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Default Tariff Cap: Policy Consultation Appendix 9 - EBIT

Consultation - supplementary appendix

Publication date: 25 May

Response deadline: 25 June 12.30pm

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Overview:

The energy market works well for consumers who shop around. Suppliers compete for these engaged consumers, offering low prices to gain or retain their custom.

But the retail energy market is not working for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be.

To address this problem, Government has introduced legislation into Parliament which would require Ofgem to design and put in place a temporary cap on all standard variable tariffs and fixed-term default tariffs. We anticipate that Parliament will approve the Domestic Gas and Electricity (Tariff Cap) Bill in the summer, and the default tariff cap will come into force at the end of 2018.

We are now consulting on how we might design and implement the default tariff cap. This supplementary appendix to the main consultation document sets out our proposals in relation to the pre-tax margin (Earnings Before Interest and Tax, or EBIT) included in the cap design. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the main consultation document.

Associated documents

Policy consultation for Default Tariff Cap – Overview
https://ofgem.gov.uk/system/files/docs/2018/05/default_tariff_cap_-_policy_consultation_-_overview.pdf

Links to supplementary appendices

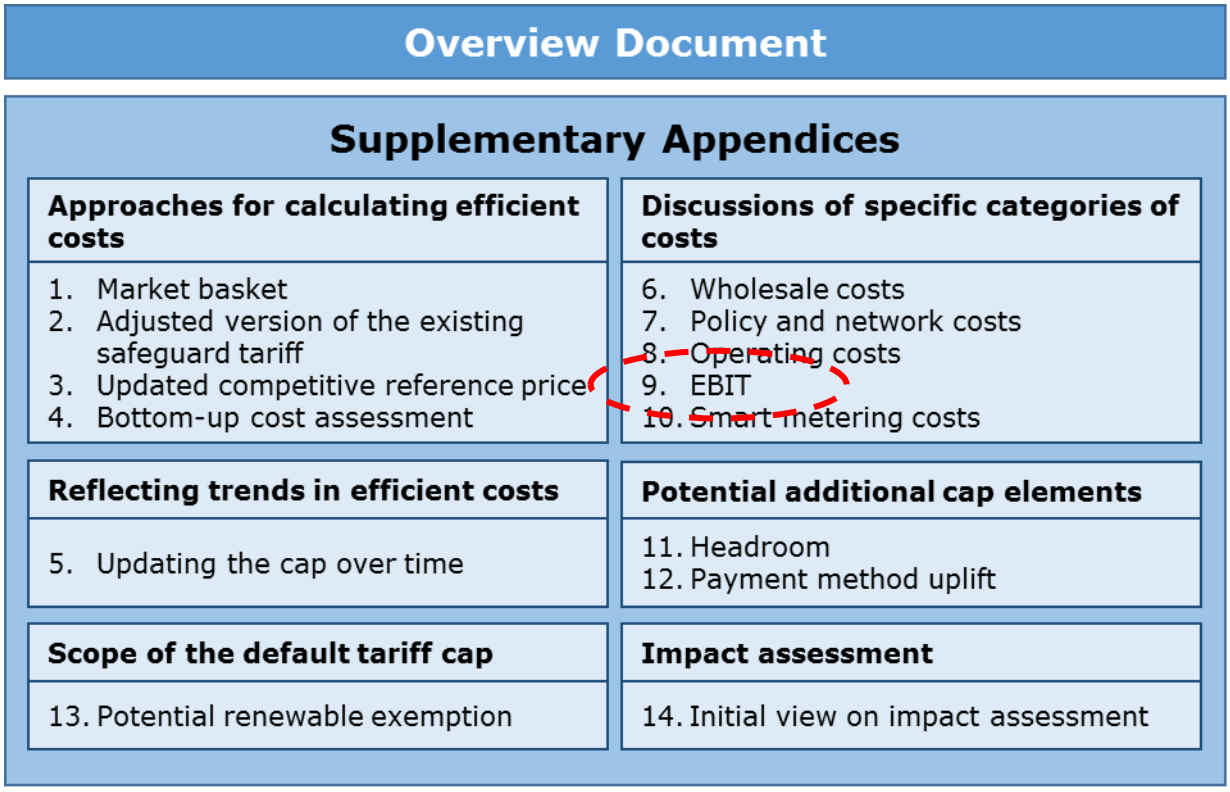
- Appendix 1 - Market basket: https://ofgem.gov.uk/system/files/docs/2018/05/appendix_1_-_market_basket.pdf
- Appendix 2 - Adjusted version of the existing safeguard tariff https://ofgem.gov.uk/system/files/docs/2018/05/appendix_2_-_adjusted_version_of_the_existing_safeguard_tariff.pdf
- Appendix 3 – Updated competitive reference price https://ofgem.gov.uk/system/files/docs/2018/05/appendix_3_-_updated_competitive_reference_price.pdf
- Appendix 4 – Bottom-up cost assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_4_-_bottom-up_cost_assessment.pdf
- Appendix 5 – Updating the cap over time https://ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf
- Appendix 6 – Wholesale costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_6_-_wholesale_costs.pdf
- Appendix 7 – Policy and network costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_7_-_policy_and_network_costs.pdf
- Appendix 8 – Operating costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_8_-_operating_costs.pdf
- Appendix 9 – EBIT https://ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_EBIT.pdf
- Appendix 10 – Smart metering costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_10_-_smart_metering_costs.pdf
- Appendix 11 – Headroom https://ofgem.gov.uk/system/files/docs/2018/05/appendix_11_-_headroom.pdf
- Appendix 12 – Payment method uplift https://ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf
- Appendix 13 – Renewable tariff exemption https://ofgem.gov.uk/system/files/docs/2018/05/appendix_13_-_renewable_tariff_exemption.pdf
- Appendix 14 – Initial view on impact assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_14_-_initial_view_on_impact_assessment.pdf

Document map

This supplementary appendix to the main overview document set out our proposals for the pre-tax margin (Earnings Before Interest and Tax, or EBIT) included in the cap design.

Figure 1 below provides a map of the default tariff cap documents published as part of this consultation.

Figure 1: Default tariff cap – policy consultation document map



Links to these documents can be found in the 'Associated documents' section of this document

Contents

1. Introduction

We explain the approach taken by the CMA to setting the pre-tax margin included in its prepayment safeguard tariff.

1.1. Any price cap needs to allow an efficient supplier to make a normal rate of return. This return on capital is part of the economic cost base of a supplier. This is distinct from the question of whether or not we allow headroom, which we discuss in Appendix 11. In allowing an efficient supplier to make a normal rate of return, we are having regard to the matters set out in the Domestic Gas and Electricity (Tariff Cap) Bill – in particular "the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence".

1.2. The Competition and Markets Authority's (CMA) prepayment safeguard tariff methodology included an Earnings Before Interest and Tax (EBIT) margin of 1.25%. This was determined based on its analysis of the sector profitability as part of its market investigation.[1]

1.3. The CMA used a Return on Capital Employed (ROCE) approach for its profitability analysis. This took into account the CMA's estimates of:

- the Weighted Average Cost of Capital (WACC) for a typical supplier of 10% (pre-tax, nominal); and
- the amount of capital required for a supplier using an intermediary trading arrangement. This reduces the amount of capital required relative to a supplier carrying out trading activities itself.

1.4. To receive the required return on capital, a supplier would need to make a certain pre-tax margin (EBIT). The CMA expressed its result as a percentage of revenue – ie an EBIT margin of 1.25%. The WACC and the EBIT margin are therefore different concepts – the WACC is the cost of a unit of capital, whereas the EBIT margin also depends on the amount of capital.

1.5. The CMA considered that a supplier that was carrying out trading activities itself (ie not using an intermediary) would require more capital. This would lead to a higher EBIT margin. The CMA estimated that the required EBIT margin would be just over 1.9% for a supplier that was not using an intermediary.[2] The CMA did not use

[1] CMA (2016), Energy Market Investigation - final report, paragraph 10.29. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf
[2] CMA (2016), Energy Market Investigation – final report. Appendix 9.10, paragraph 159. https://assets.publishing.service.gov.uk/media/576bcc23ed915d3cfd0000bb/appendix-9-10-analysis-of-retail-supply-profitability-roce-fr.pdf

this figure as part of its prepayment safeguard tariff methodology, because Ovo and First Utility (the benchmark suppliers) were using intermediary arrangements.[3]

1.6. Based on information published through the Consolidated Segmental Statements, in 2016, the six largest suppliers made £1.0bn profit from domestic consumers, an EBIT margin of 4.5%.[4] If their profits had been in line with the CMA's suggested margin (1.25%) then profits would have been £0.3bn. Their additional profit should not be confused with the CMA's estimate of detriment (£1.4bn on average over 2012 to 2015).[5] That estimate of detriment combined profits that are higher than would be expected in a competitive market, and operating costs that were higher than the CMA would expect if suppliers were efficient.

[3] CMA (2016), Energy Market Investigation - final report, paragraph 10.29 and footnote 7. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf
[4] Ofgem (2017), State of the energy market 2017 report, p29.
[5] CMA (2016), Energy Market Investigation – final report, paragraph 194. https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf

2. Our proposed approach for setting the cap

We set out our proposal to use one of the figures calculated by the CMA, and explain which figure would apply under each of our methodologies for setting the default tariff cap.

Overview

2.1. **We propose using one of the figures calculated by the CMA** when setting the EBIT margin for the default tariff cap, depending on which approach we use for setting efficient costs.[6] We would use a 1.9% EBIT margin for a bottom up cost assessment; for the adjusted version of the existing safeguard tariff we would use 1.25% and for updated reference price we will set the margin according to which suppliers are in the sample.

2.2. The CMA's profitability analysis was a key part of its in-depth market investigation. This reflected the CMA's expertise in this area. In our decision to refer the market to the CMA, profitability was one of the issues which we said the CMA was well-placed to investigate given its experience of competition in other sectors.[7] The CMA's analysis was developed over two years, and involved three rounds of opportunities for stakeholders to comment.[8]

2.3. Alternatively, we could calculate our own estimate of a supplier's normal rate of return. To do this, we would need to do an equally significant amount of work as the CMA, over a similar period of time – and this would not guarantee a figure that improves on the CMA's work. We do not consider that the time required for this approach would be proportionate for a temporary cap.

[6] We welcome views on all the points raised in the paper and for stylistic reasons we do not necessarily state this each time a particular point is discussed.
[7] Ofgem (2014), Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain, paragraph 2.17. https://www.ofgem.gov.uk/sites/default/files/docs/2014/06/state_of_the_market_-_decision_document_in_ofgem_template.pdf
[8] The CMA issued a working paper on the cost of capital in February 2015. (https://assets.publishing.service.gov.uk/media/54edfe9340f0b6142a000001/Cost_of_capital.pdf). Its provisional findings in July 2015 then included appendices on retail supply profitability (appendix 10.3, https://assets.digital.cabinet-office.gov.uk/media/559fb6bee5274a155900002d/Appendix_10.3_Retail_return_on_capital_employed.pdf) and the cost of capital (appendix 10.4, https://assets.digital.cabinet-office.gov.uk/media/559fb6ce40f0b61567000049/Appendix_10.4_The_cost_of_capital.pdf). The CMA's provisional decision on remedies in March 2016 included an appendix on retail supply profitability (appendix 3.4, https://assets.publishing.service.gov.uk/media/56ebdf12e5274a14d7000006/appendix-3-4-analysis-of-retail-supply-profitability-roce.pdf).

2.4. The CMA's analysis is relatively recent (it published its final report in June 2016), and we have not identified any developments which would suggest that a materially different approach could be required.

2.5. Our choice of EBIT margin (1.25% or 1.9%) is likely to depend on which option we choose for selecting the initial benchmark, and whether this reflects the use of an intermediary trading arrangement.

Approach for bottom-up cost assessment

2.6. If we set the benchmark using a bottom-up cost assessment approach, we would not intend to make explicit provision for the costs of an intermediary trading arrangement. In this case, we would therefore apply a 1.9% EBIT margin, to reflect the capital required by a supplier who was not using an intermediary.

Approach for reference price approaches

2.7. If we used the adjusted version of the existing safeguard tariff method, we would continue to use the same 1.25% EBIT margin figure as the CMA. This would be because the benchmark would be made up of suppliers who were using an intermediary trading arrangement when the benchmark was defined.

2.8. If we used an updated competitive reference price, for each supplier included in our analysis, we would use the margin figure which corresponded to their own trading arrangements. For suppliers who were using an intermediary trading arrangement, we would adjust their prices so that they were making a 1.25% EBIT margin. For suppliers who were not using an intermediary trading arrangement, we would use a 1.9% EBIT margin.

QA9.1 Do you agree with our proposed approach to setting the EBIT margin?

3. Key judgements

This chapter examines the appropriateness of a Return on Capital Employed (ROCE) approach for measuring suppliers' profitability, and within this approach, there are then judgements about the cost of capital (WACC), and the amount of capital required.

Issue 1: ROCE approach to measuring profitability

Issue

3.1. The CMA selected a ROCE approach to measuring profitability. As noted by the CMA, the return on capital has a clear economic interpretation.[9] However, this approach depends on being able to develop an estimate of the capital employed. Referring to its guidelines, the CMA said that: "in situations where capital employed cannot be reliably valued, we may consider alternative measures, such as the return on sales or other relevant financial ratios".[10]

3.2. Relative to other types of energy businesses (e.g. electricity generators), suppliers need relatively small amounts of capital. It may also be harder to value the capital employed, given that supply businesses have relatively few tangible assets. Suppliers have told us that ROCE is an inappropriate methodology for an asset-light industry. The question is therefore whether ROCE is appropriate.

Options considered

1. Option 1: Continue using ROCE to measure profitability.

2. Option 2: Rely on alternative measure, such as profit margins.

Our minded-to position

3.3. We propose to maintain the ROCE approach used by the CMA to measure retail profitability (option 1).

[9] CMA (2016), Energy market investigation – final report. Appendix 9.9, paragraph 23. https://assets.publishing.service.gov.uk/media/576bcc14e5274a0da9000080/appendix-9-9-approach-to-profitability-fr.pdf
[10] CMA (2016), Energy market investigation – final report. Appendix 9.9, paragraph 23. https://assets.publishing.service.gov.uk/media/576bcc14e5274a0da9000080/appendix-9-9-approach-to-profitability-fr.pdf

Rationale and analysis

3.4. From an economic perspective, ROCE has a strong theoretical justification as an analytical approach. It is still coherent to look at the return on capital employed, regardless of the level of capital in a business. The theoretical basis is a particular advantage of ROCE over alternative approaches such as margins. While margins may be more commonly used by suppliers as a way of measuring their performance, it is harder to use them to determine a normal rate of return.

3.5. In the context of energy supply, where suppliers have few tangible assets, significant adjustments need to be made to the capital employed. For example, one adjustment recognises the difference between accounting and economic capital values in relation to the value of customer relationships. As well as requiring judgement, alterations to the capital employed are also dependent on the quality of the data.

3.6. In our view, this does not invalidate ROCE as an approach – though it does increase the importance of the capital assessment. The CMA spent significant time making those adjustments and consulting on them. Combined with the theoretical benefits of ROCE, this increases our level of confidence in using the CMA's ROCE analysis. We discuss the assessment of capital under issue 3 below.

3.7. We recognise that any ROCE approach in energy supply will involve an element of judgement, but this is also true of alternative approaches (option 2). For example, benchmarking profit margins (Return on Sales) requires judgements about the risks that different companies would face, and therefore the capital that they would require. We would still therefore need to make many of the same judgements. This would apply whether we were comparing different energy suppliers (e.g. in different countries) or companies in different industries.

Issue 2: WACC

Issue

3.8. Under a ROCE approach, we need an estimate of the WACC. While suppliers provided comments on the details of the CMA's approach during its market investigation, the WACC estimate has not been the focus of their recent concerns. The question is therefore whether there have been developments since the CMA's investigation that would make its WACC estimate inaccurate.

Options considered

1. Option 1: Retain the WACC figure used by the CMA (10% pre-tax nominal).

2. Option 2: Calculate our own updated estimate of the WACC.

Our minded-to position

3.9. We propose to adopt option 1, and retain the same WACC figure used by the CMA (10% pre-tax nominal).

Rationale and analysis

3.10. We have identified a couple of reasons why the CMA's WACC figure may now be an overestimate.

3.11. First, the CMA concluded that the nominal risk-free rate was 4%.[11] Market interest rates have continued to fall – this has been illustrated, for example, by work as part of the next RIIO price control.[12] If we decided to be consistent with the RIIO analysis, this would lead to a lower risk-free rate, which would reduce the WACC.

3.12. Second, the rate of corporation tax has fallen over time. The CMA's calculation assumed a corporation tax rate of 27% - this was based on the average rate between 2006/7 and 2013/4.[13] The current corporation tax rate is 19%.[14] A lower corporation tax rate would reduce the value of the pre-tax WACC.

3.13. However, we are not minded to change the CMA's parameters in a piecemeal way, as this would reduce the internal consistency of its approach. If we were updating the WACC, we would need to consider the full range of input parameters. We would also be cautious about updating the WACC but not the estimate of the amount of capital required.

QA9.2 Do you agree that it is acceptable to retain the WACC figure used by the CMA? If not, do you have views on the factors we would need to consider if we were updating the WACC?

[11] CMA (2016), Energy market investigation – final report. Appendix 9.12, paragraph 21. https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf
[12] Ofgem (2018), RIIO-2 framework consultation, figure 5. https://www.ofgem.gov.uk/system/files/docs/2018/03/riio2_march_consultation_document_final_v1.pdf This shows the trend in real rates over time.
[13] CMA (2016), Energy market investigation – final report. Appendix 9.12, paragraph 44. https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf
[14] HMRC, Rates and allowances: corporation tax. https://www.gov.uk/government/publications/rates-and-allowances-corporation-tax/rates-and-allowances-corporation-tax

Issue 3: Amount of capital

Issue

3.14. Under a ROCE approach, we also need an estimate of the amount of capital employed. Determining this involves a number of decisions, including around: whether a supplier buys wholesale energy itself or through an intermediary, the approach to measuring working capital and the approach to measuring risk capital. These decisions accounted for the largest section of comments from stakeholders on the CMA's approach.

Options considered

1. Option 1: Maintain the capital estimates used by the CMA.

2. Option 2: Carry out our own estimates of the capital employed.

Our minded-to position

3.15. We propose to maintain the CMA's estimates of the capital employed (option 1).

Rationale and analysis

3.16. As discussed above, the CMA carried out an in-depth review of profitability as part of its market investigation. While we accept that judgements are inherent for this approach, we have no reason to believe that we would necessarily be able to develop a more robust answer for the amount of capital employed than the CMA.

3.17. We have also not identified factors which would appear to have materially changed the amount of capital required since the CMA's investigation. In particular, there are several elements of supplier's capital bases where we cannot identify a reason why these would have changed on average – these include tangible fixed assets, billing systems, and the value of customer relationships. Other elements of the capital base may have fluctuated in line with prices (eg Renewable Obligation Certificates, or the effect of wholesale prices on working capital), but we do not consider that these changes are likely to have been material.

3.18. We therefore do not consider that it would be proportionate to develop our own estimate, given that this is a temporary cap.

QA9.3 Do you agree that we should maintain the CMA's estimates of the capital employed by energy suppliers? If not, please specify which element you think we would need to revalue.

4. Updating the cap

In this chapter we discuss how the profit level included in the initial level of the default tariff cap will be updated over time.

4.1. Under the prepayment safeguard tariff methodology, the EBIT margin is included as part of the other costs category. This is indexed in line with inflation (using the Consumer Prices Index).

4.2. This approach has the advantage of simplicity. Given the size of the EBIT margin, even if we indexed it in a different way, the absolute impact on the level of the default tariff cap would be small.

4.3. An alternative approach would be to develop a process for updating the EBIT margin over time in line with factors which could affect it. For example, if wholesale costs increased, then this could increase the amount of capital required as collateral. This could help to identify any major trends affecting the cost of capital or the amount of capital required. However, this would be significantly more complex. Furthermore, any approach to try and update some, but not all, inputs to the CMA's analysis could introduce distortions. We therefore do not consider that taking this approach would be likely to improve the accuracy of the cap in practice. We also do not consider that this would be proportionate for a temporary cap.

4.4. We are therefore minded to update the EBIT margin in the same way as operating costs (ie inflated using the Consumer Prices Index including owner occupiers' housing costs (CPIH) as set out in Appendix 5).

QA9.4 Do you agree with our proposed approach to updating the EBIT margin?

5. Responses to stakeholder feedback

Provided below is a summary of the responses to our working papers in relation to EBIT and any additional stakeholder feedback received to date.

5.1. This chapter summarises the key stakeholder feedback we have received and which we have not covered in the previous sections.

5.2. One supplier told us that the CMA's calculation was not reliable and at odds with other evidence on competitive margins in retail energy businesses. In a later submission, it referred to a number of sources, including regulated supply margins in other countries and benchmarking analysis in other sectors. Another supplier said that it was "entirely incongruous" that the CMA's EBIT margin for a supplier carrying out trading activities itself (ie 1.9%) was below the regulated margin in Northern Ireland (which was 2.2% when the CMA published its final report). It also referred to analysis it presented to the CMA suggesting that EBIT margins should be compared between different sectors by focusing on asset light companies with a relatively low level of capital intensity. As mentioned in paragraph 3.7, benchmarking profit margins (Return on Sales) requires judgements about the risks that different companies would face, and therefore the capital that they would require. We would still therefore need to make many of the same judgements as under a ROCE approach. While we would be happy to consider further evidence about suitable comparators to use as a sense check, we therefore do not consider that such information is determinative in and of itself. We also note the theoretical advantages of a ROCE approach, and the fact that the CMA's in-depth review was focused on this particular market.

5.3. A supplier said that the benchmark should take into account peak working capital requirements, rather than average working capital. It also argued that additional capital would be required to cover unusual market events. We note that the CMA considered this point, and concluded (with reference to evidence from the USA) that a standalone supplier would have access to a credit facility. We would expect an efficient supplier to find the most cost-effective way of managing its risks, rather than simply relying on retaining large amounts of expensive equity.

5.4. Suppliers have questioned whether an intermediary approach would be scalable. One supplier said that the cost of an intermediary arrangement would be higher for a larger supplier. A supplier said that the CMA's approach was based on "a wholly artificial construct of an imagined efficient supplier". In response, we note that mid-tier suppliers are able to use intermediary trading arrangements, and it is not clear why this approach would become infeasible for larger suppliers.

5.5. A supplier said that the CMA made incorrect assumptions about the costs to a standalone supplier of using letters of credit to cover regulatory capital requirements. We note that the CMA has already considered a range of submissions and evidence in

this area.[15] While we accept that the cost was an approximation, developed based on the evidence available to the CMA, we do not consider that we would be in a position to refine this answer.

[15] CMA (2016), Energy market investigation – final report. Appendix 9.10, paragraphs 137 to 141. https://assets.publishing.service.gov.uk/media/576bcc23ed915d3cfd0000bb/appendix-9-10-analysis-of-retail-supply-profitability-roce-fr.pdf

6. Consultation response and questions

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can. The full list of consultation questions is available in Chapter 7 of the main consultation document.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

Chapter 2 - Our proposed approach for setting the cap
Question A9.1: Do you agree with our proposed approach to setting the EBIT margin?

Chapter 3 – Key judgements
Question A9.2: Do you agree that it is acceptable to retain the WACC figure used by the CMA? If not, do you have views on the factors we would need to consider if we were updating the WACC?

Question A9.3: Do you agree that we should maintain the CMA's estimates of the capital employed by energy suppliers? If not, please specify which element you think we would need to revalue.

Chapter 4 – Updating the cap
Question A9.4: Do you agree with our proposed approach to updating the EBIT margin?