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Consumer Champion for the Over-50s

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Dear Marzia,

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

Please see below my response to the latest consultation on amending the methodology for setting the EBIT allowance.

I would like to highlight that we oppose this vast increase to supplier profits and find it worrying that Ofgem would suggest not periodically reviewing this methodology after increasing profits for suppliers. Since 2020, the average consumer in the UK has seen their energy bills more than double whilst the remaining energy suppliers in the industry have seen profit levels triple in some cases.

As the regulatory body charged with protecting energy consumer interests, I would expect Ofgem to see the apparent flaws in increasing energy supplier profits further during an energy crisis.

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

No, not for the reasons given by Ofgem. The EBIT formula does need to change but in a way that reduces supplier profits, especially during a time of increasing costs where we are currently seeing massive supplier profits while we struggle to heat our homes. I counter your justifications from section 3 of the latest EBIT consultation document with the points below.

There is no evidence that improved EBIT will result in "better quality of services", in fact the opposite is true, in that customer service standards have significantly dropped over the last two years whilst suppliers like British Gas and Shell Energy have published record levels of profit for 2022.

Ofgem have stated that the previous target of 1.9% profit margin was not being attained by many suppliers and some were even making a loss. Whilst there is no refuting this, I would like to know if the following has been taken into consideration:

- Ofgem have already increased many other allowances in the price cap to counteract a miscalculation in costs to suppliers. This means that those costs will now be adequately covered and suppliers will get more profit without a change to the EBIT allowance. Many other reviews of allowances in the price cap are also scheduled in Ofgem's Programme of Work
- Prior to the crisis 50% of the UK were on cheap fixed rate tariffs, which were loss making for many energy suppliers but those prices were set by the suppliers themselves. This means any claim by suppliers of insufficient profit levels pre-crisis should be ignored as this was, at

least in part, of their own making. Today around 95% of UK households are on Standard Variable Tariffs rather than fixed rates.

The proposed £19.20 fixed element is extremely high. Consumers will only begin to see a financial benefit of this new proposed formula if the price cap rises to over £4,000 in the future, which is very unlikely and not really helpful at all.

Using the "protecting consumers from excessive costs of failure" excuse is misleading to consumers. For clarity, the excessive supplier failures at the end of 2021 and beginning of 2022 cost the consumer around £1.8bn, which sounds big but is actually around £0.20 per month per household for each failed supplier (0.20*30 failed suppliers *12 months *25 million homes paying the cost = £1.8bn). This 20p per month cost to us has been used to justify:

- Huge backwardation allowances
- Increases in additional wholesale cost allowances
- Changing to a quarterly price cap at a time when energy prices were increasing
- The extension of the market stabilisation charge which has killed off competition now energy prices are falling
- 3 separate increases to standing charges over the last 12 months
- Currently being used to justify changing operational allowances

We would appreciate if "protecting consumers from excessive costs of failure" would stop being used as an excuse to increase the cost of energy to consumers.

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

Yes.

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

No, I do not agree with a higher cost of capital to "provide an additional buffer" for energy suppliers, as stated in paragraph 4.50.

Ofgem have used a "mid point" for most calculations in this proposed reformulation however for the capital employed you're using the "highest average amount of collateral posted" (as per paragraph 4.64). A mean average of the average capital employed should be used to ensure this is kept fair for the consumer and bring down this figure to remove unnecessary buffers for the energy suppliers.

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

No response.

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

N/A

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

No, the CEPA report published in August 2022 suggested a fair asset beta range of 0.7 to 0.8, Ofgem should not be swayed to increase this to a range of 1.0 to 1.2 by energy suppliers looking to increase profit margins.

In response to the report commissioned by an energy supplier, I'd like to highlight that the energy sector is not comparable to the airline industry as the airline industry is a luxury product afforded by those with spare disposable income, whereas the energy industry is an essential service delivered to every household in the UK and depended on by people to live! I would argue people are more likely to forego a holiday than they are to forego heating the home their kids sleep in.

Additionally, the aim here is to set a cap for an independent, non-vertically integrated supplier, such as those you have asset beta data for whose ranges did not exceed the existing 0.7-0.8 range. Suppliers arguing that risks are higher in their circumstances should have little weighting if those making the arguments are not representative of an independent, non-vertically integrated supplier. **As you state in paragraph 5.115 "listed suppliers are vertically integrated and therefore offer limited insight on the likely beta of a non-vertically integrated supplier" if their insight is limited then it should carry little-to-no weighting.**

Paragraph 5.135 states "… a beta between 1.0 and 1.2 can be justified while current market and regulatory conditions continue" which to me indicates that there is no justification for this beta range as the programme of work set out by Ofgem shows the huge change in regulatory conditions of the cap in the coming months and years, mostly designed at providing a "fairer" cap for energy suppliers and the "market conditions" just moved us from a price cap of over £4,200 to a cap of over £2,000, meaning prices have halved in the last 6 months, showing that the market is stabilizing and returning to more normal levels.

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

No, as per my answer to question 3, I think collateral capital should be scaled down to a mean average rather than a highest average, which in turn would result in a reduced ROCE.

Additionally, CEPA recommended an asset beta of 0.7-0.8, I think this is the fairest asset beta range to implement in the EBIT allowance. Employing the mid-point asset beta of 0.75 would bring the ROCE down to £37.43 (without the collateral capital being reduced, however this number would be marginally lower if the collateral capital comes down to a more reasonable level) made up of a £15.38 fixed element and a 1.14% scalar.

For cap period 11a, the formula created using the lower asset beta range would result in an EBIT figure that is roughly equal to the current formula but has the benefit of giving energy suppliers reduced profits if the price cap is over £2,000 (compared to the current formula), therefore protecting consumers in times of a crisis, and increased profits if the price cap is below this figure.

Changing the asset beta back to the CEPA recommended range offers a far better outcome for consumers and reducing the collateral capital to a mean average would provide a fairness to consumers that is being missed in this particular instance.

I also do not agree with splitting the profit figures across standing charges and usage charges, profit should be earned on the sale of the product i.e. gas or electric sales, it shouldn't be forced upon people with low or no usage. There have already been 3 increases to the standing charges over the last 12 months, making it near impossible for low usage households to reduce the cost of their energy bills, a further increase would be further penalising low usage, typically low income, households.

***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.***

No, it seems odd that Ofgem would use phrases like "this is fair considering current market conditions" and then propose not offering regular reviews of the EBIT methodology for when market conditions settle. A further review of the EBIT formula should be scheduled once every 3 years as market conditions and regulatory procedures change frequently. This also ensures that factors that are put in place due to current high risks are reviewed regularly if risks should change.

Thank you for taking the time to consider my answers to your consultation, please understand that any increase in the profit margins given to energy suppliers will result in a negative outcome for consumers, not a positive one. We trust Ofgem to do the right thing for all consumers.

Kind regards,

**Richard Winstone**
**Director**
**Over50smoney**