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By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's statutory consultation on amending the price cap EBIT allowance

Dear Marzia and Shai

Thank you for an opportunity to comment on the proposed changes to the price cap EBIT allowance. As you know from our previous responses, we do not support this review at this time. Given this, we have limited our response to a number of high level observations.

1. **Overall, we would like to see Ofgem limit the time it spends fixing the cap.** There is increasing consensus that the "absolute cost stack" price cap does not work. We would like Ofgem to free up more time to work with DESNEZ on the future of price protection and consumer protections for a smart tariffs/products world. A different approach to price protection - such as a relative price cap - may help reduce risk and develop more financial resilience in the sector.

2. **When updating the cap, we urge you to prioritise updates that will benefit customers - such as reducing the payment uplift for standard credit**. The current payment uplift is not cost-reflective and hits some of the most vulnerable and lowest income households in the country. Correcting this error is a tangible way Ofgem can support customers through the cost of living crisis. We're glad to see this has been prioritised through the opex review and urge you to move quickly.

3. **We're concerned that the EBIT increase - which is mostly driven by the RO ringfencing allowance - puts bills up in favour of legacy suppliers.** Ofgem's decision to allow legacy companies to use PCGs to sidestep RO ringfencing means they face no substantive change to their costs or impact on working capital, yet their customers' bills will go up by £8 annually. While it makes sense for RO ringfencing to form an element of the fixed part of the EBIT allowance, we are concerned that Ofgem's RO decision favouring legacy suppliers is now being permanently translated into higher bills for all customers.

4. **The EBIT review further exposes the increasing unsuitability of the concept of the "notional supplier" within the current cap.** The market is no longer dominated by one type of supplier, it is made up of legacy suppliers, scale challengers and new entrants with different costs of capital, financing structures, investor risk appetites and business models. The risk with trying to shoehorn suppliers into one approach is

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shown in the weaknesses of some of the capital employed assumptions which we detail below. The EBIT allowance runs the risk of pushing all suppliers into a low innovation, low and steady returns "utility" business model. This model is not compatible with the innovation needed for the energy transition, nor is it realistic. As Citizens Advice wrote recently "*any supplier whose preferred destination is simply to be allowed to make a decent profit from selling kwhs of electricity and gas should perhaps look away now: you have no future.*"[1]

In terms of the specific approach to the EBIT allowance, we endorse the observations made in the Charles River Associates (CRA) report attached to the response from Energy UK and make the following points:

5. **We welcome the developments on cost of capital - and caution against going backwards on previous decisions.** We support your decisions to shift the cost of capital up slightly by increasing the asset beta and recognising that the risk in retail energy exceeds the economy norm. We think this still understates the cost of capital for non-investment grade companies. It's impossible and inappropriate to arrive at a single cost of capital for all suppliers. The costs of capital vary very significantly across the sector, and aiming to settle on one risks removing the diversity of business models from the market.

6. **We would like Ofgem to think carefully about the links and distinctions between this EBIT allowance and the wider financial resilience framework.** Ofgem has said, quite correctly, that the working capital inputs into the EBIT allowance and the Target Capital level proposed in the financial resilience framework do different jobs. However, this is not yet being fully reflected in Ofgem's modelling and outputs. A more accurate (and higher) working capital input will incentivise prudent supplier behaviour and reduce risks of failure. The Target Capital level can then do its job of acting as truly loss absorbing capital and be set at a more appropriate level (i.e below £130), rather than being set too high and constraining efficiencies and innovation.

7. **Ofgem underestimates the working capital requirements of a notionally efficient supplier.** Ofgem's model, in particular the assumption that a supplier would allow its cash balances to reach zero, misrepresents the operational realities of suppliers. The scenario testing Ofgem has done to assess market risk is also problematic. Given the increasing fragility of the "notional supplier" model, especially related to EBIT, we would expect Ofgem to test its model against a range of scenarios, rather than one static scenario.

[1] Citizens Advice, Future fantastic? Remaking an energy supply market that's fit for the future, June 2023.

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8. **Ofgem's reasoning in defining collateral requirements is inconsistent and likely underestimates the collateral capital component.** We support Ofgem's decision to include collateral in the definition of capital employed - this is a key risk retailers need to cover. However, as the CRA report points out, Ofgem has applied inconsistent logic to its definition of collateral picking data from some types of suppliers and not others. A more prudent approach would look at collateral requirements in the round (including non-wholesale collateral requirements) and include a focus on peak collateral requirements, which is more representative of the approach prudent suppliers take.

9. **Ofgem's approach to fixed assets could be updated.** There are some assumptions in Ofgem's approach to fixed assets which may have reflected the market back in 2018, but do not reflect the technology-enabled market today. In particular, for most suppliers, IT investment is opex not capex as suppliers purchase software as a service. If included in capex, 3 years is a more appropriate amortisation period than 6 as it reflects technology innovation cycles.

10. **The fixed and variable approach to arriving at the EBIT allowance must be very clear and implementable.** The new methodology is complex and limited time is spent explaining it in the consultation. Suppliers must be able to forecast the price cap accurately in order to manage their business. Clarity on expected returns also supports investor confidence in the GB retail market. To aid understanding we recommend Ofgem sets out some examples of how the fixed and variable elements will work to arrive at EBIT. We also suggest Ofgem stress test this approach against various wholesale scenarios to avoid unintended consequences. In the case of the price cap payment uplift, some error in the variable element seems to be driving a divergence between the actual and price cap payment differential, a quirk which is driving higher prices. We would not like to see the same happen with EBIT.

We have contributed financially to the analysis Charles River Associates has done for Energy UK and endorse and support its findings. We would also be happy to discuss any elements of our response with you in more detail.

Your sincerely

Alexandra Meagher
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