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28 June 2023

Dear Marzia,

STATUTORY CONSULTATION ON AMENDING THE METHODOLOGY FOR SETTING THE EARNINGS BEFORE INTEREST AND TAX (EBIT) ALLOWANCE

We welcome the opportunity to respond to this consultation on amending the methodology for setting the EBIT margin in the price cap. Annex 1 contains our responses to the consultation questions and we summarise key points below. In summary, we believe Ofgem has made significant progress in developing a methodology for estimating capital employed but there are still a number of important aspects that need further work. Given that this methodology is intended to remain in place for a significant period, it is important for it to be accurate. We therefore recommend that Ofgem delays implementation until 1 January 2024 and uses the additional 3 months to address outstanding issues, using further targeted RFIs where appropriate. We note that Ofgem intends to remove the current allowance for RO ringfencing capital employed when it implements the new EBIT methodology, and as a result, the new EBIT margin is not expected to have a material impact on suppliers or consumers in October. There will therefore be no material detriment to consumers or suppliers from such a delay.

Working capital

Ofgem has published its working capital model that aims to measure working capital and risk capital. We have identified several issues with this model set out in more detail in Annex 1. Ofgem has only modelled one scenario, that of prices increasing. We do not consider this to be a robust approach to measuring risk capital. A notional supplier would be expected to have sufficient capital to withstand a range of possible scenarios including prices falling, extreme weather events and others. In addition, the model has been calibrated such that the notionally efficient supplier's cash available for operations reaches zero. Had many scenarios been modelled, this assumption may be more appropriate since the range of scenarios should satisfy the requirement to be resilient to a 1 in 20 stress scenario. If no further scenarios are modelled, Ofgem should consider some headroom above a zero cash floor, for example, one month operating costs. In addition, Ofgem has optimised over two years but only included the average of one year in its calculation. We would suggest aligning the two periods.

Whilst the cap does include allowances for expected costs, it does not cover the risk capital, ie the potential for more extreme shaping costs or levels of bad debt, associated with high prices and the impact delayed recovery has on working capital. Ofgem should include this impact in its modelling. Finally, direct debit assumptions are unrealistic since they assume that customer direct debit increases are actioned by suppliers for all customers on the date that the price cap changes, such that all customers are paying the increased level from that date. In practice this is not possible due to operational constraints and the requirements of the Direct Debit Guarantee. We suggest changes to direct debit levels are made over at least a 2 month period in the model.

Collateral capital

Although we agree with Ofgem's minded-to position to include collateral as part of capital employed, we do not agree with the approach to estimating collateral. Ofgem used the RFI data and based the collateral capital on the highest average amount of collateral posted by a non-vertically integrated supplier calculated over 2021 and 2022 using monthly observations. We are concerned that Ofgem's use of the RFI data is unduly selective. Ofgem should not have excluded all vertically integrated suppliers from the data it has used. Most suppliers are not vertically integrated in both fuels. Indeed, the impact of our approach to trading on collateral, at least in ScottishPower's case, is visible in the data (see Figure 3). The data used by Ofgem reflects capitalised trading fees to yield the equivalent capital value. These fees may have been negotiated at a date prior to market turbulence, so may not reflect fees that would have been charged more recently. Furthermore, the data set used covers a period of mainly rising prices, not falling ones, and Ofgem should have requested additional data to include this in its re-assessment prior to implementation, not just from those who use intermediaries.

Our proposal is for Ofgem to model collateral capital alongside the working capital model. If not, it should use the RFI data to calculate collateral required by a notional supplier carrying out trading activities itself, using peak collateral requirements. This is because it is difficult to find trading fees that are genuinely arm's length, reflecting the current market and clean ie not contaminated by additional covenants or services. If data relating to trading OTC is used, credit risk should be included.

Fixed assets

Ofgem is proposing to use the CMA's 7 year old depreciation and amortisation estimates to back-calculate the fixed assets per customer at £85 whilst at the same time undertaking a review of the operating cost allowance. We understand the difficulty of changing different elements of the cap together but consider that Ofgem should assess the impact that any operating cost changes would have on the EBIT allowance and consult on whether any consequential changes are needed.

Cost of Capital

We support Ofgem's approach to increasing its estimate of asset beta. Ofgem's change has recognised that energy retail risk factors are systematic in nature and correlated with the wider market environment, and have reflected these in the beta estimate. We agree that a comparison with airlines is appropriate. However, we see strong arguments in favour of aiming up and using the high point of 1.2, not the average of 1.1. This would recognise the limitations of the CAPM approach to calculating EBIT which does not reflect the impact of volatility on margin and would also recognise that to deliver net zero, the sector requires investment. As such, there are higher risks to consumers from using a lower asset beta than there are from using a higher asset beta.

Implementation of the EBIT margin

We have highlighted some issues with the implementation of the EBIT margin in annex 1. This is largely related to inconsistent rounding between and within formulae.

[✂].

Yours sincerely,

Pp Richard Sweet
Director of Regulatory Policy

Annex 1

FURTHER CONSULTATION ON AMENDING STATUTORY CONSULTATION ON AMENDING THE METHODOLOGY FOR SETTING THE EBIT ALLOWANCE

We were part of a group of Energy UK supplier members who retained CRA to examine Ofgem's proposed changes to the EBIT margin allowance in the default tariff cap. The report from CRA is referred to in our answers to Ofgem's questions below.

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

We agree with the primary policy intent as stated in paragraph 3.14 of the consultation.

> *"that the EBIT methodology should deliver a fair return which protects consumers against both the risks of higher-than-normal profits and excessive costs of failure. A fair return ensures the sector is investable, appropriately reflecting risks suppliers are exposed to"*

We agree with the proposed increase in the cost of capital to reflect the increased levels of risk and perceived risk in the sector. We also agree at a high level with the approach to calculating working capital and risk capital, although we would have preferred modelling of collateral capital alongside these. In the remainder of our response, we propose some changes to the approach to modelling capital employed to ensure that the EBIT return is fair and reflects the risks that suppliers are exposed to.

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

Ofgem is proposing to use the CMA's 7 year old depreciation and amortisation estimates to back-calculate the fixed assets per customer at £85 whilst at the same time undertaking a review of the operating cost allowance. We understand the difficulty of changing different elements of the cap together. We do not disagree that it would be disproportionate to pause the review of the EBIT allowance until the operating costs review concludes. However, we consider that Ofgem should assess the impact that any operating cost changes would have on the EBIT allowance and consult on whether any consequential changes are needed as part of the operating cost review.

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

We agree in principle with Ofgem's approach to estimating working capital and risk capital. It aligns with the proposal made by ScottishPower in its response to the "Further consultation on amending the methodology for setting the EBIT allowance" 9 January 2023.

However, we do not agree with how this has been implemented in practice as we consider that the model does not represent supplier working capital and risk capital in severe but plausible stress scenarios. Overall, the model optimises the opening balances based on a look forward at the balance sheet over a two-year period. The model applies the constraint that the notionally efficient supplier will "never run out of cash" due to sufficient shareholder equity injection at the beginning of the period. The model optimises the amount of shareholder equity injection based on the notionally efficient supplier's cash available for operations never falling below zero but hitting zero during the 1-in-20 price shock period.

We do not agree with the following:

- Stress scenarios: Ofgem has only tested one scenario not a range
- Zero cash calibration: The model has been unrealistically calibrated to zero cash minimum, a more significant issue since only one scenario has been modelled
- Inconsistent timescales: Ofgem has optimised over two years but taken the average of one year
- Direct debit payments: timescales for DD payment changes are unrealistic
- Market Stabilisation Charge (MSC) assumptions. The MSC extends beyond its expiry date in the model
- Variation to price cap allowances: working capital associated with variation to price cap allowances does not appear to have been modelled
- Volume risk multiplier: the volume risk modelling takes place outside the working capital model and the assumptions behind it are opaque and difficult to critique

We cover these in more detail below.

Stress scenarios

To effectively model risk capital, we would expect Ofgem to model scenarios that are representative of 'severe but plausible financial stress', eg 1 in 20 year worst case scenarios. We do not believe that the stress tests currently cover severe enough scenarios for this. Scenarios should include, for example:

- Extreme weather events
- Market circumstances leading to rapid exodus of customers from SVT to FTC
- Emergence of cut-throat supplier competition
- Sharply falling markets (with consequent need to post variation margins)
- Sharply increasing markets with associated volume ('unexpected SVT') risks
- Market volatility with markets rising and then subsequently falling or vice versa
- Severe cost of living squeeze and impact on consumer debt
- Wider energy industry stress leading to counterparty failures

We would expect that the peak working capital from these severe but plausible scenarios should then guide the capital employed element of the EBIT calculation. We consider that selecting one scenario does not cover the risk capital that a prudent supplier would need to ensure that it did not go into insolvency in a 1 in 20 scenario. The CRA report refers to the Basel framework and the requirements to identify possible events of future changes in conditions that may have unfavourable effects on banks' exposure and assess their ability to withstand it. A similar approach should be taken here when designing scenarios.

In addition, the approach to setting prices for the single 1 in 20 scenario appears to use variation around current price curves. Thus, if the current price curve is lower, the 1 in 20 scenario prices are also lower. As a result, as market prices fall, the prices modelled do not come close to reflecting the real life high prices that we have seen in the recent past and therefore we do not consider this to be an effective approach to developing a 1 in 20 stress scenario. We note the same disadvantage to how Ofgem sets the scenarios for its financial stress test where the high price scenario assessed has reduced over the last 2 quarters. In both these cases, the implication is that the same price changes that we saw in 2021 could not happen again. The 1 in 20 price scenario modelled appears to be only a 30% increase in the wholesale cost component of the price cap. As a comparison, the recent energy market crisis resulted in an over 400% increase in the wholesale component. CRA has modelled some additional scenarios that may be more realistic. CRA shows the impact of a 40% uplift on Ofgem's wholesale cost assumptions and can be seen in section 5.2 of the CRA report. In section 5.3, CRA further highlights that the shape of the Ofgem price shock has also had an

impact on the output of the model. The additional scenarios run by CRA, (whilst only indicative due to the lack of data available to adequately model fully eg backwardation) serve to highlight the importance of using a range of plausible scenarios to set the working and risk capital element of capital employed in the EBIT calculation.

The calibration of the model to zero cash minimum

In calculating average working capital maintained over the period, the model applies the constraint that the notionally efficient supplier will "never run out of cash" due to sufficient shareholder equity injection at the beginning of the period. The conditions of the model optimise the amount of shareholder equity injection based on the notionally efficient supplier's cash available for operations reaching zero during the 1-in-20 price shock period.

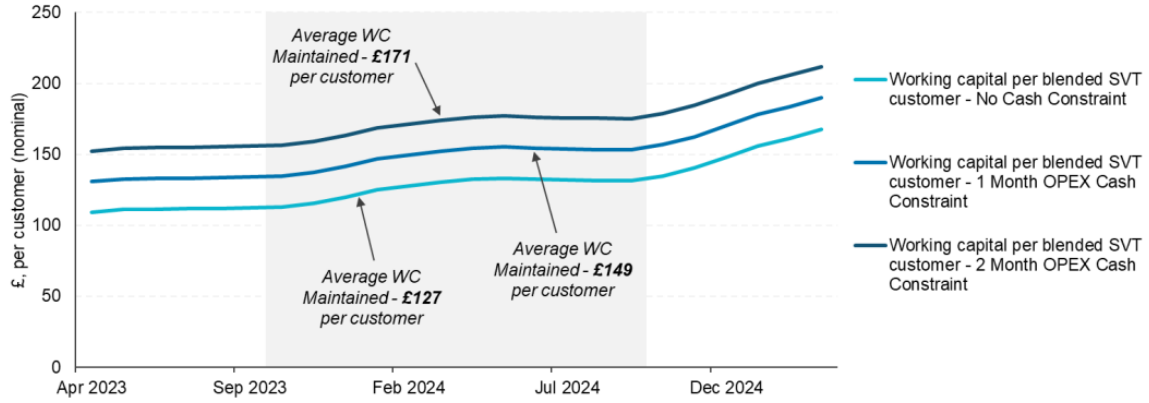
We consider that, had many scenarios been modelled, the assumption of zero cash may be more appropriate since the range of scenarios should satisfy the requirement to be robust to 1 in 20 stress scenario. However, Ofgem has only modelled rising prices and hence the working capital assumption may not reflect the capital a supplier should hold in other severe but plausible scenarios.

In paragraph 5.23 Ofgem has said "*Also, in establishing a level of capital employed we assume our notional suppliers holds sufficient capital employed to remain cash positive under high price scenarios*." A prudent approach to financial resilience would require cash coverage above zero since suppliers should maintain sufficient capital to withstand severe but plausible scenarios, where costs increase. Both these provide a good rationale for Ofgem and the working capital model to use a non-zero cash requirement in the model.

Having a zero cash minimum could require the notional supplier to use any customer credit balances for cash needs if it could not secure these elsewhere to avoid insolvency. This is something that Ofgem has consistently warned against.

CRA has modelled the working capital under different cash constraints of one and two months.

Figure 1: Working capital maintained under different cash constraint levels



For every month worth of average operational cost added to the model's cash constraint, the average working capital maintained per blended SVT customer rises by £22. We consider that in the absence of other scenarios being modelled, a one month operating cost cash constraint would be appropriate.

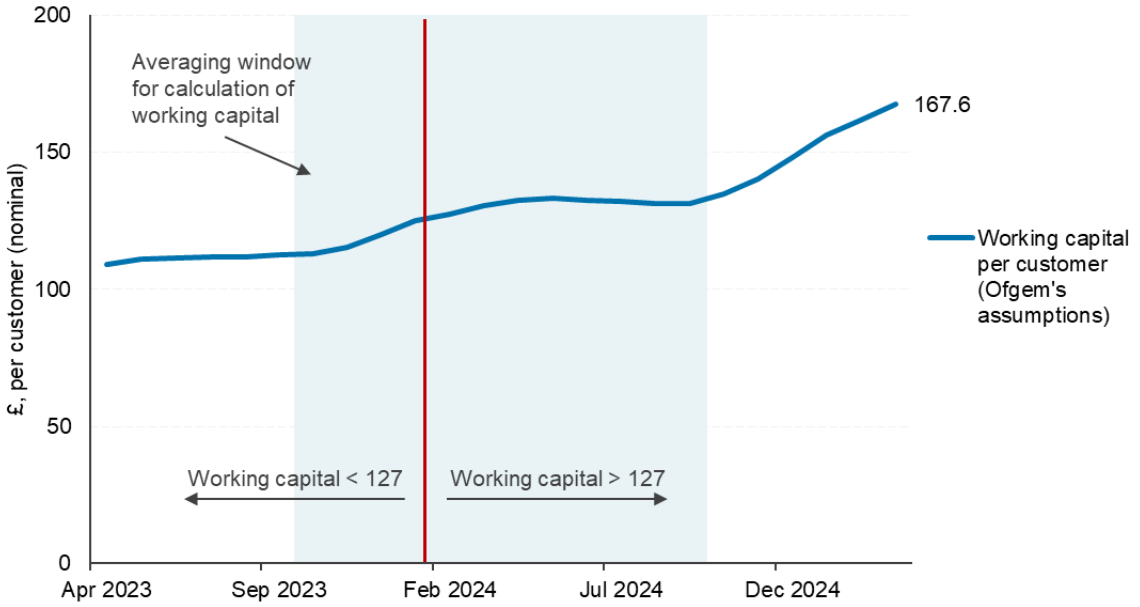
Two years modelled average of one year used

Overall, the model optimises the opening balances based on a look forward at the balance sheet over a two-year period. This means the model is optimising shareholder equity and cash

positions to cover circumstances over two years. However, in calculating the average working capital from the model, Ofgem chooses to average over only a one-year period. CRA's report section 3.1 highlights that the periods before, and after, a shock are important determinants of a supplier's ability to withstand the shock itself, indicating a longer average should be used. Further CRA says that working capital is higher than £127 per customer in 14 of the 24 months modelled, and in 8 of the 12 months averaged under Ofgem's approach, reaching £168 per customer by the end of the modelled period.

CRA has depicted this graphically in Figure 2.

Figure 2: Evolution of working capital maintained by the notionally efficient supplier throughout the modelled period



It is not clear what the full impact would be of using consistent timescales for optimising and averaging but Ofgem should accurately model lead in and lead out periods, including backwardation and should consider the impact of using a two year vs one year average. In fact, in section 5.3, CRA discusses its findings that the not complete modelling of the lead out period does in fact impact average working capital in the one year window used. This could be significant. Since, without access to the underlying stochastic (SWPM) model, we and CRA are unable to fully model this, we propose that Ofgem models the full two years for different scenarios and bases the average on a timescale consistent with the optimisation.

Direct debit payment cycles

One of the assumptions baked into the working capital model is that as soon as the cap value is amended by Ofgem, a supplier is able to amend customer direct debits to receive the value implied by the new price cap amount. In the case of this model, this is an increase in the direct debit amount. This assumption is unrealistic. Ofgem announces the new cap value 5 weeks prior to it going live. Within a week of this we would begin to undertake direct debit reassessments for all our customers. We expect to be able to do [✂] reassessments a week to check the extent to which a customer direct debit would need to increase. For a supplier with [✂] customers in the working capital model, direct debit reassessment would take

between 14 and 28 weeks to conclude. This is at least 10 weeks after the go-live date of the new price cap.

Therefore, in total, if we take the earliest timescales of 10 to 24 weeks for reassessment this is on average 5 to 12 weeks, including a 10 working day notice period is 7 to 14 weeks. A 7 weeks delay is the minimum we would expect on average and in reality this could be significantly longer. Ofgem should correct its working capital model to reflect this point.

Use of the MSC in the model after the final expiry date

The model includes the MSC which Ofgem has made clear is a short term measure, due to expire in March 2024 unless Ofgem takes action to extend it. The model shows this working beyond March 2024 which should be corrected. Ofgem should also consider modelling the whole period without the MSC if this is not going to remain a long standing feature of the price cap. This is so that the EBIT margin assumptions are reflective of the price cap risks beyond March 2024. Even if Ofgem were to commit to considering an extension of the MSC should market conditions require it, the elapsed time it would take to consult and decide on this could have significant impact. Finally, since the MSC formula does not take into account any adjustment allowances or backwardation, the MSC provides less protection for suppliers. This may not be recognised in the current model, although it is possible it has been taken into account in volume risk, we do not have the data to confirm and note the adjustment allowance is set to zero.

Modelling variation to price cap allowances

Allowances in the price cap cover the expected costs for suppliers, not the potential for more extreme costs associated with 1 in 20 stress scenarios. In stress scenarios, Ofgem has shown that it has a process to acknowledge the additional costs that suppliers have been exposed to and to account for these by including adjustment allowances in the price cap. This was seen during the recent energy market crisis. Ofgem recognised the increased costs in cap period seven and gave suppliers an adjustment allowance to cover the excess costs from shaping and balancing, volume risk and backwardation. For shaping and imbalance this was £12 per customer for electricity. In its decision[1] Ofgem recognised *"wholesale market volatility has caused electricity shaping and imbalance costs to be materially higher than the price cap methodology had accounted for and* in August 2022 it stated[2] *"While we include an allowance in the cap for shaping and imbalance costs, wholesale price increases could push costs above it."*

Ofgem is currently considering bad debt costs for the energy market crisis and has previously given adjustment allowances for increases in bad debt as a result of the Covid-19 pandemic. Although Ofgem did (and would be expected to) approve an allowance such that on average, suppliers are able to recover costs, there are working capital implications for suppliers and these are not factored into the model.

Ofgem has noted that "*The SWPM model includes shaping and imbalance costs as part of its wholesale cost forecasts, and consequently, these are taken account of within the price cap allowance forecasts"*. As such, it has not modelled any impacts on shaping and balancing in the model. However, we would expect, that when the price increases in the 1 in 20 scenario, shaping and balancing costs would be impacted and in the single scenario selected by Ofgem these costs would likely be in excess of the price cap allowance as we have seen previously and Ofgem itself has noted[12].

[1] Decision on the potential impact of increased wholesale volatility on the default tariff cap (ofgem.gov.uk) para 2.4
[2] Price Cap - Decision on possible wholesale cost adjustment (ofgem.gov.uk) Executive summary

Similarly it would also likely lead to an increase in bad debt relative to the price cap allowance. Although any impact could be recovered by an additional allowance in the price cap, however, as with shaping there is a working capital implication.

In the model, the adjustment allowance in the price cap stack is zeroed and the delayed cost recovery implicit in that is not counted as increased working capital. It is not clear what impact including the adjustment allowance and the corresponding working capital costs would have and Ofgem may have decided it was simpler to leave this out. However, for the particular 1 in 20 scenario tested, Ofgem should include a working capital impact of delayed recovery of shaping costs and potentially bad debt costs.

Volume risk multiplier

The volume risk element uses a volume risk multiplier and other assumptions which are not fully explained. The calculation of these elements is largely done in the SWMP model and as such, we have been unable to challenge this area. We also note that the scenario does not cover volume risk on prices falling. It also seems likely, that the volume risk multiplier does not fully mirror the impact on suppliers that have a mix of SVT and FTC customers. In addition, the volume risk is likely impacted by the assumption that the MSC is in place throughout the period. Ofgem should consider the level of working capital with and without the MSC if this is not going to remain a long standing element of the price cap, including the impact on volume risk. Ofgem should enable challenge of the volume mix assumptions by detailing them

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

Although we agree with Ofgem's minded-to position to include collateral as part of capital employed, we do not agree with Ofgem's approach to estimating collateral. We consider that modelling collateral capital in the same model as working capital should be possible and would be the preferred approach to understanding the peak capital required by a notional supplier.

Ofgem used the RFI data and based the collateral capital on the highest average amount of collateral posted by a non-vertically integrated supplier calculated over 2021 and 2022 using monthly observations. We do not agree with the following elements:

- Using costs of trading with an intermediary
- Excluding non-vertically integrated suppliers
- Credit risk
- Using the average amount – it is peak collateral that drives capital requirements
- Using data prior to October 2022

If Ofgem does not model collateral capital alongside the working capital model it should use RFI data that reflects the collateral required by a notional supplier trading on its own. If a supplier trades OTC this should include credit risk.

Using costs of trading with an intermediary

Ofgem has stated that its benchmark reflects the costs of a supplier trading with an intermediary as a result of excluding vertically integrated suppliers. This is a different approach to that taken by the CMA and Ofgem when establishing the cap where they conceded that an independent supplier trading for itself would have higher costs and recognised these costs in calculating the EBIT margin. Ofgem, in its 2018 policy consultation[3] linked the bottom up cost

[3] Appendix Template (ofgem.gov.uk) para 2.6

assessment with reflecting the capital required by a supplier who was not using an intermediary. In its policy decision on EBIT in 2018 Ofgem stated that "the operating cost allowance and wholesale cost allowance do not capture the additional working capital costs associated with wholesale trading. The 1.9% EBIT margin captures these costs."[4] The price cap remains a bottom up cost assessment and Ofgem has not provided rationale for amending the link with an independent notional supplier trading on its own account. We address the exclusion of vertically integrated suppliers which left only those who use intermediaries below. Our view is that Ofgem should consider costs for a notional supplier who carries out trading activities itself because it is difficult to find trading fees that were genuinely arm's length, reflecting the current market and clean, not contaminated by additional covenants or services.

Ofgem has implied that the trading agreements with intermediaries over the period of the RFI were largely free from the requirement to provide any collateral. Suppliers who are using intermediaries are likely to have negotiated these deals some time ago. Ofgem must consider whether the data it is basing the allowance on is realistic in a future, more risky market. We do not think collateral free arrangements would be available as new deals, therefore basing the allowance on such deals is incorrect.

In addition, we think there could be significant unrecognised cost in using services of an intermediary related to covenants within the agreements that give the intermediary certain rights over the business. Ofgem recognises this and says that it is neutralised by the fact that trading fees also include different services such as short-term credit facilities. We expect that the former outweighs the latter. Ofgem should do additional work in this area to consider whether any changes to the collateral amount in the capital employed is required to account for this.

<u>Excluding non vertically integrated suppliers:</u>

Ofgem anticipates that vertically integrated suppliers have some ability to net off collateral at the group level, hence it considers their estimates are likely to represent theoretical costs for their domestic customers rather than actual costs faced by them. We dispute this expectation from a ScottishPower perspective for several reasons:

- ScottishPower is considered to be vertically integrated, however it should certainly not be considered to be vertically integrated in gas. Therefore, there is no rationale for Ofgem not to use the ScottishPower gas collateral data.

- In our case, the impact of how we trade electricity is reflected in our collateral data in Figure 3. [✂].

Figure 3: A comparison of gas and power collateral for ScottishPower

[✂]

[4] Consultationtemplate2018 (ofgem.gov.uk) Default Tariff Cap: Decision, Appendix 9 – EBIT para 2.2

[✂] We would expect that other "vertically integrated" suppliers may not be vertically integrated in both fuels and the collateral data they have submitted, for the relevant fuel, may reflect the different types of trading and would not include credit risk for OTC trading. We discuss credit risk further below.

As a result, we do not consider that Ofgem should exclude ScottishPower and potentially other vertically integrated suppliers from the data set used to estimate collateral using peak collateral as described above.

Credit risk

Credit risk would not be directly covered in any of the capital employed calculations including in the collateral RFI data received by Ofgem. When purchasing energy OTC, participants will typically trade with a number of counterparties, unlike the single counterparty in the case of exchange trading. [✂].

There would be a serious impact in the event that one of our counterparts was to fail and leave us exposed. This is a risk that has become significantly greater since markets became volatile. [✂]

In a rising market in this scenario, 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 - as can be the case in OTC markets - the utility is bearing credit risk itself. This is not considered, at all, in the calculation of the EBIT allowance.

Using collateral data from the RFI relating to trading only on an exchange would avoid the need to consider a majority of the credit risk. To the extent that the trading fee was genuinely arm's length, reflected current market offerings and was uncontaminated by anything else this would also avoid some credit risk considerations.

Using the highest average amount

Ofgem uses the highest *average* amount of collateral posted by a non-vertically integrated supplier calculated over 2021 and 2022 using monthly observations. This means taking the total collateral capital employed per customer for each month for each supplier over the time period then using the average of this monthly series over the two years and selected the highest value by supplier. It says that this is conservative and provides a buffer should trading fee arrangements be re-negotiated in the future. We do not believe this is a conservative approach at all. Ofgem should use the *peak* collateral to calculate collateral capital because a resilient supplier must be able to fund the peaks. Although there is a range over time, the peak is what drives the need for capital employed.

Using data up until October 2022

The time period of the RFI was largely a rising market. In a high price, volatile, falling market it is likely that higher levels of collateral would be required. [✂]

Conclusion

Our proposal is for Ofgem to model collateral capital alongside the working capital model. If not, it should use the RFI data to calculate collateral required by a notional supplier carrying out trading activities itself, using peak collateral requirements. This is because it is difficult to find trading fees that are genuinely arm's length, reflecting the current market and clean ie not

contaminated by additional covenants or services. If data relating to trading OTC is used, credit risk should be included.

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

This is not applicable to ScottishPower but we provide a confidential attachment with our updated collateral requirements since October 2022. If Ofgem would like additional detail in relation to this data we would be happy to provide it.

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

We welcome Ofgem's recognition of the increased risk associated with energy retail that is reflected in the asset beta which has increased from 0.7 – 0.8 to 1.0 – 1.2. We consider that this decision is supported by the evidence, both quantitative and qualitative of the increased risk in the sector including:

- Energy retail businesses are (and are perceived as) riskier than at any time in the last 10 years. Press reports as recently as 8 December 2022 highlight the need for additional working capital to cope with additional volatility from some organisations[5]. A response to the consultation described an analogy with banks whose asset betas went up after the banking crisis.

- Market exits and limited market entry in the recent past relative to prior to the price cap and to insolvencies in England and Wales more generally

- EBIT margins from a range of non-legacy suppliers demonstrating limited or negative profitability, including prior to the current crisis

- Whilst noting the issue with relevant comparators, Ofgem agreed with the trend in Good Energy's asset beta which has increased over time and that of Centrica

We agree with the rationale behind the increase. Ofgem has given its reasons behind setting the midpoint of the range. However, we propose that Ofgem "aims up" and selects an asset beta of 1.2 for the following reasons:

- To deliver net zero, the sector requires investment. As such, there are higher risks to consumers of under versus overcompensation of suppliers.

- Aiming up would recognise the limitations of the CAPM approach to calculating EBIT which does not reflect the impact of volatility on margin.

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

We accept the approach to setting the EBIT allowance.

However, we do not believe the rounding in the current calculations outlined in the "Draft overview model – Default tariff cap level" is appropriate. The rounding is inconsistent both between different elements and in the case of the fixed EBIT allowance, row 65, even between

[5] Shell injects $1.5 bn into UK retail power business to help it weather volatility | Reuters

the formulae for the October 2023 and January 2024 price caps. This last one appears to be an error that should be corrected, at least 2 decimal places is appropriate here.

EBIT element	Level of rounding	Intermediate step?	Suggested rounding
Current EBIT %	4 dp	No	4 dp
Cost of capital	3 dp	Yes	None or 6 dp
Fixed EBIT allowance (cell H65)	1 dp	No	4 dp (minimum 2dp)
Fixed EBIT allowance (cells I65 onwards)	2 dp	No	4 dp (minimum 2dp) Consistency required
Variable EBIT allowance	6 dp	No	4 dp consistency required

Our view is that for intermediate steps rounding is not recommended. Therefore for cost of capital neither either within final result rounding is required. However, if deemed necessary, 6 decimal places would be appropriate.

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.

At a high level we agree with Ofgem's approach not to schedule periodic reviews but to consider changes in operating conditions such as significant changes in market conditions or policy changes or to the structure or number of suppliers operating in the market. However, in the near term, there are strong linkages between the EBIT allowance and the operating cost review. We believe that if significant changes are made as a result of that review, for example to the level of fixed assets, it may require changes to the EBIT allowance but a review may not be triggered. As such, we propose that as part of a minded to decision on operating cost allowance, Ofgem consults on whether changes should trigger a limited review of the inputs to EBIT calculation.

ScottishPower
June 2023