Energy UK

The voice of the energy industry

Ofgem
10 South Colonnade
London
E14 4PU

28th June 2023

Dear Price Protection Team,

We welcome the opportunity to respond to the Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance.

In response to the consultation, we have on behalf of a group of our members, commissioned independent reports from Charles River Associates (CRA) to examine the approach taken by Ofgem to calculate capital employed. A confidential and a public report are being shared because they draw on supplier data submitted to Ofgem in the November 2022 request for information and a continuation of data series beyond October 2022.

Our response is focused on capital employed, specifically on Ofgem's approach to working capital and collateral capital – the subject of Questions 3 and 4 in the consultation. This is where we have been able to focus our effort in the time available. Our members will be providing their views and evidence individually on cost of capital, the approach to setting and scaling the allowance and the triggers for revisiting the EBIT approach.

Summary

The Energy UK view, informed by the CRA reports is that Ofgem underestimates the working capital (including risk capital) and collateral capital components to the capital employed allowance. Key issues we see with the Ofgem position are:

- Inconsistency in time periods used in the optimisation of the supplier's financial position (two years) and averaging of the working capital maintained (one year);
- Unrealistic zero minimum cash requirements for the supplier to continue operating during the price shock;
- Unrepresentative modelling, in magnitude and shape, of the 1-in-20 price shock that the notional supplier could experience;
- Underestimation of the 'real-world' collateral requirements of suppliers due to a discrepant approach to determination of collateral levels[1].

The approach that Ofgem has taken does not appear consistent with the rhetoric accompanying this consultation and for the direction of the retail market from Ofgem around strengthening finance resilience.

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[1] Charles River Associates (2023) A report on Ofgem's proposed changes to the EBIT margin Allowance, Section 7

In 2021/2022 over 30 suppliers failed at a cost of £2.7 billion or £94 per customer[2]. Designing appropriate working and collateral capital allowances is how Ofgem can - and should - incentivise prudent supplier behaviour. Conversely, a failure to allow adequate working and collateral capital is likely to drive further supplier failure and exits in the market; contractions in supplier diversity and scope for competition, which leads to poor customer service outcomes including additional costs. As a result, the current position does not appear consistent with statutory duties to enable suppliers "to recover costs" and therefore "to compete effectively" and therefore "consider the impact of the cap on public spending"[3].

The report provides expert input that highlights the evidence available that when stress testing risk capital that contributes to financial resilience should reflect a requisite diversity of scenarios and adequately severe conditions, which we do not believe Ofgem's 1-in-20 possible scenario achieves[4].

A revised approach will be needed to better protect customer finances and service levels through resiliently financed suppliers. We think improved consumer experiences in a better more stable and functioning market should be quantified alongside costs of supplier failure, such as a Special Administration Regime (SAR) in the trade off with the higher ongoing costs of a more robust financing scenario.

We believe that the proposed allowance would mean that a supplier faced with a price shock similar to that experienced in 2021/2022 would not have recovered their capital employed and been highly reliant on securing further capital at short notice in order to remain operating.

Working Capital adjustments

We think the approach to risk capital should fully reflect the key drivers of risk capital:

- **Market risk** - arising from pricing and demand outcomes in the market place;
- **Credit risk** - arising from exposure to the risk that a company's customers and suppliers renegue on supply/payment obligations; and
- **Operational risk** - arising from exposure to non-market risk affecting the company's core business activities[5].

Currently, Ofgem's approach appears to underestimate the risk capital required to compensate for credit risk and does not consider operational expenditures. As examples, firstly, in a rising market, a utility buying physical forwards is exposed to the risk that the seller does not deliver its promised volumes and the replacement cost of the transaction being defaulted upon is higher than what it had previously agreed. To the extent this is not collateralised the utility is bearing credit risk itself. This is not considered in the calculation of the EBIT allowance. Secondly, Ofgem's risk capital approach also doesn't account for unexpected change; for example, the opening cash balance is optimised by the model to withstand the period of volatility perfectly that it can predict, without testing for impact of any unforeseen circumstance.

Alongside the treatment of risk, the averaging approach to working capital creates an unrealistic scenario in which working capital is higher than the proposed £127 per customer in 14 of the 24

[2] National Audit Office, The energy supplier market, p. 4. We note that a further two suppliers failed between Q3 2022 and Q4 2022

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

[4] Charles River Associates (2023) A report on Ofgem's proposed changes to the EBIT margin Allowance, Section 5.1

[5] *Ibid*, Section 5

months modelled, and in 8 of the 12 months averaged under Ofgem's approach, reaching £167 per customer by the end of the modelled period.

Alternative proposal

The recommended actions that Ofgem should take relating to working capital:

- Amend the calculation approach for working capital maintained from the period of the price shock (one year) to the full two-year period of the model;
- Introduce a cash constraint to the model to cover potential unforeseen operational expenditure requirements during the peak of the price shock;
- Re-run its Stochastic Wholesale Prices Model (SWPM) model with a set of assumptions that is more representative of the price shock observed over 2021/2022.

The following estimates for adjustments to working capital have been provided in Table 1.

Factor	Impact to working capital
Amending the calculation approach for working capital maintained to two years	£2
Applying a one-month operational cost cash constraint to the model's pre-conditions	£22
Adjusting the magnitude and shape of the price shock with unadjusted backwardation costs	£14

When applying all the factors summarised in Table 1, the average working capital maintained by the notionally efficient suppliers increases to £163 which is a £36 increase from Ofgem's base calculation of £127. The cumulative impact of modelling together means they do not add neatly because the overall impact is different to the sum of the parts due to the interactions within the model.

Collateral capital adjustments

Energy UK think that Ofgem's approach to calculating the collateral levels does not accurately reflect suppliers' real-world capital requirements needed to cover supplier trading positions.

Our view is that Ofgem's due process should be to use direct observations of collateral costs as a more accurate estimate of supplier costs than the inferred cost of trading arrangements between suppliers and trading companies.

We think Ofgem should be very cautious choosing a notional supplier approach which makes it unaffordable for a supplier without a trading relationship to operate sustainably in the retail market. E.g. a supplier raising their own collateral. Providing margin for independent suppliers based on a potentially narrow range of trading relationships may present challenges to the diversity of the energy market and have unintended consequences.

In price controls the default position is to seek direct observations of required company costs from regulated activities. It is unusual to require a prescriptive market dependency, particularly without consideration about broader risks including the implications for competition.

A further issue is that Ofgem's averaging approach does not accommodate peak collateral requirements and conflicts with the more likely approach taken by suppliers to arrange sufficient funding to cover peak requirements, as opposed to the average.

These issues cause collateral capital, alongside working capital to be significantly underestimated. We would strongly encourage Ofgem to re-issue its Request for Information to obtain up to date information on the actual wholesale, and total, collateral requirement of suppliers.

For a more detailed explanation and reasoning for the position provided we refer you to the CRA reports provided, which Energy UK and our members fully support.

Energy UK and CRA would welcome the opportunity to discuss any points raised in this response or the reports in more detail.

Kind regards

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Energy UK