

# Consultation Appendix

## Default Tariff Cap: Statutory Consultation

### Appendix 9 – EBIT

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We are consulting on our proposals for setting and updating a default tariff cap in accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018. This supplementary appendix provides details of the proposals and methodology in relation to an allowance for Earnings Before Interest and Tax (EBIT). 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 Default tariff cap – Overview document.

We welcome views from stakeholders on all of our proposals set out within this document. Please see the Default tariff cap – Overview document for instructions on how to respond to the consultation.

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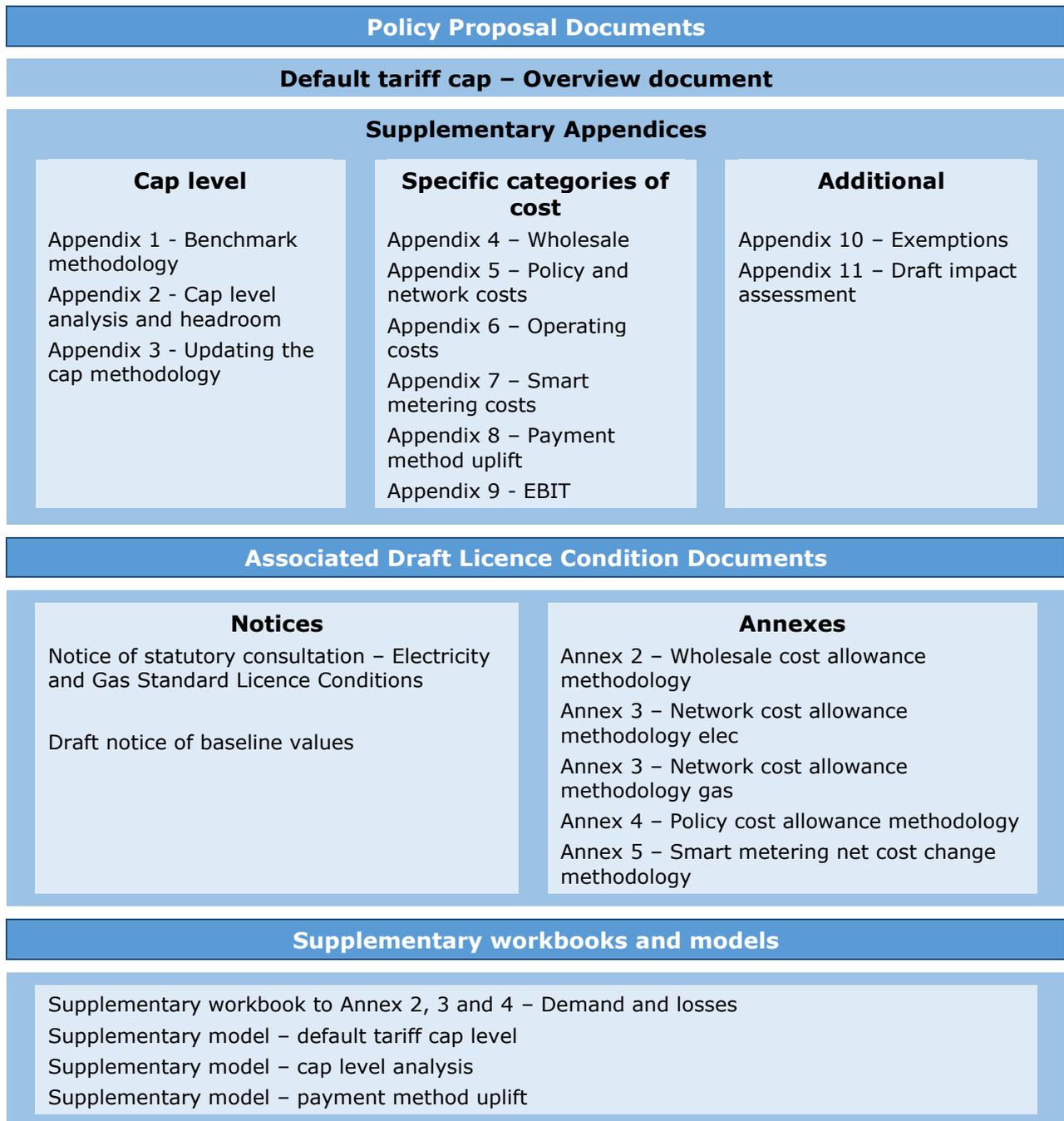
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## Document map

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

**Figure 1: Default tariff cap – statutory consultation document map**



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## 1. Introduction

### Overview

- 1.1. A price cap should allow an efficient supplier to make a return on the capital it uses in its business. This return on capital is part of the economic cost base of a supplier.
- 1.2. As part of designing the default tariff cap, we have sought to calculate the costs of an efficient supplier. We refer to this as the efficient benchmark. One element of the efficient benchmark is our estimate for the amount required to deliver a normal rate of return for an efficient supplier. (The normal rate of return is a standard economic concept, reflecting the minimum profit that providers of capital require given the risks involved and the amount of capital employed).
- 1.3. In reaching our proposed decision, we have taken into account feedback in response to our working paper on setting the level of the cap<sup>1</sup> and May consultation<sup>2</sup>. We have also taken into account the objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018 and the matters to which we must have regard. In summary:
  - We are protecting existing and future domestic customers who pay standard variable and default rates by ensuring that our estimate of the efficient benchmark does not deliver excess profits through the return on capital.
  - We have had regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence, by including an Earnings Before Interest and Tax (EBIT) margin, and by basing this on the extensive analysis carried out by the Competition and Markets Authority (CMA).
  - We do not consider that the other matters to which we must have regard are relevant to this specific appendix.

### Methodology (Chapter 2)

- 1.4. Our proposed decision is that we will use the EBIT margin analysis calculated by the CMA as part of its energy market investigation. This maintains the position we set out in our May consultation.<sup>3</sup>

### Baseline value (Chapter 3)

- 1.5. In line with our proposed decision to maintain the CMA's EBIT margin figures, we are implicitly proposing to maintain the CMA's use of a Return on Capital Employed (ROCE) approach, and its estimates of the Weighted Average Cost of Capital (WACC) and of

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<sup>1</sup> Ofgem (2018), Default tariff cap working paper – setting the level of the cap. [https://www.ofgem.gov.uk/system/files/docs/2018/03/working\\_paper\\_1\\_-\\_design\\_issues\\_-\\_for\\_publication.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/03/working_paper_1_-_design_issues_-_for_publication.pdf)

<sup>2</sup> Default tariff cap: policy consultation May 2018 <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-policy-consultation-overview>

<sup>3</sup> Ofgem (2018), Default tariff cap: policy consultation. Appendix 9 – EBIT. [https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix\\_9\\_-\\_ebit.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_ebit.pdf)

the capital required by suppliers. This maintains the position we set out in our May consultation.

- 1.6. We are proposing to set the efficient benchmark using a bottom-up cost assessment. In light of this, we would use the 1.9% EBIT margin calculated by the CMA for a supplier who is carrying out trading activities itself. This reflects that our bottom-up cost assessment does not include a fee for an intermediary to carry out trading activities on behalf of the supplier. Such a company would have a higher working capital requirement than a supplier using an intermediary, increasing its amount of capital employed.

#### **Updating the cap (Chapter 4)**

- 1.7. Our proposed decision is that we will apply the EBIT margin each time we update the cap. This means that the change in EBIT will be 1.9% of the change in wholesale costs, policy costs, operating costs and the payment method adjustment. This is a change in our position from the May consultation, where we said that we would update the EBIT margin component alongside operating costs. It reflects that we are now proposing to use a bottom-up cost assessment to set the default tariff cap, as well as feedback from stakeholders.

### **Context and related publications**

- 1.8. The CMA's prepayment meter cap methodology included an EBIT margin of 1.25%. This was determined based on its analysis of the sector profitability as part of its market investigation.<sup>4</sup>
- 1.9. The CMA used a ROCE approach for its profitability analysis. This took into account the CMA's estimates of:
  - the 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.
- 1.10. To cover its WACC, a supplier would need to make enough pre-tax profit (EBIT). The CMA expressed this required return on capital 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 is the return a supplier makes as a percentage of its revenue, which needs to be sufficient to cover its WACC.
- 1.11. 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 it to require a higher EBIT margin. The CMA estimated that the required EBIT margin would be just

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<sup>4</sup> CMA (2016), Energy Market Investigation - final report, paragraph 10.29.  
<https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

over 1.9% for a supplier that was not using an intermediary.<sup>5</sup> The CMA did not use this figure as part of its prepayment safeguard tariff methodology, because Ovo and First Utility (the benchmark suppliers) were using intermediary arrangements.<sup>6</sup>

- 1.12. 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%.<sup>7</sup> If their profits had been in line with the 1.9% margin for suppliers who carry out trading themselves then profits would have been £0.4bn. Their additional profit should not be confused with the CMA’s estimate of detriment (£1.4bn on average over 2012 to 2015).<sup>8</sup> That estimate of detriment combined profits that are higher than would be expected in a competitive market, and costs that were higher than the CMA’s benchmark suppliers.

### **Related publications**

- 1.13. Ofgem (2018), Default tariff cap working paper – setting the level of the cap.  
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-setting-level-cap>
- 1.14. Ofgem (2018), Default Tariff Cap: Policy Consultation. Appendix 9 – EBIT.  
[https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix\\_9\\_-\\_ebit.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_ebit.pdf)

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<sup>5</sup> 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>

<sup>6</sup> 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>

<sup>7</sup> Ofgem (2017), State of the energy market 2017 report, p29.  
[https://www.ofgem.gov.uk/system/files/docs/2017/10/state\\_of\\_the\\_market\\_report\\_2017\\_web\\_1.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf)

<sup>8</sup> CMA (2016), Energy Market Investigation – final report, paragraph 194.  
<https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

## 2. Methodology

### Overall approach

#### Proposed decision

- 2.1. Our proposed decision is that we would use the EBIT margin figures calculated by the CMA as part of its energy market investigation.
- 2.2. We are proposing to set the efficient benchmark using a bottom-up cost assessment (see Appendix 1 – Benchmark methodology). In light of this, we would use the 1.9% EBIT margin calculated by the CMA for a supplier who is carrying out trading activities itself. This reflects that our bottom-up cost assessment does not include a fee for an intermediary to carry out trading activities on behalf of the supplier.

#### What we consulted on

- 2.3. In our May consultation, we said that we could use the CMA's figures or carry out our own estimate of a normal rate of return. We proposed to use one of the CMA's EBIT margin figures – the relevant figure would depend on which methodology we used to set the efficient benchmark.

#### Stakeholder feedback

- 2.4. We cover the bulk of the feedback from stakeholders in the next chapter – the paragraphs below cover general points which do not fit under specific issues.
- 2.5. One consumer group supported our use of the profit figures from the CMA's energy market investigation.
- 2.6. One supplier agreed with our proposed approach to setting the EBIT margin.
- 2.7. Several suppliers referred to the impact of the EBIT margin on new suppliers. For example, one supplier said that new suppliers would incur losses in the short term which they would not be able to recover in the long-term under our proposed EBIT margin.
- 2.8. **Our response:** If a supplier is able to enter the market and become more efficient than the benchmark selected, this would allow it to make a higher EBIT margin in practice. Even if an entrant supplier is not more efficient than the benchmark, it may also be able to make a higher EBIT margin if it attracts customers who are less costly to serve than the level included in our efficient benchmark.
- 2.9. A supplier may have costs of entry (eg losses made when it was below an efficient scale). However, once it is at scale, even small additional returns on a larger customer base should be sufficient to recover losses on a smaller customer base. We do not consider that allowing excess returns to subsidise entry would fulfil the objective in the

Act of “protecting existing and future domestic customers who pay standard variable and default rates”.<sup>9</sup>

### **Rationale for proposed decision**

- 2.10. As we explained in our May consultation, 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.<sup>10</sup> The CMA’s analysis was developed over two years, and involved three rounds of opportunities for stakeholders to comment.<sup>11</sup>
- 2.11. The CMA’s analysis was 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.
- 2.12. To calculate our own estimate of a supplier’s normal rate of return, 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 delay to customer protection that would be required for this approach would be proportionate for a temporary cap. We note that the Act requires us to implement the default tariff cap “as soon as practicable after this Act is passed”.<sup>12</sup>

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<sup>9</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6).

<sup>10</sup> 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](https://www.ofgem.gov.uk/sites/default/files/docs/2014/06/state_of_the_market_-_decision_document_in_ofgem_template.pdf)

<sup>11</sup> 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](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](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](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>).

<sup>12</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(1).

### 3. Setting the baseline value

We explain our proposed decisions that lead to our proposed decision on EBIT. These are the proposed decisions on: ROCE, WACC, and the amount of capital.

## Return on Capital Employed

### Proposed decision

- 3.1. Our proposed decision is to use the CMA's EBIT margin figures, which it calculated using a ROCE approach. (Specifically, we propose to use the 1.9% EBIT margin figure for a supplier carrying out trading itself). The CMA analysed companies' capital employed and made adjustments to accommodate differences in accounting treatments and intangible assets.

### What we consulted on

- 3.2. We consulted on two options: continuing to use ROCE to measure profitability, or relying on an alternative measure, such as profit margins. We proposed to maintain the ROCE approach used by the CMA.

### Stakeholder feedback

- 3.3. Several suppliers said that ROCE is an inappropriate methodology for asset-light firms like energy suppliers. For example, one supplier referred to the judgement and complexity involved in making adjustments when applying a ROCE analysis to asset-light firms. Another supplier said that Ofgem appeared to have reached a similar conclusion (that ROCE is not an appropriate methodology for asset-light firms) in deciding not to proceed with the CMA's recommendation to calculate ROCE. (We understand this as a reference to Ofgem's decision not to require suppliers to publish a Balance Sheet as part of their Consolidated Segmental Statements – see below).
- 3.4. **Our response:** See rationale section below. When analysing asset light firms, ROCE can be a volatile metric because suppliers have little capital (as defined in accounting terms). However, the CMA did not analyse capital as suppliers define it in their accounts (balance sheets). It made several material adjustments to account for varying accounting policies and to recognise 'economic assets' that companies had not or could not include in their balance sheets (which are drawn up in line with standard accounting principles). We consider that this is an appropriate approach for economic analysis.<sup>13</sup> Ofgem decided not to require suppliers to publish a balance sheet within their Consolidated Segmental Statements. In our view, publishing a balance sheet that is compatible with accounting rules would not allow outside parties to perform the

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<sup>13</sup> See, for example:  
Oxera for the Office of Fair Trading (2003), Assessing profitability in competition policy analysis.  
<https://www.oxera.com/wp-content/uploads/2018/03/OFT-Assessing-profitability-1.pdf>

CMA's ROCE analysis. This decision does not mean that the CMA's ROCE analysis – based on adjusted capital values – was inappropriate.

- 3.5. One supplier told us that adopting the CMA's analysis would be inconsistent with our previous use of EBIT margin benchmarking as part of the Retail Market Review<sup>14</sup> in 2011. It said that this analysis suggested a competitive benchmark EBIT margin of 3% for a vertically integrated supplier, and up to 9% for an independent supplier buying energy two years forward. It also referred to other previous estimates of EBIT margins.
- 3.6. **Our response:** The CMA considered a range of analytical approaches, including EBIT margin analysis, before it adopted its approach. It had the opportunity to consider Ofgem's previous analysis, and decided to adopt a ROCE approach. Although the methodologies differ, we do not consider the matter of consistency with our previous analysis in 2011 to be relevant. The ROCE approach (as applied by the CMA) and EBIT margin benchmarking require many of the same conceptual judgements, and it is normal to use different approaches depending on the quality of information or particular context of an investigation. We note the CMA's expertise in this area, and are satisfied it was well placed to choose a robust approach.
- 3.7. One supplier said that the CMA has avoided estimating firms' capital in its two most recent market investigations. It referred to the CMA's statement in the investment consultants market investigation about the difficulty of identifying and measuring intangible assets.
- 3.8. **Our response:** Using a ROCE approach is more challenging in a sector with lots of intangible assets. In its guidelines, the CMA already recognises that it may be necessary to make adjustments to accounting data, and that it may consider alternative measures in situations where capital cannot be reliably valued.<sup>15</sup> We should be cautious about interpreting the CMA's analytical choices in particular investigations (retail banking and investment consultants) as implying a general change in its views. It is possible to make adjustments to firms' balance sheets to include some intangible assets for the purpose of assessing profitability. While this is not straightforward, the long process and multiple rounds of consultation followed by the CMA in the energy market investigation enabled it to make these adjustments.

### Rationale for proposed decision

- 3.9. As set out in the May consultation, 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

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<sup>14</sup> The Retail Market Review was an Ofgem project to assess the retail energy market and identify reforms to address the issues identified.

<https://www.ofgem.gov.uk/gas/retail-market/market-review-and-reform/retail-market-review>

<sup>15</sup> The CMA's guidance on market investigations was first published by the Competition Commission (one of its predecessor bodies).

Competition Commission (2013), Guidelines for market investigations: Their role, procedures, assessment and remedies (CC3 (Revised)). Annex A, paragraphs 13-15.

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/284390/cc3\\_revised.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/284390/cc3_revised.pdf)

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.

- 3.10. 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.
- 3.11. 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.
- 3.12. We recognise that any ROCE approach in energy supply will involve an element of judgement, but this is also true of alternative approaches. 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 (eg in different countries) or companies in different industries. We would have a challenge of finding suitable comparators, where the relevant data is available.

## **WACC**

### **Proposed decision**

- 3.13. Our proposed decision is to use the WACC figure calculated by the CMA (10% pre-tax nominal).

### **What we consulted on**

- 3.14. We consulted on the options of retaining the WACC figure used by the CMA, or calculating our own updated estimate. We proposed retaining the CMA’s WACC figure.

### **Stakeholder feedback**

- 3.15. Some suppliers agreed with our position of using the CMA’s WACC figure, at least in the context of using the CMA’s methodology. Another supplier said that we should only consider updating the WACC if we also updated the capital base.
- 3.16. One supplier cited analysis which showed that the CMA’s WACC figure of 10% would have implied excess returns in the Industrial and Commercial segment<sup>16</sup> – despite this segment having been excluded from the scope of the market investigation.

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<sup>16</sup> The Industrial and Commercial segment is a term used to describe large business energy consumers.

- 3.17. **Our response:** We have not seen evidence that the CMA’s WACC figure is materially understated. As noted in the May consultation, there are some reasons to believe that the WACC figure may have fallen since the CMA’s analysis.
- 3.18. One supplier disagreed with the use of the Capital Asset Pricing Model (CAPM) to calculate the cost of capital. It said that CAPM did not take into account factors affecting energy supply which are uncorrelated with the performance of the economy. It said that this would have a particular impact on privately owned new entrant suppliers.
- 3.19. **Our response:** In principle, investors should be able to manage such risks through a diverse portfolio of investments. Ownership structures may vary between suppliers, but the financeability matter to which we must have regard in the Act only refers to an “efficient supplier”.
- 3.20. One supplier said that we should use the mid-point of the CMA’s WACC estimates (10.25%), rather than the 10% figure used by the CMA – it referred to this as arbitrary.
- 3.21. **Our response:** The CMA estimated a range of values for the WACC in retail supply, between 9.3% and 11.5%.<sup>17</sup> It used a point estimate of 10.0% to calculate its EBIT margin figure.<sup>18</sup> It was aware of stakeholder feedback that it should use the mid-point at the time of its final report.<sup>19</sup> We do not propose to make piecemeal changes to the CMA’s analysis.

### Rationale for proposed decision

- 3.22. As set out in the May consultation, there are possible reasons why the CMA’s WACC figure may now be an overestimate. Market interest rates have fallen (reducing the risk-free rate) and the rate of corporation tax has fallen over time.
- 3.23. However, we do not consider that it would be reliable to update the CMA’s WACC figure in a piecemeal way, without considering the full range of factors which could affect the WACC. For example, even if the risk-free rate has fallen, there may also have been changes to the equity risk premium. We have not seen evidence that the WACC is likely to have changed significantly since the CMA’s decision.

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<sup>17</sup> CMA (2016), Energy market investigation: final report. Appendix 9.12, table 1.  
<https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf>

<sup>18</sup> 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>

<sup>19</sup> CMA (2016), Energy market investigation: final report. Appendix 9.12, paragraphs 99-99.  
<https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf>

## Amount of capital

### Proposed decision

- 3.24. Our proposed decision is to use the CMA's estimate of the amount of capital employed by suppliers.

### What we consulted on

- 3.25. We consulted on two options: maintaining the capital estimates used by the CMA, or carrying out our own estimates of the capital employed. We proposed maintaining the capital estimates used by the CMA.

### Stakeholder feedback

- 3.26. One supplier agreed with maintaining the CMA's estimates of the capital employed by energy suppliers.
- 3.27. Several suppliers referred back to comments made to the CMA about its estimates of the capital required.
- 3.28. **Our response:** We have already considered the points raised previously by stakeholders to ourselves and the CMA. As noted in the May consultation, 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.<sup>20</sup> We have not received material new evidence on these issues – our position therefore remains unchanged.
- 3.29. Several suppliers also repeated that the CMA was incorrect to assume that a supplier at scale could trade through an intermediary (and therefore reduce its capital requirements).
- 3.30. A couple of suppliers told us that the CMA's analysis covered a period of relatively benign wholesale trading conditions and one referred to a recent increase in volatility. Another supplier said that particularly warm or cold weather affects the capital requirements of suppliers.
- 3.31. **Our response:** The CMA's analysis was based on the average capital employed by the six largest suppliers over an eight year period (2007 to 2014).<sup>21</sup> This will therefore include a range of wholesale market conditions – for example including the spike in wholesale prices before the financial crisis.

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<sup>20</sup> Ofgem (2018), Default tariff cap: policy consultation. Appendix 9 – EBIT, paragraph 3.16.

<sup>21</sup> CMA (2016), Energy market investigation: final report. Appendix 9.10, paragraph 158.

<https://assets.publishing.service.gov.uk/media/576bcc23ed915d3cfd0000bb/appendix-9-10-analysis-of-retail-supply-profitability-roce-fr.pdf>

### **Rationale for proposed decision**

- 3.32. 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.
- 3.33. We note that the CMA's estimate of the amount of capital required was calculated based on supply businesses as a whole (ie including working capital for standard credit customers). As we are making specific allowance for the working capital costs of standard credit through the payment method adjustment, using the CMA's figure may slightly overstate the amount of capital required for direct debit customers. We cannot calculate the size of this effect, but we would not expect it to be large.
- 3.34. 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.
- 3.35. We therefore do not consider that it would be proportionate to develop our own estimate, and potentially delay protection to default tariff customers, given that this is a temporary cap.

## 4. Updating the cap

We explain our approach to updating the EBIT margin component of the default tariff cap.

### Approach to updating the cap

#### Proposed decision

- 4.1. Our proposed decision is to update the EBIT margin component each time the cap is updated. We will multiply the updated components for wholesale costs, network costs, policy costs, operating costs and the payment method adjustment by the 1.9% EBIT margin. We will not update the 1.9% EBIT margin itself over time. More information on the update process is provided in Appendix 3 - Updating the cap methodology.

#### What we consulted on

- 4.2. In our May consultation, we mentioned two options for updating the EBIT margin component.<sup>22</sup> The first was to index it in line with inflation, which is the approach taken for the existing safeguard tariff. The second was to develop a process for updating the EBIT margin over time in line with factors which could affect it.
- 4.3. We stated that we were minded to update the EBIT margin in the same way as operating costs (ie inflated using CPIH).

#### Stakeholder feedback

- 4.4. Several suppliers broadly agreed with the approach we proposed in the May consultation for updating the EBIT margin component over time.
- 4.5. A couple of suppliers disagreed with the approach we proposed in the May consultation and said that we should keep the EBIT margin as a percentage. One supplier told us that this would reflect changes in energy costs, which would affect the capital required.
- 4.6. **Our response:** We have now changed our proposal to adopt the approach proposed by these stakeholders – see rationale section below.
- 4.7. One supplier disagreed with the rationale we presented in the May consultation for our approach to updating the default tariff cap. It disagreed with three points we had made to justify our approach. First, it disagreed that the EBIT margin was small. Second, it disagreed that trying to update some, but not all, of the inputs to the CMA's analysis could introduce distortions. Third, it disagreed that making changes would not be proportionate for a temporary cap.
- 4.8. **Our response:** On the first two points, we have now changed our proposal, and are no longer proposing to update the EBIT margin component solely in line with CPIH.

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<sup>22</sup> See Chapter 4 of Appendix 9 of the May consultation.

However, on the first point, we still consider that changing how the EBIT margin component is updated would have a small impact on the overall level of the default tariff cap, given that the EBIT margin component would be a small element of the overall cap.

- 4.9. On the second point, we are proposing updating the EBIT margin component, but we are not proposing to update the EBIT margin percentage calculated by the CMA. While some of the inputs to this EBIT margin percentage may be easier to update, we would be cautious about making piecemeal changes, as this would not necessarily improve the accuracy of the end result.
- 4.10. On the third point, creating a more complex approach to updating the cap (eg developing a revised ROCE analysis) would be a substantial undertaking. When deciding what analysis is proportionate to update the cap, it is reasonable to consider the limited period for which the cap will be in place, because this reduces the potential for any inaccuracies to compound over time. Taken together with the size of this component, the potential absolute error is small. There would be no guarantee that any more complex analysis would increase the accuracy of the cap.

### **Rationale for proposed decision**

- 4.11. We are now proposing to use the bottom-up model to set the cap. Under this model (unlike a reference price approach), it is straightforward to calculate EBIT once all other elements have been updated.
- 4.12. In light of this, and the comments from some stakeholders, we have amended our proposal for updating EBIT over time. We are proposing to apply the 1.9% EBIT margin to the other components of the cap (except headroom), each time the cap is updated.
- 4.13. This means that the absolute value of the EBIT margin component would change over time in line with the trends in the other cost indices. This would include our direct cost indices, rather than just CPIH as proposed in the May consultation. This may increase the accuracy of the default tariff cap slightly, given that some capital requirements are likely to vary with trends in direct costs. (For example, the collateral needed for trading may grow if wholesale energy becomes more expensive). We consider that this is a proportionate approach for taking into account how capital needs may evolve over time.
- 4.14. As a consequence of our proposal, the EBIT margin component would vary slightly between regions. This is because we would multiply the 1.9% EBIT margin by components which vary regionally (primarily network costs). We consider that this is justifiable because a supplier's capital needs may vary with its direct costs. (For example the amount of working capital required to cover outstanding bills may be slightly higher in regions with higher costs).
- 4.15. Our proposal would create a small amount of double counting for the working capital requirements related to serving standard credit customers. These costs are already included in the payment method adjustment, but we are proposing to apply the EBIT margin to this. We do not consider that there is a reasonable way of avoiding double counting. It would be too complex to subdivide the payment method uplift further to allow us to apply the EBIT margin to some components but not others. In particular, there is an interaction term between bad debt and working capital which would make it difficult to separate these terms.