E.ON UK plc
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28 June 2023

Dear Marzia and Shai,

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

We welcome the opportunity to comment on this statutory consultation, as part of the process to update the methodology for setting the EBIT allowance within the price cap. We also appreciate Ofgem's recognition of some of the points raised by us in prior consultations .

We have contributed to analysis undertaken by Charles River Associates (CRA), arranged by Energy UK to review the proposed changes to the EBIT allowance on behalf of suppliers, with particular focus on the approach to calculating capital employed. We encourage Ofgem to review their report in detail and take into account the points raised as part of any decision being made.

<u>CRA Report</u>

We endorse the findings of the report published by CRA and believe Ofgem should review some of the key assumptions relating to the notional supplier and functioning of the market.

In addition, there are a number of sources of working capital, particularly risk capital, that Ofgem does not seem to have accounted for. For example, whilst we understand Ofgem's view that certain costs (such as shaping and imbalance or unexpected weather) may be reflected elsewhere in the cap (for example, on the basis of the expected value of those costs), it is not clear that the cost of the risk capital required to manage the variation in those costs is reflected. As an illustrative example, the outturn impact of weather may average at £0 over a long enough period of time, but significant risk capital is likely to still be required to manage the volatility during that period.

<u>RO ringfencing</u>

. When reviewing any potential increase in supplier return, Ofgem needs to be mindful of other regulatory measures which could bear an impact on this figure for the average notional supplier. Any increase in costs due to the requirement to ringfence RO as part of the recently imposed financial resilience measures must be captured as part of this .

There could be further impact on any theoretical calculated increase in return due to minimum capital requirements for suppliers and potential credit balance ringfencing, however, these have not been valued yet.

<u>Oxera analysis and the Free Option</u>

In our response to Ofgem's earlier consultation on amending the EBIT methodology (September 2022) we attached a report we had commissioned from Oxera. This report highlighted a particular feature of the current price cap design which drives volume risk: that suppliers are effectively required to provide a "free option" to customers, allowing them to switch between capped SVT tariffs and other tariffs, at low or even zero cost. This means that customers can benefit from a lagged hedge when the wholesale market rises, and a shorter hedge when the market falls, despite the fact that switching between the two can drive significant costs for suppliers. Ofgem recognises volume risk as part of working capital, including unexpected demand shocks, however, as highlighted in section 5.3 of the CRA report, Ofgem's price shock scenario assumes a steady state after the peak. This scenario does not consider the impact of a falling market following any peak which could have a material impact on a supplier's working capital requirement in line with the "free option" analysis conducted by Oxera.

<u>Summary</u>

Upcoming reviews present an opportunity to engineer out some of the risks suppliers face and provoke a discussion about the trade-offs between the costs and benefits of different cap designs. As we have discussed throughout the consultation process, the design of the price cap itself introduces significant additional costs over and above those which are recovered through the individual allowances, and future Ofgem and DESNZ wider reviews of the price cap provide a great opportunity to determine whether the current price protection framework offers adequate protection and value for money to customers.

We would relish the opportunity to discuss this in more detail with you as part of the future planned review and engage in any necessary bilateral meetings to ensure a common understanding of these important topics. We have set out our response to the specific questions asked within the statutory consultation in Annex 1.

Yours sincerely

Annex 1

Question 1: *Do you agree with our assessment for the case for change? Please explain your reasoning.*

We agree that Ofgem has correctly identified that the risks faced by the retail sector have changed since the EBIT allowance was initially introduced, however as noted above, we also want to highlight that some specific risks linked to the design of the price cap are still not recognised or accounted for (e.g. the free option).

The underlying case for change presented as part of this consultation is valid for most allowances in the price cap which have not been reviewed since implementation. The EBIT a supplier actually makes (or loses) is as much a function of how well the other allowances, set based on a one-size-fits-all notional supplier, reflect its actual costs as it is a function of the EBIT allowance itself.

A full, bottom-up review of all components of the price cap against the costs which suppliers face is essential in the near term in order to derive any positive benefit for consumers and suppliers, and we are fully supportive of Ofgem in their ongoing review of the price cap via their Programme of Work.

Longer term, Ofgem have the opportunity together with DESNZ to use this analysis to determine the costs versus benefits of the price cap, weighed against other price regulation options, and ensure that it offers cost effective protection to consumers.

Question 2: *Do you agree with our approach to estimating fixed assets? If not, why not? Please explain your reasoning.*

We are in agreement that fixed assets should be included as a component of capital employed given that they represent an investment by a company in a business (i.e. in this case the retail market) with a view to generate future positive returns.

Question 3: *Do you agree with our approach to estimating working capital? If not, why not? Please explain your reasoning.*

We endorse the findings of the report published by CRA and encourage Ofgem to review some of the key assumptions relating to the notional supplier and functioning of the market.

In addition, there are a number of sources of working capital, particularly risk capital, that Ofgem does not seem to have accounted for. For example, whilst we understand Ofgem's view that certain costs (such as shaping and imbalance or unexpected weather) may be reflected elsewhere in the cap (for example, on the basis of the expected value of those costs), it is not clear that the cost of the risk capital required to manage the variation in those costs is reflected. As an illustrative example, the outturn impact of weather may average at £0 over a long enough period of time, but significant risk capital is likely to still be required to manage the volatility during that period.

Question 4: *Do you agree with our approach to estimating collateral? If not, why not? Please explain your reasoning.*

We agree with the approach of including collateral as part of capital employed as set out in option 2, however, it is not clear that Ofgem's analysis of collateral captures all of the components required. We have set out specific examples below, but would also direct Ofgem to section 6 of the CRA report.

We understand the underlying reasoning behind restricting the sample data to medium non-vertically integrated suppliers. At the same time, the risks of outlier events impacting larger market participants needs to be recognised somewhere in the price cap. We have seen the severe impacts of credit/collateral issues for large wholesale market participants such as Uniper and it is essential that these scenarios are recognised in the level of resilience used in Ofgem's modelling.

The proposed approach to calculating the collateral levels risks misrepresenting the real-world capital requirements needed to cover larger and vertically integrated suppliers who are trading in the wholesale markets. By dismissing evidence provided by a wider group of suppliers, Ofgem proposes an implied expectation that other parts of a business (e.g. generation) are expected to subsidise the collateral requirements of the retail part of the same Group.

. The CRA paper illustrates that whilst prices and volatilities are positively correlated with initial margin, that correlation is not constant (Figure 8). It is quicker to increase when prices are rising and slower to reduce when prices are falling.

Ofgem has already collected data on margin through multiple RFI submissions and has access to what this looks like in practice. In line with our previous responses to EBIT consultations we remain concerned that should the wholesale market fall significantly and quickly, suppliers could face extreme cash flow issues due to margin calls.

Question 5: *For suppliers trading via an intermediary, how has your wholesale collateral requirements changed since October 2022?*

No comment.

Question 6*: Do you agree with our proposals on cost of capital? Please explain your reasoning.*

We agree with the update to the cost of capital using a higher asset beta range of 1.0 to 1.2, which takes into account evidence we submitted in prior stages of the EBIT consultation, including the report completed by Oxera.

Question 7*: Do you agree with our approach to setting and scaling the EBIT allowance? Please explain your reasoning.*

We have no additional comments on the proposed methodology.

Question 8: *Do you agree with the conditions which may trigger revisiting the EBIT allowance parameters or its methodology? If not, why not? Please explain your reasoning.*

We agree with the conditions which may trigger revisiting the EBIT allowance.