

28 June 2023

Marzia Zafar and Shai Hassid
Retail Price Regulation
Ofgem
10 South Colonnade
London E14 4PU

Email: Alisonrussell@utilita.co.uk

Dear Marzia and Shai,

Re: Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) Allowance

Thank you for the opportunity to comment on the Statutory Consultation (Statcon). As you are aware, Utilita is a specialist smart prepay supplier, and as such has a unique focus and expertise within the industry, in particular with respect to the efficient costs faced by prepay suppliers.

In the Statcon, Ofgem appears to recognise that the industry requires a higher cost of capital to provide the necessary resilience and higher capital employed. We agree that this is the case and that an early resolution to this issue to ensure suppliers are adequately recompensed for the risks borne and to hold the appropriate levels of capital per customer.

We have carefully reviewed the model provided and the text of the Statcon, and we believe that the document and/or model may contain errors. Based on our evaluation, we believe the allowance to be understated and to not deliver the intent of the Statcon. We also believe that there are additional, material errors in respect of the necessary levels of collateral to held within the calculations, and that the proposals need to be updated prior to implementation.

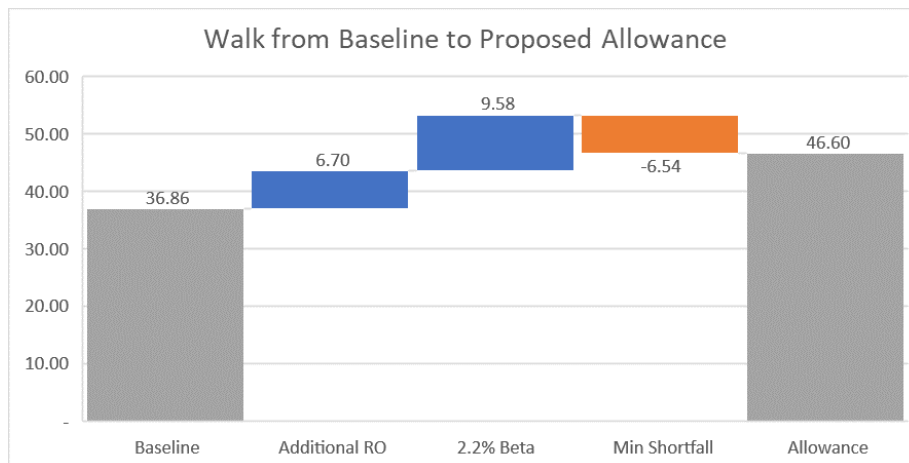
We have set out our concerns below, in Sections 1 and 2, and Appendix 1, followed by brief answers to each of the questions contained in the Statcon set out in Appendix 2.

1) The proposed allowance, as calculated, is too low

The model proposed by Ofgem of a typical dual fuel customer (based on an average dual fuel price cap of £1,940), implies a lower capital employed figure than that used by the CMA. Based on discussions and industry engagement, it was our belief that there was a common understanding within Ofgem that there was not enough capital employed in supplier businesses to deliver the required financial resilience: i.e. it is considered too low. In line with the implementation of the Enhanced Financial Responsibility Principle (EFRP), we therefore expected that there would be an uplift in the implied level of capital employed.

We have set out below our assessment of the basis on which we believe the allowance to be at least £6.54 too low. In Figures 1 and 2 we provide a 'walk' from the current baseline to the proposed allowance.

Figure 1: Walk from Baseline to the Proposed Allowance

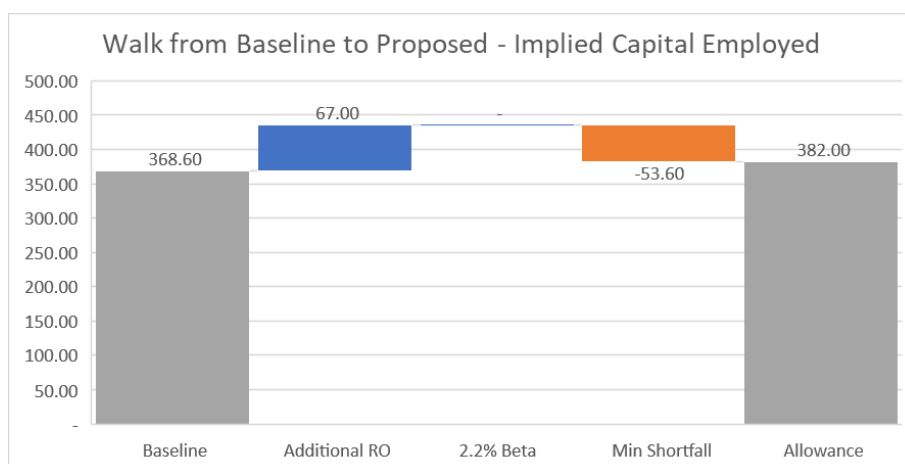


To populate the figure above, we have completed the following calculations:

- **Baseline** – the CMA applied a 10% WACC, therefore using the 1.9% return at £1,940 this equates to £368.60 of capital employed in the business and a baseline ‘allowance’ of £36.86.
- **Additional RO allowance** – Following the decision on the ringfencing of the RO this was calculated to have an impact of £6.70 at a 10% WACC. The impact assessment of this figure is materially in line with the RO in the proposed capital employed
- **Additional 2.2% added to the WACC reflecting the beta increase** – Assuming no change in the capital employed this would equate to £9.58 which is $£368.60 + £67.00 \times 2.2\%$ (please see figure 2 as well).
- **Min(imum) Shortfall** – Leaving a minimum shortfall, *ceteris paribus* of £6.54 in order to result in the proposed allowance value of £46.60.

To assist clarity, we have included in Figure 2 below the equivalent to Figure 1, expressed in terms of the Implied Capital Employed (ICE). This ties back to the Impact Assessment (IA) provided with the Statcon.

Figure 2: Walk from Baseline to Proposed Allowance – Implied Capital Employed



Making no allowance in ICE to reflect the additional 2.2% allocated to the increased cost of capital attributed to the increased beta, this still leaves a clear shortfall in the ICE, even without addressing the second issue we have identified, please see next section.

It cannot be right that in addressing the RO allowance, and ostensibly assisting suppliers to reach greater financial resilience that Ofgem assumes a lower ICE than the CMA. We therefore consider this to be an error.

2) The allowance attributed to Collateral is inadequate

Moving to the second issue, the allowance attributed to Collateral is inadequate. We believe this has originated due to inconsistencies in the methodology used. Ofgem has calculated the working capital based on a notional supplier using the price cap. While we continue to believe that the notional supplier used will not allow two thirds of suppliers to recover their efficient costs¹, and is flawed, it is consistent. However when calculating the Collateral allowance, rather than taking the approach of using a notional supplier, Ofgem has diverged and instead, an RFI approach has been taken. This approach will not represent a notional SVT Price cap supplier, whether understated as a lower quartile supplier or not.

We fundamentally disagree with Ofgem's approach to Collateral. Ofgem sets the Hedging Policy of the notional supplier through the methodology used in the price cap, prudent suppliers must therefore seek to follow the cap in their Hedging Policy. As Ofgem has forced suppliers towards the Hedging Policy under the cap, based on a notional supplier, it must apply the same approach to the associated Collateral. On this basis Ofgem must model the Collateral requirement of a notional supplier, as it has done with Working Capital, not simply take an RFI approach which will not produce a complete picture.

To illustrate the point, we have carried out our own assessment, which is set out below. There are three material items covered in collateral:

- Hedges – specifically out of the money, mark-to-market margin calls
- Balancing – as required by Elexon and Xoserve
- Industry parties' collateral – Networks and the DCC

The Collateral associated with Hedging is by far the most substantial of the three items.

We have modelled the Hedging collateral requirement for a P95 confidence level for a notional price cap supplier, which we estimate results in a collateral requirement of £346.26 (see Appendix 1). This value is significantly higher than that proposed by Ofgem based on RFI data, which results in an allowance in Ofgem's proposed model of £165. We stress this is only the Hedging element of the calculation, the Balancing and Industry Parties' Collateral elements will also need to be added to this sum, but this is a straightforward calculation based on clear rules around credit levels. There is no reason therefore why this cannot be estimated with reasonable accuracy.

Conclusion

We believe that Ofgem has significantly understated the EBIT allowance for a notional SVT supplier due to the error set out under Section 1 above and the unnecessarily inaccurate methodology, namely the use of RFI data set out under Section 2 above. This is not necessary when the facts and data are at Ofgem's disposal to enable it to model the allowances more accurately. Based on an increase in Collateral to reflect our modelled approach, the ICE would need to be of the order of £563 (not including Balancing and industry costs which we have not modelled).

¹ Please see Utilita Submission to the Call for Input on the Operating Costs Review, June 2023

We would be happy to discuss our model or commission an independent third party to help Ofgem model a notional supplier operating under the price cap.

During the transition to net zero, volatility will remain. The EBIT allowance goes hand in hand with capital adequacy, it is imperative that Ofgem get this allowance correct to ensure that the market is attractive for investment and resilient.

We appreciate that our analysis has produced an outcome which is substantially different from that presented by Ofgem. However, our analysis shows that a figure of £165 for Collateral is close to a P50 confidence level. We believe that it is not appropriate for Ofgem to be stress testing suppliers at a P95 level, but demonstrably only funding to a P50 level in a critical and substantial area of financial impact. We believe that this matter requires addressing transparently.

We would welcome an opportunity to discuss this contribution in more detail with Ofgem colleagues once you have had chance to consider our submission. Please let me know suitable dates and I will be happy to co-ordinate diaries.

Kind regards

By email only

Alison Russell
Director of Policy and Regulatory Affairs

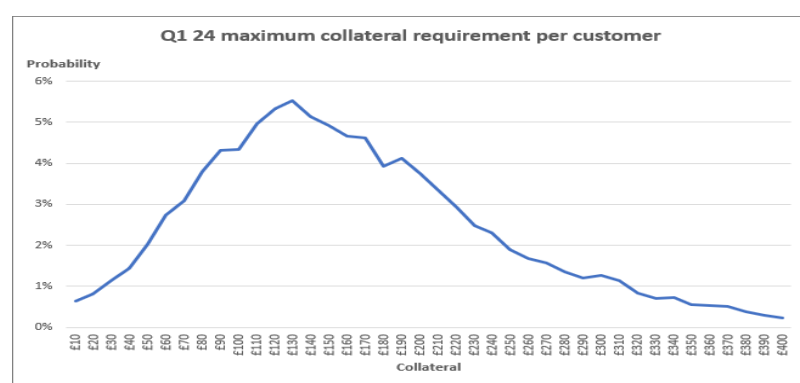
Appendix 1 – Modelling of Collateral Requirement (support for Section 2)

Utilita has modelled the collateral requirement for a notional supplier. We describe in this Appendix how this has been carried out. We calculated the collateral requirement of an energy supplier by taking a customer using 3,100 kWh of electricity and 12,000 kWh of gas (the values at which the price cap is calculated). The P95 value, which is used by Ofgem in its other calculations, is £346.

Table A.1: Collateral at different levels of confidence

Confidence level	Collateral per customer
P50	£146.47
P75	£207.53
P95	£346.26
P99	£482.04

Figure A.1: Q1, 2024 maximum collateral requirements using an average customer



To simplify the modelling, we have taken the requirement for the Q1 2024 hedges only. In reality, suppliers will have hedges for more than one price cap period concurrently.

Please note:

- The requirement is the maximum over the hedging and delivery period for each iteration of the simulation, which is the appropriate way to understand the collateral requirement at any given level of confidence.
- The results are the output of a simulation:
 - 10,000 iterations have been run.
 - Gas prices are simulated as a lognormally distributed stochastic process. The price used at the start of the hedging window is the current price for Q1 2024. The standard deviation used in the simulation is derived from recent observed values.
 - Electricity prices are derived from simulated forward gas prices, subject to a degree of randomness that results in a linear correlation of 95% (being the typically observed correlation of movements of gas and electricity forward prices).
 - Volatility of prices is treated as a constant

We consider the results of the simulation model to be reliable. We have made a few simplifications for the sake of timeliness, namely assuming volatility of forward prices to be constant, assuming no excess kurtosis in the probability distribution of forward price movements, and assuming a supplier does not have hedges for more than one price cap period concurrently.

All of these simplifications reduce the collateral requirement at any given level of confidence i.e., the P95 collateral requirement is a value greater than £346.

Appendix 2 - Consultation questions

We have provided only brief answers to the questions set out in the Statcon, but these should be read in conjunction with our covering letter and Appendix 1.

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

Utilita, as set out in the response to the last consultation, agrees that there is a case for change, both under the present unusual circumstances and under normal market conditions, given the risks of operating an energy supply business, insufficient allowance for EBIT is provided in the price caps.

This has been a long running issue and we have called repeatedly for a fundamental review of the price cap allowances to ensure that both suppliers can recover their efficient costs and that they are fairly recompensed for the risks borne.

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

As outlined in the last consultation response, Utilita believes the average time on supply for a customer is less than the 6 years assumed by Ofgem.

While average time on supply will clearly vary by supplier, with former monopoly suppliers likely to have more disengaged customers and therefore a higher average time on supply. Enjoyment of this inefficient advantage would not be available to the efficient notional supplier, whose customers would be of the sort supplied by entrants to the market since liberalisation.

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

The estimation of working capital, including risk capital, appears to exclude volume risk as it relates to weather. Weather-related volume risk is of great significance to energy suppliers, especially given its correlation with price risk, and cannot be omitted from an assessment of a 1-in-20 event without materially understating the level of risk capital required. While there is a 'risk allowance' elsewhere in the price cap of 1% of wholesale costs, the choice of a 1% allowance is arbitrary and does not reflect the 1-in-20 outcome that forms the basis of the EBIT calculation.

There is no quantitative justification provided of using a 'P95 scenario' in judging the risk appetite of the efficient supplier. Suppliers' risks are idiosyncratic, which is why the CAPM model is not appropriate for estimating a supplier's cost of capital. The risk appetite of an efficient notional supplier ought to be related to its cost of capital, which is itself a reflection of the risks to which the notional supplier is exposed.

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

No, Utilita does not agree. Please see covering letter and Appendix 1.

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

The agreement with Utilita's trading partner has not changed.

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

Ofgem acknowledges that CAPM is flawed when applied to energy supply, but nevertheless continues to consider it the most suitable approach. On this basis, Ofgem must therefore recognise that the calculation of a supplier's cost of capital will always been understated to some extent. Please see Utilita's previous submissions describing the deficiencies of CAPM.

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

Utilita agrees that the hybrid approach is suitable.

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.

For the reasons given in Utilita's response to the November 2022 EBIT consultation, Utilita agrees that the EBIT allowance methodology should be reviewed in response to material changes in conditions affecting EBIT, rather than be subject to a scheduled review of inputs.