliers have permanently ring-fenced capital to meet these peak requirements.

3.124 We acknowledge that other sources of collateral, notably LCCC and capacity markets provisions, were not included in our calculation. We received

confirmation that these represent a very small fraction of collateral requirements, and as a result added £3 of capital per consumer to account for them.

3.125 We disagree with the suggestion that credit risks should be added to trading costs. Systemic credit risks are already captured by the cost of capital through the asset beta. Residual credit risks or trading risks often take the form of monitoring a business' ability to cope with some of its partners defaulting. This usually does not involve financial provisions in case such an event was to happen, and therefore does not require a specific allowance under the price cap.

Use of RFI

3.126 We acknowledge that we have followed different approaches to estimating working capital and collateral requirements. However, we do not believe this shows inconsistency and believe it retains flexibility on how to best measure costs faced by suppliers.

3.127 As we outlined in the May 2023 consultation, we are not convinced a bespoke collateral model would improve upon the use of market data. For instance, a model would assume wholesale collateral being posted fully in cash, which is neither the case of the vertically integrated suppliers who responded to the RFI, nor many of the non-vertically integrated suppliers that use a trading intermediary.

3.128 A couple of suppliers shared a copy of their own model showing what capital requirements for a notional supplier acquiring volumes for DTC customers would look like. However, their own reported collateral positions often differed and were at times lower than those calculated by their models. This suggests that many suppliers, either through their parent company or intermediary, have the ability to optimise collateral, potentially through netting off their positions against their generation arm. As a result, such modelling may misrepresent costs actually faced by those suppliers.

Notional supplier and exclusion of VI suppliers from cost benchmarking

3.129 We take note of comments related to a perceived change of the notional supplier's features, which was previously inferred to be independent and trade directly.

3.130 We seek to set the cap at an appropriate level, rather than trying to replicate costs of a specific business model.

3.131 In its 2016 EMI report, the CMA assumed that a supplier trading directly would have similar costs to those of a supplier trading with an intermediary. However, it calculated two different EBIT values, reflecting the higher capital requirements for a supplier trading on its own account compared to a supplier using a trading partner (which would pay a trading fee instead). The current cap methodology has followed the first approach, using a higher EBIT which reflects that the cap does not have any allowance for trading fees elsewhere. We are still accounting for the cost of trading within capital employed in our revised approach.

3.132 The CMA calculated the total capital employed for a supplier trading on its own account by adding the capitalised trading fees to the other sources of capital employed. Our revised approach is similar given we are accounting for the cost of trading in capital employed using a consistent type of source data (trading fees) and methodology (capitalising).

3.133 While we acknowledge that collateral requirements for many VI suppliers exceeded the implied collateral level within the EBIT allowance in Q4 2022 and Q1 2023, we do not aim to set the cap at a level routinely covering for the most extreme capital requirements. We believe that looking at VI suppliers' peak collateral calculation leads to overestimation and overlooks the fact the EBIT allowance scales according to overall cap levels. Such an inclusion is unlikely to strike an appropriate balance between fair prices and supplier resilience.

3.134 We received further confirmation that some suppliers which are part of integrated groups are not required to post collateral when trading via their parent company. While we appreciate trading costs are still supported by the business, albeit at a different operating level, this continuously questions the amount of collateral actually posted by VI suppliers compared to their official accounting positions. Including VI suppliers' estimates could skew our estimates of capital employed and explains the information they submitted is not used for benchmarking purposes.

Trading arrangements

3.135 We appreciate that trading arrangements are complex agreements which often feature rights and obligations, with the cost of each provision being difficult to individually assess. However, through our engagement with suppliers, we have had access to 'pure' fees covering trading costs only. This has given us confidence in the rationale to use them as a benchmark.

3.136 Some suppliers suggested that trading fees underestimate actual trading costs, and that the value of the covenants – such as claims of the intermediary over the supplier's business – should adjust our estimate. However, we regard some of these covenants as being no different to those existing in other sectors, such as banking. For instance, a bank has rights to repossess a property/business if loan terms are not respected. The cost of borrowing is widely accepted as the interest rate only, with no ascribed value to the bank's rights to repossess the property/business. In this regard, we believe it is acceptable to look at trading fees only.

3.137 Several suppliers trading with an intermediary informed us that they do not expect their trading terms and fees to be renegotiated in the near-term. As a result, we regard existing contracts as the best proxy to assess current market costs. We are aware that new entrants had commercial discussions with trading partners to procure volumes on their behalf. This confirm that this business model is still available in the current market environment, although new entrants may make a commercial decision to trade on their own account instead.

3.138 Trading fees tend to be fixed either per customer or on a volumetric basis, meaning that costs of suppliers trading with an intermediary are more stable than those of a supplier trading directly. Following ad-hoc engagement with suppliers, we now understand that the rate can be periodically reviewed. We still consider that using more stable, mainly fee-based costs is more appropriate for setting a forward-looking EBIT allowance.

4. Cost of capital

This chapter sets out our approach to estimating the pre-tax nominal Cost of Capital (CoC) of a non-vertically integrated energy supplier. In it we consider our overall approach to modelling the CoC and then also consider our approach to each of the relevant parameters, including the risk-free rate (RFR), Total Market Return (TMR), measure of systematic risk (beta) and tax-rate. Through this we establish a plausible range for the CoC of 11.7% to 12.9%. We conclude by setting out how we propose to select the middle of this range (12.3%), consistent with established regulatory practice.

4.1 The CoC is the rate of return investors expect for providing capital to a company. In the context of setting an EBIT margin the CoC is used to determine the rate of return suppliers should make on their capital employed. By setting the Return on Capital Employed (ROCE) equal to the CoC, suppliers should be able to attract the funding needed to finance their businesses.

4.2 When setting the first cap in 2018, we used the CMA's estimate of the CoC for a notional supplier. The CMA estimated a nominal pre-tax Weighted Average Cost of Capital (WACC) of 10%. In practice, this was a cost of equity figure as the CMA assumed a 100% equity financed supplier.

4.3 In our August 2022 consultation we set out a high-level approach to estimating a CoC. Alongside that consultation, we also published work commissioned from the consultancy CEPA which sought to update and refine the CMA's CoC estimate to reflect newer data.[26] In our November 2022 consultation we set out more detailed CoC proposals and sought stakeholder views on different approaches, but we did not provide a minded-to CoC value.

4.4 In our May 2023 consultation we set out clear minded-to positions on the use of the Capital Asset Pricing Model (CAPM), each of the CAPM parameters, the resulting CoC range and the final point estimate.

4.5 Following consideration of stakeholder responses we have decided to proceed with our previously set out minded-to positions unchanged. Using the data available as of the end of July 2023 this results in a CoC estimate of 12.26% for the October 2023 price cap update. The risk-free rate (RFR) parameters will be

[26] CEPA (2022), "Default Tariff Cap cost of capital", https://www.ofgem.gov.uk/sites/default/files/2022-08/CEPAReport_DTCCostofCapital_2022.08.24.pdf

updated annually for each October price cap update, resulting in a new CoC value.

Summary

4.6 Table 2 below provides summary of our decisions related to estimating the CoC of an efficient energy supplier with a notional capital structure which is 100% equity financed.

4.7 These decisions are unchanged compared to the minded-to positions set out in the May consultation.

Table 2: Summary of Cost of Capital decisions

Issue	Sub-issue	Decision	Rationale
Use of CAPM	N/A	Use a standard CAPM framework	CAPM is used in almost all regulatory CoC decisions and is recommended in March 2023 UK Regulators Network (UKRN) guidance.
Risk-free rate	Choice of benchmark	UK government gilts	Common practice supported by regulatory precedent and UKRN guidance.
	Inflation risk	Account for inflation risk by using nominal gilt yields	Even with EBIT scaling with the overall DTC level suppliers still face inflation risk, it should therefore be incorporated into EBIT. Doing so via nominal gilt yields is in line with the CMA and CEPA approaches.
	Maturity of gilts	Use 10- year gilt maturities	A reasonably long maturity, reflecting the nature of equity investments. Consistent with UKRN guidance and CMA cost of equity approaches in other sectors.
	Observation period	One-month average of daily spot yields with analysis cut-off date two months prior to relevant cap period	Use of recent gilts is in line with UKRN guidance and other regulatory precedents including RIIO-2.
	Adjustments	Inflation adjustments using Office for Budget Responsibility (OBR) forecasts	Use of OBR forecasts for inflation adjustment in line with common regulatory practice and UKRN guidance.
	Forecast error	Annual updates of RFR via amended EBIT sheet of DTC overview model	With yields subject to volatility and forward rates having low predictive power, annual updates using recent observed yields ensures RFR remains reflective of current circumstances.
Total Market Returns	N/A	TMR value of 6.5%, as used in the RIIO-2 price controls	RIIO-2 TMR has been subject to robust consideration.
Asset beta	N/A	Asset beta range of 1.0 to 1.2, with a point estimate of 1.1.	Reflects that risks suppliers face have increased since 2019. Range based on the estimated change in Good Energy's asset beta since 2019, CEPA's independent assessment, and observed variability in profit and loss outcomes.
Tax-rate	N/A	Corporation tax rate of 25% with annual updates	In line with proposal on RFR, ensures tax rate remains reflective of current circumstances.

4.8 Taking these decisions together results in a CoC between 11.7% and 12.9%, as set out in Table 2 below.

Table 3: CAPM calculation

Ref	Parameter	Low	High
A	Nominal risk-free rate [1]	4.3%	4.3%
B	Real risk-free rate [1,2]	2.1%	2.1%
C	Total Market Returns [3]	6.5%	6.5%
D	Equity Risk Premium (= C – B)	4.4%	4.4%
E	Asset beta	1.0	1.2
F	Gearing (%)	0%	0%
G	Equity beta (= E / (1 – F))	1.0	1.2
H	Nominal post-tax cost of equity (%) (= A + (D x G))	8.8%	9.7%
J	Tax rate (%)	25%	25%
K	**Nominal pre-tax cost of equity (= H / (1 – J))**	**11.7%**	**12.9%**

1. Average daily spot yields on 10-year gilts in July 2023.
2. RPI-CPI wedge of 1.21% calculated as the difference between OBR RPI and CPI 5-year ahead forecasts from March 2023.[27]
3. Total Market Returns as used in RIIO-2 ED2 final determinations.

4.9 In line with our minded-to consultation position we have decided to follow UKRN guidance and use the mid-point of this range to set the CoC used in the calculation of the fixed and variable EBIT allowances.

4.10 This result in a CoC of 12.26% for the October 2023 price cap update. This will be change annually at each October price cap update as a result of updating the RFR parameters.

[27] OBR (2023), "Historical official forecasts database", "CPI" and "RPI" sheets https://obr.uk/download/historical-official-forecasts-database/

Use of CAPM

Context

4.11 The CAPM is the primary approach used by regulators to estimate the cost of equity. Under the CAPM approach, the cost of equity is estimated as a function of the RFR, the expected return of the market above the risk-free rate, i.e. the equity risk premium (ERP), and the systematic risk of the relevant activity, i.e. the equity beta (βe). The CMA used a CAPM approach in its 2016 EMI.

4.12 However, just as with any model, CAPM is a simplified and stylised representation of reality. Different approaches to estimating the cost of capital do exist, each with their own set of assumptions. For completeness we therefore sought to establish whether there is any substantive reason to deviate from the standard CAPM approach.

Decision

4.13 We have decided to use a standard CAPM framework to estimate the nominal pre-tax cost of equity of a notional supplier.[28]

Overview of responses

4.14 Most stakeholders did not comment explicitly on the use of CAPM in their responses. One energy supplier expressed support for the use of CAPM. Another, while not rejecting the use of CAPM, noted some of its limitations and stated these justified 'aiming up' on the CoC.

4.15 One supplier reiterated its view that CAPM was an inappropriate framework for estimating an energy supplier's CoC. The supplier stated that the risks suppliers face are idiosyncratic and therefore not reflected in the CAPM framework, a CAPM derived CoC estimate will therefore understate the true CoC. The supplier signposted back to the issues it raised with CAPM in its submission to the November 2022 consultation.

4.16 Finally one supplier, while not rejecting the use of CAPM explicitly, gave the view that the estimate we had come to via CAPM was low when compared with

[28] The cost of equity in a standard CAPM framework is assumed to described by the following equation: Cost of Equity = Risk-free rate + (Equity risk premium x βe); where the Equity risk premium = (Total Market Return – Risk-free rate).

empirical evidence. This supplier suggested that we should look at data on what the actual cost of capital has been when equity has been raised under current market conditions and/or we should seek proxies for such information through interviews with informed capital allocators.

Considerations

4.17 No new issues have been raised in response to the May 2023 consultation compared to the November 2022 consultation. As a result, the considerations detailed in the May 2023 consultation remain valid.

4.18 We do not see a strong case for attempting to incorporate measures of idiosyncratic risk within our estimate of the CoC. There is no well-established method for doing so and moreover a range of specific supplier (i.e. idiosyncratic) risks are already captured by our approach to estimating the notional suppliers capital employed as well as by the wider design of the price cap and other supplementary policies.

4.19 Reflecting arguments suggesting existing allowances are insufficient or new allowances are needed is not within the scope of this review and decision. Stakeholders can see our workstream priorities for price cap development in our published Programme of Work letter.[29]

4.20 Finally, we do not consider that replacing or supplementing the CAPM approach with contextual information from actual capital raises or interviews would alter our judgement on the cost of capital. We are attempting to estimate the cost of capital of a notional supplier with specific characteristics. Even if it were possible to directly obtain reliable cost of capital estimates from current suppliers or financing institutions, it is not clear that these would be reflective of our notional supplier or that these would not be unduly subjective. We also note that we are seeking to establish a cost of capital estimate that is suitable for an on-going allowance, whereas interviews and specific investment decisions are likely to be represent short-term point estimates.

4.21 CAPM is a well-established framework which is widely used by regulators when setting price controls. We therefore consider its use appropriate and justified in this case.

[29] Ofgem (2023), "Price cap – Programme of Work: Update" https://www.ofgem.gov.uk/publications/price-cap-programme-work-update

CAPM components: Risk-free rate

Context

4.22 The RFR provides the foundation of the cost of equity under the CAPM framework. It aims to estimate the required return on a riskless asset and is generally used twice in the CAPM equation. First as the base level of return investors require and secondly to identify the portion of equity returns which are affected by a company's expose to systematic risk – the Equity Risk Premium (ERP).

4.23 In the May 2023 consultation we set out minded to position across a range of choices related to estimating the RFR. Our final decisions are unchanged from those minded-to positions. However, as we highlighted we would, we use more up to date data resulting in revised RFR estimates.

Decisions

Choice of benchmark

4.24 We have decided to use UK government gilts as the basis of our estimate of the RFR.

4.25 We have decided not to incorporate evidence from other assets, such as AAA-rated corporate bonds.

Inflation risk

4.26 We have decided to incorporate compensation for inflation risk into our estimate of the RFR by using nominal gilt yields to estimate the standalone RFR parameter in the CAPM equation. This is in line with the original CMA approach and replicated in the independent CEPA analysis.

Maturity

4.27 We have decided to use yields on government bonds with 10-year to maturity.

Observation period

4.28 We have decided to use a 1-month average of the daily spot yields across July 2023.

Adjustments

4.29 We have decided to adjust RPI based yields on index-linked gilts so that they are expressed in CPI terms. We have done this using the difference between the five-year ahead forecasts of CPI and RPI as published by the Office for Budget Responsibility in March 2023.

Forecast error

4.30 We will update the RFR estimates annual using daily yields observed in July each year ahead of each October price cap update. Will we do this through updates to the EBIT sheet ('3k EBIT') in the Default Tariff Cap model published alongside each price cap update.

Final RFR estimates

4.31 Given the decisions above, we have decided to use the nominal and real RFR values set out in the table below for the price cap period October 2023 to September 2024.

Table 4: Risk-free rate inputs

Inputs	Source	Calculation	Value
Nominal UK government gilt yields	Bank of England daily UK nominal spot curve	Average of 10-year maturity yields (03 July – 28 July 2023)	4.32%
Real UK government gilt yields	Bank of England daily UK real spot curve	Average of 10-year maturity yields (03 July – 28 July 2023)	0.85%
RPI-CPI wedge	OBR historical official forecasts database	Difference in OBR 2027 RPI and CPI forecast using Fisher equation	1.21%

Table 5: Risk-free rate final parameters

Outputs	Components	Calculation	Value
Nominal risk-free rate	Nominal UK government gilt yields	N/a	**4.32%**
Real risk-free rate	Real UK government gilt yields and RPI-CPI wedge	Real UK government gilt yields plus RPI-CPI wedge using Fisher equation	**2.07%**

Overview of responses

4.32 One supplier explicitly agreed with our proposals to use 10-year UK gilts and with our approach to adjusting RPI linked bonds using OBR forecasts. They did however also reiterate their view that adjustments should be made to UK gilt yields to reflect the "convenience" premium associated with them, citing precedent from a CMA decision in the water sector.[30]

[30] CMA (2021), "Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, Final Report",

4.33 Two suppliers, while not disagreeing with any of our proposed choices in estimating an RFR, did highlight an inconsistency in our approach to rounding gilt yields within the EBIT sheet of a draft version of the DTC Overview model we published alongside the May consultation. One supplier also told us they were unable to replicate our approach to calculating the RPI-CPI wedge.

4.34 Beyond these points stakeholders provided limited further feedback on our proposed approach to estimating and updating the RFR component of the CoC calculation.

Considerations

4.35 We previously responded to the view that adjustments should be made to gilt yields to reflect their convenience premium through incorporating evidence from AAA corporate bonds in our November 2022 consultation.[31] In the absence of further evidence our view remains unchanged.

4.36 The CMA PR19 judgement cited by the supplier ignores that the CMA, in its determination on the RIIO-2 appeal, also concluded that "GEMA's decisions to focus on ILG yields and exclude AAA data were not wrong on the basis of the balance of evidence" and that "we do not consider that either the CMA's PR19 approach or GEMA's approach of just using ILG yields, can be said to be the clearly 'superior' one."[32] We therefore have decided to not consider data from AAA bonds in establishing an RFR estimate.

4.37 We accept the view that the approach to rounding in the draft overview model published alongside the May consultation was inconsistent. In the overview model published alongside the August 2023 price cap decision we will ensure that all intermediary values remain unrounded, and we will round the final fixed and variable EBIT allowances to four decimal places.

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paragraphs 9.106-9.108
https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf

[31] Ofgem (2022), "Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance", paragraphs 5.64-5.66
https://www.ofgem.gov.uk/publications/further-consultation-amending-methodology-setting-earnings-interest-and-tax-ebit-allowance

[32] 6CMA (2021), Energy Licence Modification Appeals 2021, Volume 2A: Joined grounds (Cost of equity), paragraphs 5.106 and 5.121

4.38 Our approach to calculating the RPI-CPI wedge can be replicated using the RPI and CPI forecasts from 2027 taken from OBR historical official forecasts database and by using the Fisher equation.[33,34]

CAPM components: Total Market Return

Context

4.39 The TMR parameter, sometimes called the Expected Market Return, measures the return expected by the marginal investor from holding a diversified portfolio of all investible securities. The difference between the TMR and RFR is the Equity Risk Premium (ERP), which represents the additional compensation investors require for being invested in the market compared to the RFR. Under the CAPM framework, the ERP is multiplied by the beta parameter to give the risk premium specific to a given company.

4.40 The TMR is not specific to any sector and tends to be thought of as a relatively stable component of the cost of equity. As a result, the TMR is often estimated by looking at historical equity returns over a long period of time.

4.41 The CMA used a TMR range of 5% to 6.5% in their Energy Market Investigation report, reflecting a judgment made in a previous determination. CEPA use a range of 6.25% to 6.75%, reflecting the CPIH real range used in the RIIO-2 price controls (T2, GD2 and ED2). In our November 2022 consultation and the May consultation we proposed to use the midpoint of the RIIO-2 range (ie 6.5%), in line with CEPA.

Decision

4.42 In line with our consultation proposals, we have decided to use a TMR estimate of 6.5%.

Overview of responses

4.43 One stakeholder told us that our estimate of TMR should be calculated using a broader set of assets than UK equities. The stakeholder cited text from a CMA determination on the RIIO-2 cost of equity which stated that the CMA agreed that

[33] OBR, "Historical office forecasts database", "CPI" and "RPI" sheets https://obr.uk/download/historical-official-forecasts-database/?tmstv=1690449518
[34] RPI-CPI wedge using Fisher equation: (1+2.8020%)/(1+1.5726%) – 1 = 1.2103%

theoretically the TMR should reflect return on all assets in the economy and that doing so could result in a lower TMR estimate.[35]

4.44 One supplier repeated its view, expressed in response to previous EBIT consultations, that a more recent inflation back-cast time series published by the Office for National Statistics (ONS) should be used when calculating the TMR. The supplier, responding to our rebuttal of this view in the May consultation, told us that the decision of the ONS to publish the data, it's relevance to Ofgem's preferred inflation index of CPIH and that lack of evidence that the dataset is biased in one direction means that some weight should be placed on this evidence, even noting some of the caveats.

Considerations

4.45 The approach we proposed, and have now decided on, to estimate the TMR is fully consistent with the approach taken under the RIIO-2 price controls. The caveats to this approach highlighted by stakeholders have been fully considered previously in that context. Given the nature of the TMR estimate there is no reason to believe a different approach is required in the context of the EBIT allowance.

4.46 In particular, while it is true the CMA indicated agreement with the idea that in theory the TMR should reflect returns wider than just equities, they also concluded by saying that "we do not consider GEMA has made an error in its choice of returns data set from which to estimate TMR".[36]

4.47 On the use of a more recent inflation back-cast series we remain of the view that there are a range of potential estimates for historic inflation and that the approach to estimating TMR taken under RIIO-2 did not place sole reliance on any one estimation approach. As a result, we do not consider the use of this newer dataset to be necessary to achieve a reasonable and justified estimate of TMR.

[35] CMA (2021), "Final determination Volume 2A: Joined Grounds: Cost of equity", paragraph 5.200 https://assets.publishing.service.gov.uk/media/617fe5468fa8f52980d93209/ELMA_Final_Determination_Vol_2A_publication.pdf

[36] CMA (2021), "Final determination Volume 2A: Joined Grounds: Cost of equity", paragraph 5.202 https://assets.publishing.service.gov.uk/media/617fe5468fa8f52980d93209/ELMA_Final_Determination_Vol_2A_publication.pdf

4.48 Overall, the CMA found it its final determination of the RIIO-2 decisions that Ofgem was "not wrong" in its use of a 6.5% as it's TMR point estimate.[37] Given the stable nature of the TMR parameter we consider this finding to also be relevant to our use of 6.5% in this context.

CAPM components: Systematic risk (Asset beta)

Context

3.1 The equity beta in the CAPM framework represents a company's exposure to systematic risk and is measured as the covariance between the returns of the company and returns in the wider market (e.g. how a listed company's share price tends to rise and fall in relation to the wider market).

3.2 In our November 2022 consultation we proposed to use an asset beta of between 0.7 and 0.8. This was in line the value that the CMA had used in its original analysis as part of the EMI. It also mirrored the assessment CEPA came to on a plausible long-term beta in the report published alongside our August 2022 consultation.

3.3 However, in our May 2023 the May consultation we amended our proposed beta range to between 1.0 and 1.2. This reflected additional evidence provided by stakeholders in response to the May consultation, in particular evidence on the increase in Good Energy's asset beta since 2019.

Decision

4.49 We have decided to maintain our consultation position and will use an asset beta between 1.0 and 1.2.

Overview of responses

4.50 Two consumer group stakeholders oppose an increase in the asset beta compared to the current EBIT allowance and compared to our proposed values in earlier EBIT consultations.

4.51 One of these stakeholders states that there isn't direct evidence of asset betas in the 1.0 to 1.2 range to justify the increase away from 0.7 to 0.8. They note that

[37] CMA (2021), "Final determination Volume 2A: Joined Grounds: Cost of equity", paragraph 5.292 https://assets.publishing.service.gov.uk/media/617fe5468fa8f52980d93209/ELMA_Final_Determination_Vol_2A_publication.pdf

none of the three independent suppliers for which asset beta estimates are provided in the May consultation had values above 0.7; suggesting that this points to the current range being too high rather than too low.

4.52 This stakeholder also noted the reference to 'narrative stakeholder arguments' in our rationale for proposing a higher beta. They argue a high level of caution should be applied when considering such arguments given that a majority of the feedback was from suppliers who stand to benefit from such a change. The stakeholder argues that too much weight is being given to qualitative arguments over factual evidence. This includes on whether risks faced by suppliers have increased since 2019 or not, about which this stakeholder expresses scepticism – pointing to the support provided by Ofgem to suppliers and lower switching rates reducing the risk of unexpected SVT demand.

4.53 The other stakeholder representing a consumer group made several related points regarding the choice of asset beta in their submission. This included arguing that representations from vertically integrated suppliers should carry little weight when the notional supplier being referenced in EBIT is non-vertically integrated. They also told us that comparisons between energy suppliers and airlines were flawed as one delivered an essential service and the other a luxury service, suggesting energy suppliers face much lower demand elasticities. Finally, they highlight a reference in the May consultation to a higher asset beta being justified while current market and regulatory conditions continue. They argue that with falling wholesale prices and significant reforms to the price cap these condition no longer hold.

4.54 Both stakeholders who oppose the increase in beta also reject the idea that the move to a higher beta range is supported by CEPA's independent judgement. They point out that CEPAs report suggests that an asset beta of 0.7 to 0.8 remained plausible in the long-term indicating that CEPAs analysis does not unconditionally support and increase in beta.

4.55 Five other stakeholders, all suppliers, explicitly supported or welcomed the move to increase the assumed asset beta to 1.0 to 1.2 – even if some still argued that the overall CoC remained too low.

Considerations

4.56 In trying to estimate a reasonable asset beta for our notional supplier we face an issue of a lack of direct evidence. It is true that none of the three non-vertically

integrated energy suppliers for which we have asset beta estimates suggest values within the 1.0 to 1.2 range.

4.57 However, it is also the case that none of these examples can be considered direct or perfect comparators. One (Telecom Plus) is not a strictly pure-play energy supplier as it has revenue streams outside of energy, another (Just Energy) no longer operates in the UK and has been subject to bankruptcy related proceedings, while the third (Good Energy) has a renewable derogation from the price cap. For these reasons, and given the overall limited sample, we do not rely on these observations alone in coming to our judgement on the appropriate asset beta.

4.58 Important to our overall judgement on asset beta is our judgement that exposure to systematic risks have increased since the EBIT allowance was first set in 2019. Qualitative assessments, including those articulated by suppliers, but have been heavily scrutinised, with some suppliers arguing for a further increase to the asset beta. Quantitative evidence in the form of rising beta estimates from Centrica and Good Energy also corroborates this view on the direction of change since 2019.

4.59 While market volatility has reduced and adjustments have been made to the cap methodology, both of which should reduce suppliers' exposure to some types of risk, we remain of the view that exposure to systematic risk is elevated compared to 2019. The extent of market exits and limited market entries seen since 2019 point to reduced appetite for investing in the sector, while limited or negative realised profits since 2019 likely negatively affect investors' perceptions of the riskiness of the sector.

4.60 An increase in, or return to, profitability for some suppliers in 2023 does not automatically imply that risks have returned to a level compatible with the asset beta range of 0.7 to 0.8 used in the existing EBIT allowance. Improved profitability in the first half of 2023 seen by some suppliers can, in large part, be explained by the recovery of previously incurred costs through deferred price cap allowances rather than a loosening in the efficiency standard set by the price cap. We also note that volatility in profit/loss levels are still higher compared to historical levels.

4.61 While CEPA's report did consider that a plausible narrative could be constructed pointing to a long run asset beta of 0.7 to 0.8 it also concluded that there were reasons to believe that an asset beta of 1.0 to 1.2 might be appropriate. This higher end judgment was not purely conditional on particular market conditions

persisting but also acknowledged the significant uncertainties in establishing an asset beta estimate, as well as the risks of placing too great an emphasis on a single source of evidence in the form of CAPM estimates.

4.62 As set out in the May consultation, we do not consider values above 1.2 to be plausible given evidence from a database of asset beta across Western Europe which find only four out of 96 industry groups included had average asset betas above 1.2.[38]

4.63 We agree with the view that demand for energy is likely less elastic than for air travel and that this would in theory, holding other differences between the sectors constant, imply a lower asset beta for energy suppliers compared to airlines. CEPA acknowledged this argument in its assessment and was not solely reliant on a comparison with airlines in coming to its conclusions. CEPA combined an updated sectoral comparison analysis with its in-depth analysis of Centrica as well as wider contextual factors in reaching the judgement that a range of 1.0 to 1,2 could be justified.

4.64 Overall, given our judgement that exposure to systematic risk has increased since 2019, we have sought to triangulate an estimate using multiple sources including CEPAs judgement on the short-term evidence, the observed change in Good Energy's asset beta since 2019 and evidence on the rarity of average sector betas above 1.2.

4.65 Given the significant uncertainties involved in this exercise we acknowledge others may come to different conclusions on the most justified precise asset beta estimate, however given the balance of evidence, we consider our decision is reasonable.

CAPM components: Tax rate

Context

4.66 Our aim is to establish a nominal pre-tax cost of capital. This is because the price cap aims to provide suppliers with sufficient pre-tax cash revenue to meet their efficiently incurred costs.

4.67 The CAPM framework provides us with a post-tax cost of equity estimate; we therefore need to convert this into a pre-tax figure. This is done by scaling the

[38] Damodaran Online (2023), "Levered and Unlevered Betas by Industry", Europe https://pages.stern.nyu.edu/~adamodar/pc/datasets/betaEurope.xls

post-tax figure by 1 / (1 - t) where t is the tax-rate faced by energy suppliers over the relevant period.

4.68 In the May 2023 consultation we proposed using the headline rate of corporation tax, currently 25%, to make this adjustment and also proposed to update the tax rate annually to reflect the headline rate as of 1 April each year.

Decision

4.69 In line with our consultation position we have decided to use the headline rate of corporation tax and to update this annually via changes to the EBIT worksheet in the DTC Overview model workbook.

Overview of responses

4.70 We did not receive any stakeholder feedback on this issue.

Considerations

4.71 Given no submissions to the contrary during our consultation we consider that the considerations articulated in the May consultation remain valid.

4.72 In summary keeping the tax rate update ensures it reflects that actual rate faced by supplier. While it could generate more volatility in the CoC estimate it is already the case that the EBIT allowance scales with the price cap, changing each quarter. The addition of an annual update to the rate of tax, which may not change between any given two years, is unlikely to materially add to the inherent volatility in the allowance.

Cost of Capital point estimate

Context

4.73 Having estimated a plausible range of CoC values, we need to narrow this down to a single number. In practice as the CoC range we have estimated is generated by the range of plausible beta values, with the remaining CAPM values being the same across the low and high scenarios, selecting a CoC point estimate is equivalent to selecting a single beta value within the 1.0 to 1.2 range we have decided upon.

4.74 In the May 2023 consultation we proposed using the midpoint, an asset beta of 1.1, based on standard regulatory practice and in the absence of evidence that the distribution of plausible CoC estimates was skewed upwards or that a marginally higher CoC would protect customers.

Decision

4.75 In line with our consultation proposal, we have decided to use the midpoint of the CoC range in establishing a final CoC value to use when calculating the fixed and variable EBIT allowances. This amounts to using an asset beta estimate of 1.1.

Overview of responses

4.76 One supplier presented arguments in favour of aiming-up within the 1.0 to 1.2 beta range (i.e. using a beta of 1.2 rather than 1.1). They highlighted the limitations of the CAPM framework, which they suggest does not reflect the impact of volatility on margin, and also the high investment requirements to deliver net zero which would be supported by a higher EBIT. For these reasons they conclude that there are higher risks to consumers from using a lower asset beta than there are from a higher one.

4.77 We did not receive any further submissions on this subject from stakeholders.

Considerations

4.78 While we acknowledge there is uncertainty about the "true" CoC for an independent energy supplier, we are not convinced that there are good reasons to deviate from the mid-point.

4.79 The evidence on the CoC does not only point in one direction. For example, the observed betas of the three independent energy suppliers we have available all suggest a beta below the range we have decided on. In contrast, the beta of Centrica, a vertically integrated supplier, potentially points to a higher beta than we have decided upon.

4.80 Overall, we do not consider the evidence as systematically pointing towards the CoC being in the upper range of our estimates.

4.81 Equally we do not see the case for "aiming up" on the basis of asymmetries in the risks to consumers of under versus overcompensation of suppliers. Any such "aiming up" would have a direct cost to customers on an ongoing basis, affecting the degree of protection provided.

4.82 In the absence of clear evidence to conclude that the distribution of values within the CoC range are skewed upwards, we see no reason to deviate from normal regulatory practice and UKRN guidance. We therefore have decided to use the mid-point of our CoC range (i.e. a CoC based on a beta of 1.1) as our point

estimate, which we will use to calculate the EBIT allowance in conjunction with our CE estimates.

5. Amending the EBIT allowance and methodology

This section sets out our decisions related to how our cost of capital and capital employed estimates will be combined to produce the EBIT allowance.

In line with our consultation positions we have decided to introduce a fixed EBIT allowance based on fixed assets and the capital required for RO ringfencing. We will also calculate a variable EBIT allowance which will be applied as a percentage of the price cap.

We also maintain our position on when to review the allowance in the future. This is to only do so when we consider there have been significant changes in, for example, market or regulatory conditions.

EBIT allowance methodology

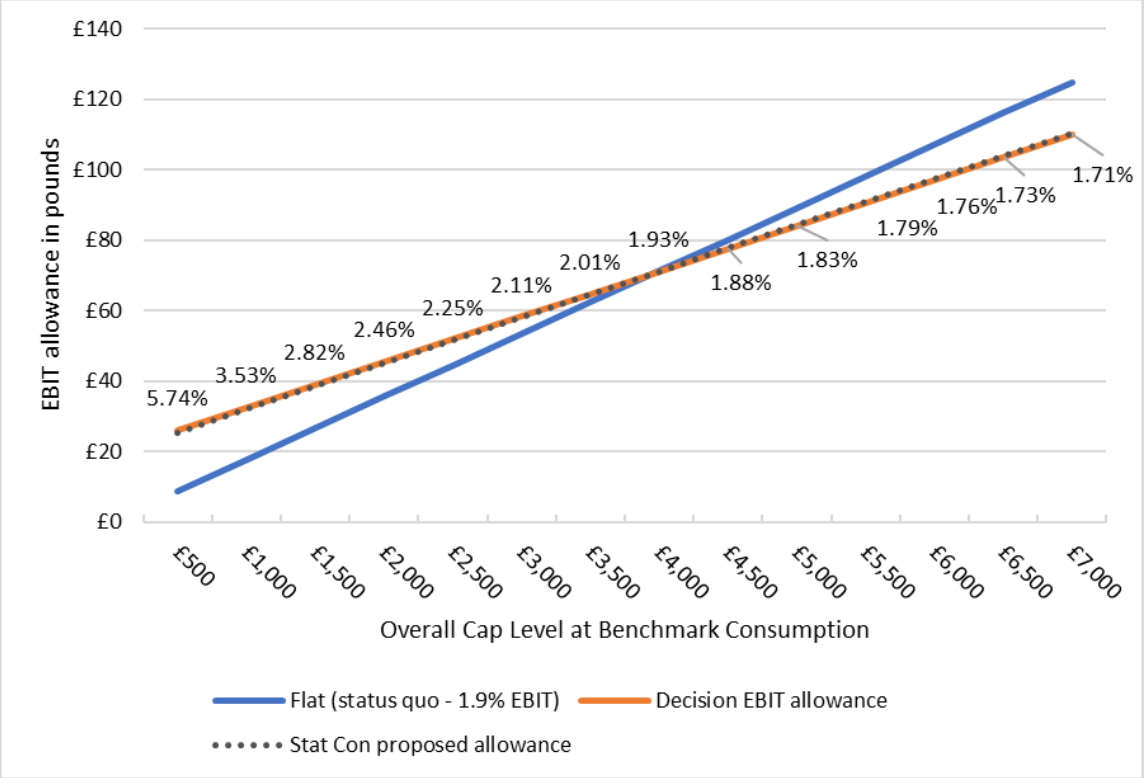
Context

5.1 In the May 2023 consultation we proposed a methodology for combining the various elements of our capital employed estimates with our CoC estimate to calculate fixed (£/customer) and variable (%) EBIT allowances, and set out the conditions that trigger future reviews of the allowance.

Decision

5.2 We have decided to maintain the methodology proposed in the May 2023 consultation. The sections below describe the calculation for cap period 11a and how EBIT allowances will be calculated for future caps.

Figure 1: EBIT allowance under different price cap levels



Fixed EBIT component

5.3 Those elements of capital employed that we consider not to scale with prices are fixed assets and the capital needed to ringfence Renewable Obligation certificates. The sum of these elements of capital employed multiplied by the CoC results in the fixed EBIT allowance, as show in the table below.

Table 6 – Fixed EBIT allowance calculation

Input/Calculation		Value (at benchmark consumption)
A	Fixed Assets	£90.00
B	RO ringfencing	£71.16
C	Cost of Capital	12.26%
(A+B) x C	**Fixed EBIT allowance**	**£19.76 / customer**

5.5 The Fixed EBIT component will be uprated by CPIH at each quarterly cap update.

5.6 Half of the Fixed EBIT component will be added to the electricity price cap and half to the gas price cap, with no differential between payment methods or regions.

5.7 While the allowance is fixed, this does not imply it will be recovered via the standing charge of customer bills. The calculation of the EBIT allowance at Nil consumption is discussed later in this section.

Variable component

5.8 The elements of capital employed we consider do scale with prices are working capital (excluding RO ringfencing) and collateral. The sum of these sources of capital employed multiplied by the CoC results in the numerator in the variable EBIT allowance.

5.9 The working capital and collateral estimates are calibrated to cap period 11a at benchmark consumption via the inputs to the working capital model.[39] We therefore use the dual fuel 11a cap level (excluding VAT, HAP and EBIT itself) at benchmark consumption as the denominator in the variable EBIT allowance.

Table 7 – Variable EBIT allowance calculation

Input/Calculation		Value (at benchmark consumption)
A	Working capital (excl. RO ringfencing)	£31.14
B	Collateral	£176.00
C	Cost of Capital	12.26%
D = (A+B) x C	Variable EBIT allowance (£/dual fuel customer)	£25.40
E	Dual fuel cap 11a (excl. VAT, HAP and EBIT) at benchmark consumption	£1,817
D/E	Variable EBIT allowance (%)	1.3975%

5.10 The variable EBIT allowance will be applied as an uplift to both the electricity and gas price caps (excl. VAT, HAP and the fixed EBIT allowance), with no differential between payment methods or regions.

EBIT allowances at Nil consumption

5.11 The EBIT allowances will be applied at the nil consumption level on an equivalent percentage basis, so that the existing cap ratio between standing charges and unit charges is not affected.

5.12 For example, in cap period 11a the EBIT allowance for the electricity (single rate) cap at nil consumption is calculated as shown below.

Table 8 – Electricity EBIT allowance in cap period 11a at Nil consumption calculation

Input/Calculation		Value
A	Fixed EBIT allowance	£19.76

[39] For example in translating trading fees charged by intermediaries in £/customer at typical consumption values.

B	Variable EBIT allowance	1.3975%
C	11a electricity cap (excl. VAT, HAP and EBIT) at benchmark consumption	£958.80
D	11a electricity cap at nil consumption (excl. VAT, HAP and EBIT)	£179.96
E = A/2 + (B x C)	Total electricity EBIT allowance at benchmark consumption	£23.28
(E/C) x D	EBIT allowance at nil consumption	£4.37

Automatic updates to EBIT allowances

5.13 As set out in Chapter 4, several of the inputs into the CoC calculation will be updated to reflect the latest data once per year as part of the updates for the October to December price cap period. The updated CoC value that results will be applied to the unchanged capital employed estimates generating new fixed and variable EBIT allowances.

5.14 Beyond this the only scheduled change to the EBIT allowance will come through the uprating of the fixed EBIT allowance by CPIH each quarter.

5.15 These changes will be enacted through updates to the DTC Overview model, which is published alongside each price cap announcement.[40] We published draft guidance explaining the EBIT related calculations in the overview model and how changes to the EBIT sheet will be made.[41] As no changes have been made compared to our consultation proposals this guidance remains relevant.

Overview of responses

5.16 Two suppliers explicitly supported or accepted the hybrid approach, with a number of other respondents offering no further comment.

Complexity

5.17 Three suppliers highlighted the additional complexity of the proposed hybrid methodology compared to the current simple percentage uplift. One told us that a fixed percentage implementation would enable greater transparency and

[40] Ofgem (2023), "Default tariff cap level: 1 October 2023 to 31 December 2023", https://www.ofgem.gov.uk/publications/energy-price-cap-default-tariff-1-october-31-december-2023

[41] Ofgem (2023), "EBIT consultation - Draft default tariff cap overview model Guidance", https://www.ofgem.gov.uk/sites/default/files/2023-06/Overview%20model%20guidance.pdf

comparability of tariffs, but also told us they recognised a hybrid approach could be justified.

5.18 Two others told us that a more complex approach would be more difficult to forecast. One highlighted that clarity of expected returns is needed to support investor confidence and that, if the hybrid approach was used, examples of how the allowances will work should be provided to aid clarity. This supplier also suggested that the methodology be stress tested against various wholesale scenarios to avoid unintended consequences. The other supplier noted that additional guidance had been published and that they were still working through the new approach.

RO ringfencing

5.19 Two suppliers disagreed with our approach to splitting the fixed EBIT allowance equally between the electricity and gas price caps. They noted that as Renewable Obligation Certificates (ROCs) only apply to power then the costs associated with holding the capital needed to ringfencing them should be recovered solely through the electricity cap.

5.20 Failure to do so would result in over-recovery from gas customers and under-recovery from electricity customers, resulting in the price cap not being cost reflective. This would benefit suppliers with a high proportion of gas customers over those with a high proportion of electricity customers.

Variable EBIT denominator

5.21 A supplier told us that the use of the 11a price cap as the reference revenue level (i.e. the denominator in the variable EBIT allowance calculation) was inappropriate. They suggest that an average over a longer period should be used instead, such as the average price cap between January 2019 and December 2023. They told us that relying on a single period could create perverse consequences, for example if there is a spike in prices around the period used to set the variable EBIT allowance.

Typical Domestic Consumption Values (TDCVs)

5.22 A supplier told us that it was essential that we use the most up to date TDCV figures in our price cap methodology.

Fixed EBIT allowance inflation uprating

5.23 One supplier noted that Ofgem updates the RO buy-out price and mutualisation ceiling annually in line with changes in the Retail Price Index (RPI) rather than

CPIH. As a result they suggested that the RO ringfencing component of the fixed EBIT allowance should be uprated by RPI quarterly rather than CPIH as we proposed.

Allowance at Nil consumption

5.24 A consumer group opposed the application of the EBIT allowance to the price cap at Nil consumption (i.e. the standing charge). They told us that profit should be earned on the sale of a product and that should not be levied on consumers with low or no usage.

Rounding of allowances

5.25 One supplier suggested that both the fixed and variable allowances should be rounded to four decimal places. This is in contrast to the mix of two decimal places for the fixed allowance and four for the variable that was present in the draft DTC Overview model published alongside the May 2023 consultation. They also highlighted an inconsistency in the excel rounding formula used for the fixed EBIT allowance in that model.

Considerations

Complexity

5.26 We acknowledge that moving from a single value to two values for the EBIT allowance does increase the complexity of the calculation and therefore potentially the complexity of forecasting of the allowance.

5.27 Subsequent to publishing the May consultation, we published additional guidance on how the calculation of the EBIT allowances, as set out in the price cap overview model, will work and which inputs will be updated over time.[42] As we have decided not to deviate from the methodology set out in our consultation this guidance remains valid.

5.28 The benefit of the hybrid approach is that it more accurately reflects the relationship between different elements of capital employed and wholesale prices. Ultimately we consider the benefits of this approach to outweigh any concerns over increased complexity.

[42] Ofgem (2023), "Overview model guidance", https://www.ofgem.gov.uk/sites/default/files/202306/Overview%20model%20guidance.pdf

RO ringfencing

5.29 Shifting the capital associated with RO ringfencing onto the electricity cap would result in an increase in the fixed EBIT allowance of about £4 for electricity and an equal decrease for gas at any given price cap level compared to splitting these costs equally between the fuels.[43]

5.30 We do not believe this would result in greater cost reflectively overall. The adjustment would result in partial accounting of the differences in the capital required to serve electricity versus gas customers.

5.31 Demand for gas exhibits much greater seasonality than demand for electricity. As a result, it is reasonable to expect that serving gas customers requires greater working capital than serving electricity customers. For example, the amount outstanding for a gas customer over the winter period, when gas use is at its highest, will be higher as a proportion of the annual bill gas bill than the equivalent debit/credit position for that individual's electricity use as their electricity consumption is more even over the year.

5.32 The working capital model demonstrates this clearly. When adjusted to assume only electricity customers, the notional supplier is able to finance its activities using lower levels of working capital. In contrast when only gas customers are assumed, more working capital is needed to accommodate with consumption seasonality. This also indicates some degree of synergy between the working capital requirements of electricity and gas customers.

5.33 The non-additive nature of the working capital estimates by fuel means that reflecting the fuel specific nature of working capital would require not just an adjustment in the fixed components for each fuel to reflect RO ringfencing, but also adjustments to their variable components. Consequentially, the EBIT allowance recovered from electricity customers would be lower than for gas.[44]

5.34 We have therefore taken an approach which aligns with the rest of the cap, using the notional case. In this context, this means that the notional suppliers serve a

[43] RO ringfencing capital of £71.16 at a cost of capital of 12.2605% equals £8.72 (£71.16 x 12.2605% = £8.72). If split evenly this would add £4.36 to the fixed EBIT allowances of both electricity and gas caps. If the full £8.72 was placed on the electricity cap the electricity fixed EBIT allowance would have increased by £4.36. Similarly, if none was placed on the gas cap it's fixed EBIT allowance would reduce by £4.36.
[44] We note some customers are use electricity for their heating needs. In that case they may also need more working capital to accommodate with consumption seasonality. Nevertheless, they still represent a small segment of households.

customer fuel mix which is representative of the GB market as a whole, and looking at the working capital requirement of that supplier. This provides a reasonable estimate for the variable and fixed component for the EBIT allowance. We therefore believe that adjusting by fuel for the fixed component (as suggested) while not doing so for the variable component would not provide a more cost-reflective outcome.

5.35 As a result, we believe the approach we've applied– using the same variable component for all fuels, and splitting the fixed component - achieves a better balance between cost reflectivity and simplicity in comparison to other proposals.

5.36 Setting a non-even fuel split within the fixed EBIT component also misaligns with the approach taken to setting the common minimum capital target requirement, which applies an even split when setting the target level.

Variable component calibration period

5.37 For those elements of capital employed which we assume scale with the cap, our approach is to estimate them with reference to a particular point in time. For example, the working capital model takes as inputs forecasted wholesale costs, backwardation costs and volume risk costs starting from cap period 11a.

5.38 The working capital estimate therefore represents the working capital our notional supplier chooses to hold given their risk tolerance, as expressed through the choice of the P95 forecasts, and conditional on a particular starting point – in this case October 2023 (i.e. cap period 11a).

5.39 The choice to scale working capital with reference to 11a follows from this. It assumes that if prices were higher at the starting point then the P95 forecasts would be higher and the notional supplier would choose to hold greater working capital; and similarly if prices were lower they would chose to hold less working capital.

5.40 The other component of capital employed we assume scales with the price cap is collateral. This is perhaps somewhat more of a simplification. The collateral requirements associated with a specific forward contract depends on the price agreed relative to the wholesale price and so may either rise or fall as wholesale prices rise or fall. Nonetheless, we expect that across a suppliers portfolio collateral requirements will broadly move in the same direction as wholesale prices.

5.41 Using a longer-run average of price cap levels as the reference point (i.e. a lower reference point) while maintaining the inputs into the working capital calculation

would misalign between the model results and outturn cap level. A choice of a ~4 year average for the calculation is likely to unduly inflate the variable component of the scaling calculation.

TDCVs

5.42 The choice of consumption values impacts the EBIT allowance in three ways. Consumption levels are inputs into the working capital model, they are used to convert wholesale trading fees into £ per customer values and they impact the denominator used in the variable EBIT allowance.

5.43 The price cap overview model, which brings together the individual allowances, calculates each price cap at benchmark consumption[45]. Our revised EBIT allowances serve as an input into that model. Calibrating the EBIT allowances to reflect current or revised TDCV values, which are lower than benchmark values, would therefore result in an under provision of the EBIT allowance in the unit rates and standing charges set by the individual price caps.

5.44 For these reasons we calculate the EBIT allowances at benchmark consumption, but for comparability with the May 2023 consultation, convert them to current TDCV in most parts of this decision document.

Fixed EBIT allowance inflation uprating

5.45 The fixed component includes fixed assets and RO ringfenced amounts. We have decided to uprate the fixed component by inflation to reflect the fact that the value of the capital needed to meet these fixed obligations links to inflation.

5.46 In the case of fixed assets the price of purchasing fixed assets to offset depreciation will likely grow over time broadly in line with inflation. To be consistent with wider price cap methodology we consider it sensible to use the CPIH measure of inflation.

5.47 The RO ringfencing portion of the fixed EBIT allowance reflects the average capital needed by the notional supplier to ringfence ROs between October 2023 and September 2024, as estimated by the working capital model. This calculation already assumes that RO policy costs will rise in line with forecasted CPIH inflation over this period.

[45] Benchmark annual consumption values are used to set the cap (3,100kWh for single-rate electricity and 2,000kWh for gas). We use those values to calibrate cap calculations and then communicate them in current Typical Domestic Consumption Values (2,900 kWh electricity for single-rate electricity and 12,000kWh for gas).

5.48 Additionally uprating the overall fixed EBIT allowance by CPIH does not lead to double counting, but instead allows for the point in time perspective of the working capital model to evolve, in effect pushing the RO policy cost forecasts out by a quarter at each quarterly price cap update. Using RPI rather than CPIH to increase the estimated RO ringfencing capital at each cap update would introduce an inconsistency between the working capital model and the EBIT methodology.

5.49 Moreover, in the working capital model the RO policy cost per MWh is assumed to equal the buy-out price of ROCs multiplied by the obligation level (ROCs/MWh). While it is the case that the buy-out price grows by RPI inflation each year, it is the movement in both values that determine RO costs and therefore the capital needed to cover them. As a result, even switching to use RPI inflation to forecast RO policy costs in the working capital model would not necessarily lead to an increase in accuracy. Doing so would require attempting to forecast both the buy-out price and the obligation level.

5.50 For these reasons we do not consider that uprating the RO ringfencing portion of the fixed EBIT allowance by RPI rather than CPIH would unambiguously improve the accuracy of the allowance. It would introduce a methodological inconsistency, which, even if resolved through amendments to the working capital model, would replace one simplified approach to forecasting RO policy costs with another without a clear gain in accuracy.

5.51 We estimate that impact using RPI instead of CPIH to uprate the RO part of the fixed component is minor, and does not justify the added complexity and inconsistency with the rest of the cap.

Allowance at Nil consumption

5.52 We have decided to apply the EBIT allowance at nil consumption in a way that ensures the ratio between volumetric charges and standing charges will be unaffected.

Rounding of allowances

5.53 We accept the view expressed by the supplier on this point and will round the final fixed and variable allowances to four decimal places for all periods.

Future review of the EBIT allowance

Context

5.54 In the May 2023 consultation we proposed not to undertake periodic reviews of the EBIT allowance methodology but to revisit the allowances subject only to significant changes to the context in which suppliers operate.

5.55 We set out that such changes could, in principle, be in the following categories or a combination of them:

- Significant changes in market conditions (eg Wholesale price levels or their volatility)
- Significant changes in regulatory and policy conditions (eg significant changes to the price cap or related government policy)
- Significant changes to the structure or number of suppliers operating in the market

5.56 We also noted that if circumstances do change we would aim to reflect changes in risks as part of existing cap allowances or ex-post adjustments when needed rather than adjusting the EBIT allowance.

Decision

5.57 We have decided to maintain our consultation proposal and will not undertake periodic reviews of the EBIT methodology. Any future EBIT review will be determined by Ofgem's assessment of whether there has been a significant change in operating conditions. In line with our general approach, we would consider whether changes were material and systematic before amending the cap.

Overview of responses

5.58 Six suppliers supported at a high level the proposal to only review the EBIT allowance in response to significant changes in conditions. However, a number of these suppliers also indicated issues they considered would require the review of EBIT or requested greater clarity on the conditions we consider would trigger a review.

5.59 One supplier highlighted the assumption made in the working capital model that the MSC would continue as a potential trigger for a review of EBIT if the MSC was in fact discontinued.

5.60 Another supplier told us that there were strong linkages between EBIT and the on-going operating cost review. As an example, they highlighted that changes to the level of fixed assets assumed in the operating cost allowance following its review may require changes to EBIT. The supplier therefore suggested that Ofgem should plan to consult on whether minded-to decisions set out in a future operating cost allowance consultation should trigger a limited review of EBIT inputs.

5.61 A further supplier pointed to the use of intermediary trading fees in our calculation of collateral capital as a potential cause for a future review. They noted that there are relatively few intermediaries used in the sector. As a result, they highlight the risk that the assumptions and data used to calculate collateral capital may fall out of kilter with reality if conditions change for a single company which acts as the intermediary for a large portion of the market. The supplier consequently suggested that Ofgem monitors the renegotiation of contracts between suppliers and intermediaries and triggers a review of EBIT if this indicates a material change.

5.62 Lastly, one supplier requested clarity and certainty on the conditions which would trigger a review to take place. They noted the length of time that had been required for this review and told us that they would welcome clarity that a more focused, presumably shorter, review of specific aspects of the model could take place in the future and if so under what conditions.

5.63 Beyond suppliers, a consumer group told us that the EBIT allowance should be regularly reviewed and suggested a schedule of once every three years.

Considerations

5.64 We do not consider it possible to provide an exhaustive list of the change in circumstances which would trigger a review of the EBIT allowance. We have provided guidelines on the range of possible triggers by setting out three categories of change (see context section). Whether the scenarios suppliers have highlighted would lead to a re-opening of some or all of the EBIT allowance will depend on a case-by-case assessment at the time. As part of this assessment we will consider whether a review is proportionate given the significance of the change in circumstances.

5.65 For example, if following a review of the operating cost allowance, new evidence emerges on the scale of fixed assets held by suppliers it will be relevant to

consider the magnitude of the difference between any updated estimate and the one used in this EBIT decision before triggering an EBIT review.

5.66 We will continue to monitor the functioning of the retail market and remain open to market participants informing us of any developments they consider relevant. This includes changes in the role of, or contractual terms offered by, intermediary trading companies. Again, the likely magnitude of any consequential change to the EBIT allowance would need to be considered before triggering a review of the allowance to reflect developments in that area.

5.67 We do not consider setting a pre-specified timeline for the review of the allowance, such as every three years, to offer benefits over a more reactive approach. Should a change in circumstances have material implications for the EBIT allowance and therefore the effectiveness of the cap, a pre-specified review cycle may delay the introduction of any remedial changes necessary. Equally should there be no material change in circumstance, conducting a review in line with a schedule may not be a good use of stakeholders, or the regulators, time and resources.

5.68 In the instance of the MSC, we acknowledge the uncertainty around whether it would be extended or not and have therefore decided not to account for it in our working capital estimate.

Appendix 1 Impact assessment

Introduction

A1.1 As with the Impact Assessment we published as part of the May 2023 Consultation, this revised Impact Assessment looks at how well the proposed EBIT allowance protects the interests of existing and future domestic customers, while having regard to the five matters Ofgem is required to consider in setting the cap by the Act.

A1.2 The five matters (as set out in section 1(6) of the Act) are:

1. the need to create incentives for holders of supply licences to improve their efficiency;
2. the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
3. the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
4. the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence;
5. the need to set the cap at a level that takes account of the impact of the cap on public spending.

A1.3 This updated Impact Assessment provides revised estimates of the costs and benefits of our decision. All figures in this impact assessment are presented at typical consumption (TDCVs). As discussed in the May 2023 consultation, the level of the existing allowance in 11a has changed, from a forecast of £37 to a now final £34 Updates to our Cost of Capital and Capital Employed parameters discussed in Chapters 3 and 4, alongside changes to the overall level of the cap, mean that the new allowance will be £44 from our estimate of £47 in the May 2023 consultation.

A1.4 The counterfactual presented here does not include the temporary RO allowance introduced following our financial resilience decision to require RO ringfencing.

Summary of stakeholder responses and considerations

A1.5 Most stakeholders did not comment on the impact assessment at length. Some suppliers noted that the allowance was not increasing by much, particularly once the effect of the RO ringfencing allowance is taken into account. One supplier argued that there was insufficient consideration of all of the 5 matters Ofgem

must have regard to, particularly the need to maintain incentives for customers to switch, to allow efficient holders of supply licences to compete, and the impact on public spending. They argued that there was too much emphasis placed on incentivising efficiency.

A1.6 We have further explained our assessment and how we have taken all of the statutory matters into account in setting the new EBIT allowance, and why we believe some of the considerations we must have regard to are more or less relevant to the EBIT decision, but are more applicable to the wider design of the cap.

Table 9: Changes to new allowance and baseline between statutory consultation and decision – all for current TDCVs

	Stat Con IA Forecast	Decision Final IA figures
Existing allowance in 11a	£37	£34.22
Proposed allowance in 11a	£47	£43.93
Change	£10	£9.71

Overall conclusion from the Impact Assessment

Direct consumer impact

A1.7 Compared to the existing allowance methodology, we estimate that our proposed allowance increases customer bills by £190m in the 12 months following October 2023, with this amount accruing to suppliers. The impact on bills beyond September 2024 will depend on the path of wholesale price projection made in monthly stress testing submission by suppliers and is therefore uncertain.

A1.8 Our quantitative and qualitative assessment of supplier and sector financeability leads us to consider that this increase in EBIT would improve the ability of efficient suppliers to finance their activities. If suppliers are unable to adequately finance themselves, existing and future customers could be harmed through a less resilient and competitive sector, providing a lower quality of service, and slowing the transition to net zero. Increasing the EBIT allowance reflects the additional return on the capital required to operate a notional supplier. This in turn increases the return a supplier serving SVT customers would be making, potentially leading to a more investible retail sector.

A1.9 Improving the ability of suppliers to finance their activities also reduces the risk that suppliers fail, which seeks to protect existing and future domestic

customers as they do not have to pay for the costs of failure. We have estimated the reduction in expected failure costs as a £210m benefit to consumers.

A1.10 The direct customer impact of our proposal is estimated to be £190m in higher bills over the period from October 2023 to September 2024, based on supplier forecasts of the path of prices. On an annualised basis, default tariff customers with typical consumption would pay £10 more on bills in cap period 11a.

A1.11 Due to the hybrid approach, the impact on bills will depend on how prices evolve, which remains uncertain. We illustrate below how the EBIT allowance would vary in cash terms under our proposed approach, at different levels of wholesale prices.

Table 10: Impact assessment outputs

Option	EBIT - £ in 11a	Bill impact - £m	Change in expected failure cost - £m	Sector profit - Oct 23 to Sept 24
Status quo	£34	N/A	N/A	N/A
Decision	£44	(£190)	£210	+0.25pp

Distributional analysis and Public Sector Equality Duty

A1.12 Ofgem considers carefully the impact of its decisions on potentially vulnerable consumers, including the groups we are asked to have regard to in performing our duties as set out in the Electricity Act 1989 and the Gas Act 1986: people who are of pensionable age, disabled or chronically sick, residing in rural areas, or with low incomes. Under section 149 of the Equality Act 2010, we are also required to consider how our policies or decisions affect people who have protected characteristics mentioned in that Act. We have assessed the potential impact on the 4 statutory groups that Ofgem is required to have regard to, as well as people with protected characteristics, using our consumer archetype framework.

A1.13 Distributional analysis finds that higher income deciles and other higher consuming groups lose more in cash terms from this change. The size of differences between income deciles and for potentially vulnerable groups compared to the average effect is small, at around £1-4 per year. The reason why the average impact in the distributional analysis is £11, when the difference in bills at TDCV is £10, is that the table shows the mean average impact, and mean consumption is higher than typical consumption.

A1.14 Similarly, using our consumer archetypes, which has more variety of consumption patterns and covers groups with protected characteristics, show that the variation in impact between groups is small.

Table 11: Effect of EBIT allowance changes on Electricity and Gas Act groups by income decile

Consumer type	Decile groups of all individuals ranked by equivalised household disposable income										
	Bottom	2nd	3rd	4th	5th	6th	7th	8th	9th	Top	**Average**
Pensionable age	-£9	-£10	-£10	-£12	-£10	-£12	-£11	-£12	-£12	-£13	-£11
Disabled	-£10	-£12	-£11	-£11	-£11	-£12	-£11	-£11	-£12	-£14	-£11
Rural areas	-£11	-£11	-£12	-£10	-£12	-£13	-£11	-£13	-£14	-£17	-£12
No internet access	-£10	-£10	-£9	na	na	na	na	na	na	na	-£10
Unemployed	-£12	na	na	na	na	na	na	na	na	na	-£12
Lone parents	-£10	-£11	na	na	na	na	na	na	na	na	-£10
ALL	-£11	-£11	-£11	-£11	-£11	-£11	-£11	-£11	-£12	-£14	-£11

Table 12: Effect of EBIT allowance changes on different consumer archetypes

Archetype	Key attributes	Average savings (negative = cost) per household
A1	High incomes, owner occupied, working age families, full time employment, low consumption, regular switchers	-£8
A2	High incomes, owner occupied, middle aged adults, full time employment, big houses, very high consumption, solar PV, environmental concerns.	-£17
B3	Average incomes, retired, owner occupied - no mortgage, electric vehicles, environmental concerns, lapsed switchers, late adopters.	-£12
B4	High incomes, owner occupied, part-type employed, high consumers, flexible lifestyles, environmental concerns.	-£13
C5	Very low incomes, single female adult pensioners, non-switchers, prepayment meters, disconnected (no internet or smart phones).	-£9
D6	Low income, disability, fuel debt, prepayment meter, disengaged, social housing, BME households, single parents.	-£11
D7	Middle aged to pensioners, full time work or retired, disability benefits, above average incomes, high consumers.	-£13
E8	Low income, younger households, part-time work or unemployed, private or social renters, disengaged non-switchers.	-£10
E9	High income, young renters, full time employments, private renters, early adopters, smart phones	-£9

Supplier financeability and risk of failure

A1.15 Aggregate supplier profitability across their domestic and non-domestic retail segments in the 12 months following October 2023 is estimated to increase by a quarter of a percentage point as a result of our proposal. We consider that this

is likely to improve suppliers' ability to finance their activities and attract needed investment, helping suppliers be more resilient and innovative over the longer term. Analysis conducted on individual suppliers' financial forecasts suggests an incremental improvement in supplier financeability, improving liquidity metrics and proxies for risk of failure such as interest coverage. However, for most suppliers, the difference made is small compared to their overall financial position.

A1.16 We have made a quantitative estimate of the expected value to consumers of the reduced risk of failure as a result of our proposal. The changes we see in proxies for risk of failure and implied credit rating, and estimates of the costs of supplier failure based on historical experience, lead to an estimate of £210 million expected benefit to consumers. There is a high level of inherent uncertainty in attempting to estimate the effect of our proposal on the risk of supplier failure, and the costs of supplier failure. We have used implied credit ratings of suppliers as a proxy for risk. As described in the May 2023 consultation, this approach tested the impact of the new allowance on metrics used in the Moody's framework for unregulated utility companies 2017.[46] We have used historical Supplier of Last Resort (SoLR) costs as an estimate of the costs of failure, and estimated Special Administrative Regime (SAR) costs as being half the cost per customer of a SOLR. The actual costs of failure would be determined by expected and actual path of wholesale prices following failure, the time taken for a failure to be resolved, and the condition of the failing business.

A1.17 Despite the limitations of our analysis, we view this quantification as a helpful indicative measure of the benefits to customers of reducing the risk of supplier failure – and the approach is consistent with the impact assessment undertaken as part of the Strengthening Financial Resilience workstream.

Efficiency incentives

A1.18 One respondent to the May 2023 consultation argued that its Impact Assessment was too focused on the criteria of maintaining efficiency incentives. However, we do not think that the EBIT allowance is the right part of the price cap to build in, or calibrate, the level of efficiency incentive provided by the overall cap level, and the rationale for proposing the new allowance is based on

[46] https://ratings.moodys.com/api/rmc-documents/75129

the level of capital employed and cost of capital that protects the interests of current and future consumers, and allows licenced entities to finance their businesses. The EBIT allowance is a small proportion of the overall cap, and we do not think that changes to it have a strong impact on supplier efficiency incentives.

Competition and incentives for switching

A1.19 The same respondent argued that the impact assessment in the May 2023 consultation did not sufficiently weight the importance of setting the overall cap at a level that allowed suppliers to compete and maintained incentives for customers to switch contracts. The supplier notes that the falling market, and the overall level of the cap being too low, is preventing suppliers from offering fixed-price deals. We noted previously that we believe that consumer expectations of future price falls and the Market Stabilisation Charge are likely to be much more impactful reasons than the level of the EBIT allowance for why there are currently fewer fixed price deals in the market, and we believe this continues to be true.

A1.20 The purpose of the EBIT allowance is to set an appropriate allowance for profit. Ofgem has an ongoing programme of work keeping allowances under review to ensure that the cap is set accurately and in accordance with the 5 needs set out in the Act. This programme includes reviews of the wholesale and operating cost allowances, which make up the majority of the cap and nearly all of the non-pass-through costs. If these allowances, or the overall cap level, is found to be too low, or too high, Ofgem will adjust them as needed – and this would be reflected in the scaling of the EBIT allowance as it is partly based as percentage of these allowances. We remain of the view that the EBIT allowance is not the right mechanism to calibrate the overall level of the cap. We have therefore taken the competition and switching incentives criteria into account as part of this EBIT review, but for the reasons outlined above believe that the impact of the proposed changes can only have a limited impact on these needs.

Impact on public spending

A1.21 In the May 2023 consultation, we noted that current expectations for prices are that they will stay below the level at which the Energy Price Guarantee will be engaged out to March 2024 – i.e. below £3,000 per year for a dual fuel household with typical consumption.

A1.22 Should prices be above the £3,000 level, then the new allowance we propose would increase public spending, with the government finances taking the position of consumers. However, due to the hybrid methodology, if cap levels go beyond £4,000, then the EBIT allowance will be lower than under the current methodology, and may result in lower public spending.

A1.23 One respondent noted that public spending could be affected through supplier failures and SAR costs, when a supplier failure is resolved through the Special Administration Regime process. We have made estimates of the reduction in expected cost of failure as a result of increasing EBIT – these necessarily come with uncertainty, but indicate that expected cost of failure is reduced – in particular in the case SAR costs are funded using government expenditure.

Appendix 2 – Summary of individual responses and considerations

A2.1 In response to the May 2023 consultation, Ofgem received a large number of responses from individual consumers. Many of these were associated with endorsing the response from Over50sMoney (O5M). The majority of individual consumer responses were to share the O5M response. However, some responses provided either additional comments, or were unlinked to the O5M response. We welcome all responses. In addition to noting the support for the points raised in the O5M response, we have also analysed and considered all other points made by individual consumers.

A2.2 A summary of those points, and our response, where not addressed in the main decision document, is provided here. In particular, these responses focussed on the case for change, and broader consumer concerns.

A2.3 13 responses challenged the timing of this proposed change in EBIT allowance, citing the context with energy prices currently high, and consumers, particularly the vulnerable, struggling to afford their energy bills, in addition to other prices rises being faced at present. 1 response suggested that the price cap should be reduced. Multiple responses provided personal stories of, or pointed to potential, challenges associated with high energy prices and any further increases. 5 responses described needing to reduce energy usage, or decisions between heating and eating, with 2 responses highlighting potential impacts of this such as foodborne illnesses. 5 responses highlighted particular challenges for vulnerable consumers, including the elderly or those with medical conditions. 1 response highlighted existing energy debt.

A2.4 We acknowledge the cost of living challenges facing consumers, and have supported the government in delivering support to energy bills. The price cap is required to reflect efficient costs suppliers face, and is not designed as a tool to keep prices artificially low. We note that market conditions have improved and that, while still high compared to historic levels, the overall price cap has fallen. The responses highlighting individual circumstances provide real-world examples of the challenges many consumers continue to face.

A2.5 16 responses highlighted high, or 'excess' profits by energy companies, and what was considered as 'profiteering' by some companies, as a reason to not increase the EBIT allowance. 3 responses suggested companies should also bear some of the current price burden, with profits reduced. 3 responses commented

on the quality of service provided by suppliers, suggesting this was low and did not merit increased profits, with 4 responses commenting that the proposed increase in EBIT allowance was not accompanied by any additional service requirements or other conditions, or would not drive efficiency. 2 responses said that reviews of the allowance should be more regular, annually or every two years.

A2.6 The energy sector is comprised of many companies operating at different points in the value chain. The price cap impacts energy suppliers only, and cannot influence profits in, for example, upstream oil and gas production. The EBIT allowance is only one determinant of supplier profits, but we note that suppliers have generally been loss making in recent years. We note that supplier behaviour has not always been of the levels we expect, and we continue to monitor supplier behaviour and intervene where necessary. We consider that a more investible retail market will help to deliver an improved quality of service as one outcome.

A2.7 24 responses queried Ofgem's role, and the extent to which this proposal was protecting consumers, or helping energy companies and other vested interests. 4 responses questioned whether Ofgem decision-making was inappropriately influenced by companies and incentives.

A2.8 Ofgem has a clear objective, set out in legislation, to protect current and future domestic energy customers who pay standard and variable default rates, and operates within a clear and established legal framework. Our decision-making is informed by evidence and detailed analysis, alongside a detailed impact assessment. We continue to consider that improving the financeability and resilience of energy suppliers has positive outcomes for energy consumers.

A2.9 Several responses highlighted broader concerns with the price cap or energy market. In particular, a small number of responses suggested the price cap as a whole needed reform, or that bigger reforms were needed, including to the regulator. 3 responses called for changes to the wholesale market, with 2 of those commenting on the current marginal pricing arrangements. 3 responses commented that consumers should not bear the costs for supplier failures. Multiple responses also highlighted the standing charge and concerns with it comprising a large proportion of some bills, with 2 responses noting it disincentivised adoption of renewables, 1 response noting regional discrepancies, and 5 responses that it penalised attempts to reduce energy usage and vulnerable households with low energy usage.

A2.10 Ofgem has a wider programme of work with regard to the price cap, and continues to work closely with government on the design of other aspects of the energy market as a whole. The standing charge is an important component of the energy bill, but Ofgem continues to consider appropriate allocation of costs.

A2.11 10 responses specifically highlighted their anger with this proposal, for a range of reasons, related to one or more of the points raised above.

A2.12 As above, Ofgem acknowledge the challenges many consumers are facing, and continue to work to protect consumers, accepting the scale of challenge cannot be solved by regulation alone.

Appendix 3 – Numbers and parameters updated between the statutory consultation and decision (at Benchmark Consumption)

Table 13:Changes in parameters since the May consultation

Parameter	Statutory consultation value	Decision value	Note
Capital Employed	£380.80(restated from £382)[47]	[£368.29]	Lower forward curves feeding into working capital model reduce working capital requirement
o/w Working Capital	£125.80 (restated from £127)	£102.30	
o/w Collateral	£165	£176	
o/w Fixed Assets	£90	£90	
o/w RO ringfencing	£67	£71.16	
Cost of Capital	12.2%	12.26%	Change in Gilt yields data
Duel Fuel annual bill at Benchmark consumption in 11a (ex. EBIT, Headroom and VAT) – Direct Debit	£1,940	£1,817	Primarily due to change in 11a forward curves since the May consultation
Fixed return	£19.15	£19.76	Slightly higher CoC
Variable component %	1.4152%	1.3975%	Proportion of capital employed which is fixed assets
Variable return in 11a	£27.4	£25.40	Variable return applied to lower price level

[47] Working capital was stated in the May consultation using typical consumption values – this has been restated at Benchmark consumption now.

Appendix 4 – EBIT working capital model update

Following the statutory consultation and further work, we have made some updates to both the working capital model and associated guidance. We have republished the updated model alongside this Decision. The associated guidance can be found with the statutory consultation[48] and should be read alongside the amendments listed below, in the context of this Decision.

Table 14: Changes to the working capital model since the May consultation

Tab	Change	Reasoning	Impact
Interface	Update to SWPM output data	Reflects updated SWPM run, incorporating actual data up to 18/05/2023[49]. The updated run no longer includes the impact of MSC in its calculation of Volume Risk values, given that this policy may expire in March 2024 or MSC parametrisation may change.	£-26.8
Interface	Wholesale Costs in the last two quarters (Q4 24 and Q1 25) now decline symmetrically with the earlier increases	In response to stakeholder feedback, we agree that the model should incorporate a period of declining prices after the peak, to account for the effect of the lead out period on the estimation period working capital.	£3.6
Interface	Updated Q3 2023 data with actual DTC values	Actual DTC values not yet available at time of statcon model run.	£-1.2

[48] 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

[49] Pre the start of the 11a observation window, to allow a range of outcomes for the calculation of the P95 case.

Interface	Correction to Q2 23 DTC values for Gas PPM DF and BKWD	Correct values are 1117.1 and 88.0, as opposed to 1125.3 and 79.82, as included in the statcon model.	£0.0
InputsC	Tangible share of fixed assets increased from 10% to 45%	Reflects analysis of asset data in suppliers' 2021 annual accounts. No effect on working capital levels.	£0.0
InputsC	Typical Daily Consumption Values revised to reflect benchmark values	Change made in line with standard Ofgem approach to policy analysis.	£-1.4
InputsM	Updates to outturn and forecast CPIH	Updated in line with latest Bank of England data/forecasts	£0.3
InputsQ	Corrections to calculations for PC, NC, OC, SMNCC and PAAC values from Q2 2024 onwards	Previous published version kept these values static rather than updating in line with CPIH in line with the stated methodology.	£0.7

Amendments to Model Guidance

To reflect the changes listed above, the following amendments to the previously published model guidance document should be noted:

- Page 7, Table 1: The Wholesale Costs / Oct-24 – Mar-25 Tail Period cell, should read "Declining values based on Jul-24 – Sep-24 and Apr-24 – Jun-24.
- Page 7, 'Notional supplier customer base', third sentence, should read: "Within the model, we assume their consumption also matches Ofgem's benchmark Typical Daily Consumption Values".