Decision Appendix

Default Tariff Cap: Decision

Appendix 9 – EBIT

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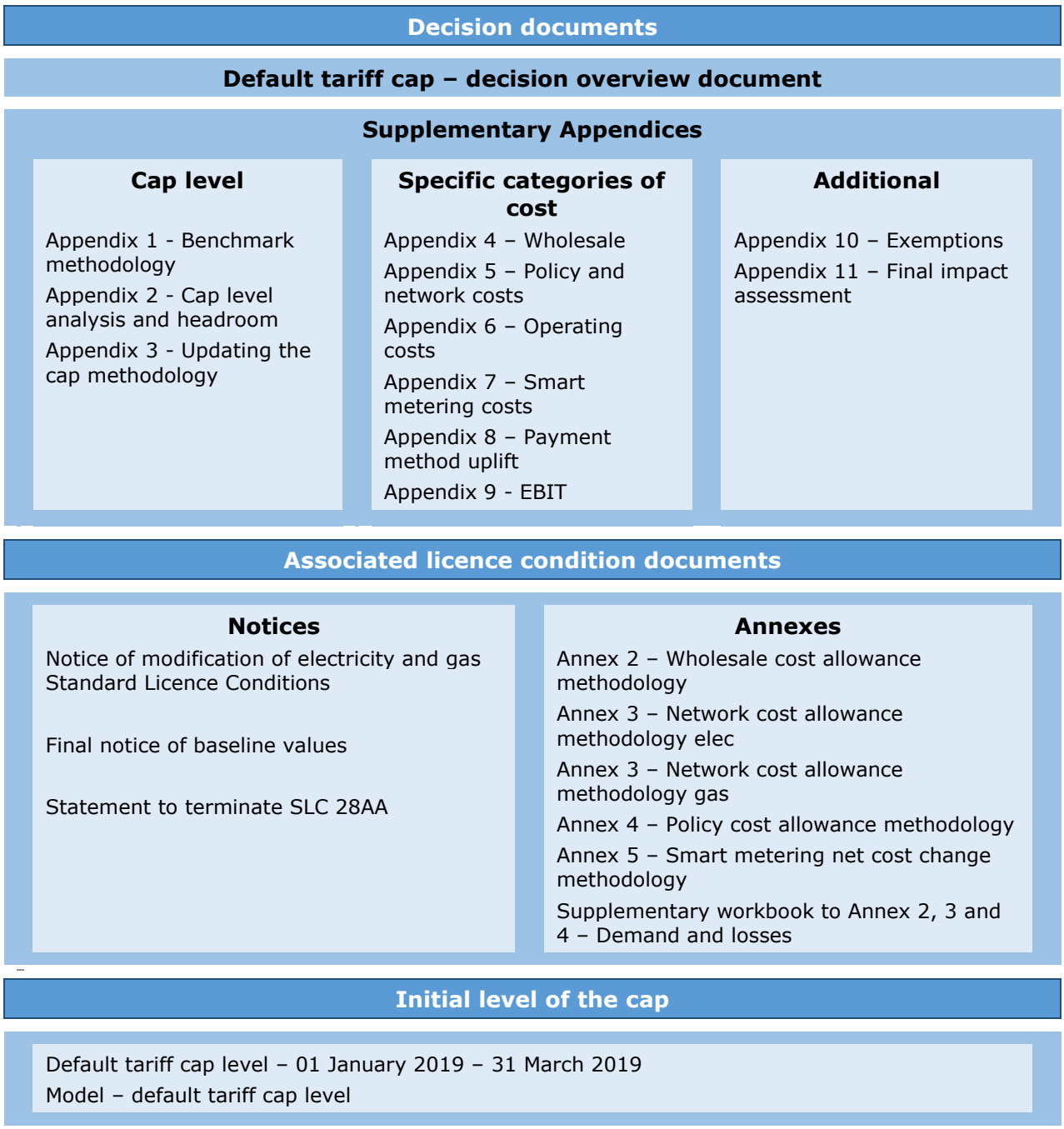
In accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018, we are implementing the default tariff cap to come into effect from 1 January 2019. This supplementary appendix sets out our decision and the detailed methodology in relation to EBIT.

Please see the default tariff cap – decision overview document for an accessible summary of the complete methodology.

Document map

Figure 1 below provides a map of the documents published as part of the decision on the implementation of the default tariff cap.

Figure 1: Default tariff cap – decision document map



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1. Introduction

1.1. We have decided to design the default tariff cap methodology using a bottom-up assessment of efficient costs. Under this approach, we set and update separate allowances for each component of a customer's bill. 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.

1.2. 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). 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.

1.3. In this appendix we set out our methodology for setting and updating the Earnings Before Interest and Tax (EBIT) allowance, and explain how we considered responses to our statutory consultation.

Methodology (Chapter 2)

1.4. We have decided to use the EBIT margin analysis calculated by the Competition and Markets Authority (CMA) as part of its energy market investigation. In doing this, 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 the capital required by suppliers.

1.5. We are therefore using the 1.9% EBIT margin calculated by the CMA for a supplier who is carrying out trading activities itself. The CMA estimated that the required EBIT margin would be just over 1.9% for a supplier that was not using an intermediary.[1] This EBIT margin accounts for the additional working capital costs of collateral (compared to a supplier that uses an intermediary to carry out wholesale trading activities on its behalf).

1.6. We will apply the EBIT margin each time we update the cap. This means that the change in the EBIT allowance will take into account the change in wholesale costs, network costs, policy costs, operating costs and the payment method uplift.

Considering consultation responses (Chapter 3)

1.7. The main themes stakeholders raised in responses were: whether ROCE is an appropriate basis for profitability analysis in energy supply, whether the WACC should be revised, whether the estimate of capital employed should be revised, general views on the margin, process issues, and interactions between the EBIT margin and headroom.

[1] 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

2. Methodology

In this chapter, we set out our methodology for setting the normal rate of return, and updating the EBIT allowance over time.

High-level summary

2.1. To set the EBIT allowance we have decided to:

- use an EBIT margin of 1.9% of revenue, to reflect the normal rate of return for a supplier who is carrying out wholesale trading activities itself
- not adjust the CMA's adjusted Return on Capital Employed (ROCE) analysis, which our EBIT allowance is based on
- apply the same percentage margin each time we update the cap, after updating the other allowances in the cap (except headroom and VAT).

The normal rate of return

2.2. To include a normal rate of return within the default tariff cap, we have decided to 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, and that our 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.

2.3. The allowance in the cap is expressed in cash terms. We calculate this by applying the EBIT margin to the other allowances in our benchmark (ie not including headroom).

2.4. The EBIT margin is a percentage of revenue. However, in this case, we are calculating the EBIT allowance based on the other cost allowances. (The efficient benchmark is made up of these other cost allowances, plus the EBIT allowance itself). Therefore, to deliver a 1.9% EBIT margin, we need to apply a 1.9%/(1 - 1.9%) multiplier to the costs. This is set out in the formula below.

$$\text{EBIT allowance} = \frac{1.9\%}{1-1.9\%}\left(\begin{array}{c}\text{Wholesale allowance} + \\ \text{Network allowance} + \\ \text{Policy cost allowance} + \\ \text{Operating cost allowance} + \\ \text{Payment method uplift}\end{array}\right)$$

2.5. In the statutory consultation, we erroneously applied the EBIT margin directly to the costs, multiplying by 1.9%. This meant that our EBIT allowance did not deliver a 1.9% EBIT margin, which was our stated policy intent. We have corrected this in our decision. The effect is to slightly increase the EBIT allowance from the one set out in the statutory consultation.

Return on capital employed

2.6. The CMA calculated its EBIT margin using an adjusted ROCE approach. The CMA analysed companies' capital employed and made adjustments to accommodate differences in accounting treatments and to recognise intangible assets that were not recognised as capital.

2.7. We have used the WACC figure used by the CMA (10% pre-tax nominal). We have also used the CMA's estimate of the amount of capital employed by suppliers.

Updating the cap

2.8. We will update the EBIT allowance each time the cap is updated. We will apply the 1.9% EBIT margin to the updated allowances for wholesale costs, network costs, policy costs, operating costs and the payment method uplift.

2.9. As above, we will take into account that the 1.9% figure is a percentage of revenue, rather than a percentage of costs. We will therefore multiply the updated allowances for wholesale costs, network costs, policy costs, operating costs and the payment method uplift by: 1.9%/(1 - 1.9%).

2.10. We will not change the 1.9% EBIT margin over time.

Implications for the licence condition

2.11. In the licence condition, we use the methodology above to calculate the EBIT allowance (the parameter 'E'). We update the EBIT allowance each time the cap is updated, so the EBIT allowance will vary over time. As it depends on other cost allowances, it also varies by all the elements that cause those cost allowances to vary – ie region, consumption level, payment method, and (for electricity) meter type. This is shown in the formula below, taken from the electricity version of the licence condition.[2]

$$E_{i,j,k,l,p} = EBIT \times (WC_{i,j,k,l} + NC_{i,j,k,l} + PC_{i,j,k,l} + OC_{j,k,l} + PA_{i,j,k,l,p})$$

2.12. The licence condition parameter 'EBIT' is the EBIT margin percentage, as set by Ofgem. We apply this to the other elements of the efficient benchmark, using the formula above. In order to deliver a 1.9% EBIT margin, as explained above, we use a 1.9%/(1 - 1.9%) multiplier. We have therefore defined this EBIT parameter as 1.9368%.

2.13. The licence condition has not changed with respect to EBIT since the statutory consultation. However, the value in the final notice of baseline values published

[2] As defined in the licence condition, the subscripts indicate different: Charge Restriction Regions (i), 28AD Charge Restriction Periods (j), Benchmark Annual Consumption Levels (k), Benchmark Metering Arrangements (l), and Payment Methods (p).

alongside this decision (1.9368%) has changed from the value published in the draft notice alongside the statutory consultation (1.9%).

3. Considering consultation responses

In this chapter, we summarise and consider the main points stakeholders raised in response to our statutory consultation.

High-level summary

3.1. In this chapter, we summarise and consider the main points stakeholders raised in response to our statutory consultation. (Where relevant, we also refer to points raised in response to our May consultation). These responses informed our decision on the methodology, as set out in Chapter 2.

3.2. Many stakeholders did not comment on our EBIT proposals in their responses. The main issues raised by stakeholders who did comment were:

- whether ROCE is appropriate for profitability analysis in energy supply
- whether the WACC should be revised
- whether the estimate of capital employed should be revised
- general views on the margin
- process issues
- interactions between EBIT margin and headroom.

Whether ROCE is appropriate

3.3. In our statutory consultation we proposed using the CMA's EBIT margin analysis, which is calculated using a ROCE approach. We therefore implicitly proposed adopting a ROCE approach.

3.4. In response to our consultations, 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).

3.5. In response to our consultations, 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[3] 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. In response to the statutory consultation, a couple of suppliers also referred to previous Ofgem analysis of EBIT margins.

3.6. In response our consultations, 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 its market investigation into investment consultants about the difficulty of identifying and measuring intangible assets.

Considering alternative methods

3.7. In its guidelines, the CMA recognises that it may be necessary to make adjustments to accounting data when using ROCE, and that it may consider alternative measures in situations where capital cannot be reliably valued.[4] Alternatives to ROCE, such as EBIT margin (or Return On Sales (ROS)) analysis, are also used when analysing asset-light firms.

3.8. There is a theoretical rationale to prefer 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.

- First, a margin is the relationship between profit and sales. However, sales do not represent the investment in the business, which is what requires a return. Ultimately, defining the normal rate of return will depend on a view of the size of investment required (ie the capital employed). As noted by the CMA, the return on capital has a clear economic interpretation.[5] This is because the ROCE builds up an estimate of the normal rate of return by considering both the amount of capital employed and the cost of capital. By decomposing the rate of return in this way, it is possible to understand what factors are driving the estimate.

- Second, margin analysis relies on finding a suitable comparator, which represents a business in a competitive market, earning a normal rate of return. This relies on finding markets which are sufficiently similar in terms of the activities carried out, as well as judgements about whether these markets are competitive.

3.9. We used ROS in our 2011 assessment. The CMA had the opportunity to consider Ofgem's previous analysis and whether to use ROS on the merits of the information

[3] 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
[4] 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
[5] 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

available to it. The CMA decided to adopt a ROCE approach. Although the methodologies (ROS and ROCE) differ, 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. Given the theoretical advantage of a ROCE approach, the fact that the CMA's analysis was more recent than our 2011 analysis and comprehensive, and bearing in mind the CMA's expertise, we consider that it is appropriate to use a ROCE approach rather than ROS.

3.10. We have confirmed with the CMA that there has not been any change to its guidance or general approach for assessing profitability. The CMA looks at what analysis to do in individual investigations on a case-by-case basis.

3.11. We note that a decision whether to use ROCE or ROS depends on the circumstances of the particular investigation, including the extent and quality of data available, and the analysts' ability to make robust adjustments. (ROCE has theoretical advantages, but if there was insufficient data to use this approach, ROS might be selected instead). 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. We therefore consider that using an EBIT margin figure based on a ROCE approach is acceptable in the circumstances.

3.12. Beyond the choice of a particular methodology, there is also a question about whether this was applied correctly. We consider this through the sections below on the WACC and amount of capital employed. In summary, we have reviewed the CMA's analysis and consider that it is appropriate.

Considering asset-light firms

3.13. It is still coherent to look at the return on capital employed, regardless of the level of capital in a business. Whatever the level of capital, the normal rate of return will still depend on the same factors (the amount of capital employed and the cost of capital).

3.14. We recognise that when analysing asset-light firms, ROCE can be a volatile metric because suppliers have little capital (as defined in accounting terms). In the context of energy supply, where suppliers have few tangible assets, significant adjustments need to be made to the capital employed. For example, adjusting to recognise 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. These practical difficulties make the analysis challenging, but do not undermine the theoretical rationale.

3.15. In its investigation, the CMA made several material adjustments to account for varying accounting policies and to recognise 'economic assets' that companies had not included 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 and a robust way to manage the challenge of applying this methodology to asset-light companies.[6]

3.16. We decided not to require suppliers to publish a balance sheet within their Consolidated Segmental Statements, which would have allowed stakeholders to perform ROCE analysis using *unadjusted* asset values. In our view, publishing a balance sheet that is compatible with accounting rules would not allow outside parties to perform the CMA's ROCE analysis, which is based on *adjusted* asset values. This decision does not mean that the CMA's ROCE analysis – based on adjusted capital values – was inappropriate.

Whether to revise the WACC

3.17. In our statutory consultation we proposed to use the WACC figure used by the CMA (10% pre-tax nominal).

3.18. In response, one supplier said that the 10% WACC was **unreflective**.

3.19. Another supplier **disagreed with our position on not making piecemeal changes**. (This point applied to our consideration of the WACC, among other areas). It said that it was wrong to say that making small changes would be worse than leaving the methodology completely unchanged. It also said that we were proposing to make some changes (to updating EBIT over time) and therefore our position was inconsistent.

3.20. In response to the May consultation, 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. In response to our consultations, 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.

Considering the level of the WACC

3.22. We have not received new evidence to justify why an alternative WACC figure would be more appropriate than our statutory consultation proposal.

3.23. As set out in our May and statutory consultations, 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.

3.24. 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

[6] 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

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.

3.25. We have not made changes to the CMA's 1.9% EBIT margin. While we are applying this figure in a different way (by applying it each time the cap is updated, rather than indexing the EBIT allowance using inflation) we do not consider that this is a change to the CMA's calculation of a 1.9% EBIT margin. Our different approach reflects that we are using a bottom-up approach to setting the cap, rather than the CMA's reference price approach. We do not consider that our decision on how to apply the EBIT margin is inconsistent with maintaining the 1.9% EBIT margin itself.

Considering the WACC value used

3.26. The CMA estimated a range of values for the WACC in retail supply, between 9.3% and 11.5%.[7] It used a point estimate of 10.0% to calculate its EBIT margin figure.[8] It was aware of stakeholder feedback that it should use the mid-point at the time of its final report.[9]

3.27. We have not seen clear reasons why selecting a different point estimate[10] would be likely to improve the accuracy of the WACC. We do not consider that there is a clear reason to depart from the approach taken by the CMA. As noted above, there are possible reasons why the WACC may now be an overestimate – this means that we would be particularly cautious about changing a parameter in isolation that would lead to a higher WACC.

Considering the use of CAPM

3.28. In principle, investors should be able to manage the risks associated with energy supply 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". We are satisfied that applying analysis which uses the CAPM is compatible with having regard to financeability for an efficient supplier.

Whether to revise the capital employed

3.29. In our statutory consultation, we proposed to use the CMA's estimate of the amount of capital employed by suppliers.

[7] 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
[8] 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
[9] CMA (2016), Energy market investigation: final report. Appendix 9.12, paragraph 99. https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf
[10] We note that the mid-point of the range would be 10.4%, rather than the 10.25% figure suggested by the stakeholder.

3.30. One supplier disagreed with our view that it would not be proportionate to develop our own estimate, and potentially delay protection to default tariff customers. It said that **financeability** was a mandatory consideration.

3.31. One supplier told us that there were several **examples of uncertainty** when estimating ROCE for an asset-light business. These were market capitalisation, goodwill yet to be amortised, and pension deficit treatment.

3.32. When responding to both the May consultation and the statutory consultation, several suppliers referred back to comments made to the CMA about its estimates of the capital required. For example, one supplier told us that **working capital, risk capital and regulatory collateral** had been underestimated.

3.33. In response to the May consultation, 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.

Considering revising capital employed

3.34. 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 be able to develop a more robust answer for the amount of capital employed, than the CMA.

3.35. The CMA has significant expertise in relation to profitability analysis. In our 2014 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.[11] The CMA's analysis was developed over two years, and involved three rounds of opportunities for stakeholders to comment.[12]

3.36. The CMA's analysis was relatively recent (it published its final report in June 2016). We have also not identified factors which would appear to have materially changed the amount of capital required since the CMA investigation. In particular, there are several elements of suppliers' capital bases where we cannot identify a reason why these would have changed on average – these include tangible fixed assets and billing systems. Other elements of the capital base may have fluctuated in line with prices (eg

[11] 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

[12] 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).

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.

3.37. For us to calculate an estimate of a supplier's normal rate of return, we would have needed to do an equally significant amount of work as the CMA, over a similar period of time – and this would not have guaranteed a figure that improved on the CMA's work. We do not consider that the delay to customer protection that would be required for this approach would have been be proportionate for a temporary cap which could be lifted in two years. We note that the Act requires us to implement the default tariff cap "as soon as practicable after this Act is passed".[13]

3.38. In reaching this view, we are still complying with the Act by having regard to "the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence". We have not identified flaws in the analysis of capital employed which would have a negative impact on financeability. We have considered the potentially limited chances of us improving the estimate of capital employed against the known delay from carrying out our own analysis and consequent harm to the consumer protection objective.

3.39. Furthermore, we also do not consider that there is any need to recalculate the CMA's estimate. As set out above, the CMA is an expert body, which conducted this analysis during a two year investigation with multiple rounds of engagement. We have reviewed this analysis and consider that it is a professional piece of work. In our view, that stakeholders contest its outcome, given the context described, only indicates that this is a complex area which involves making judgements.

Considering specific points

3.40. Two suppliers made a number of detailed points. We consider them in turn below:

- **Market capitalisation:** This is not relevant to estimating the amount of capital employed.
- **Goodwill:** The CMA already considered goodwill as part of its market investigation.[14] It excluded goodwill to avoid capitalising excess profits. We agree with this rationale.
- **Legacy pension costs:** We have considered these through our operating cost work (see Appendix 6), rather than through the EBIT allowance.
- **Peak working capital and risk capital:** As set out in our May consultation,[15] 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

[13] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(1).
[14] CMA (2016), Energy market investigation: final report. Appendix 9.10, paragraphs 58-63. https://assets.publishing.service.gov.uk/media/576bcc23ed915d3cfd0000bb/appendix-9-10-analysis-of-retail-supply-profitability-roce-fr.pdf
[15] Ofgem (2018), Default tariff cap: policy consultation. Appendix 9, paragraph 5.3. https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_ebit.pdf

facility.[16] 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.

- **Regulatory collateral:** As set out in our May consultation,[17] we note that the CMA has already considered a range of submissions and evidence in this area. 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. This is on the same basis as our consideration above of revising capital employed, given that regulatory collateral would need to be examined in the context of the overall analysis of capital employed. As above, we also need to consider the potentially limited chances of us improving the estimate against the known delay from carrying out our own analysis and consequent harm to the consumer protection objective.

Considering wholesale market conditions

3.41. The CMA's analysis was based on the average capital employed by the six largest suppliers over an eight year period (2007 to 2014).[18] This will therefore include a range of wholesale market conditions – for example including the spike in wholesale prices before the financial crisis.

Application to the default tariff cap

3.42. In the statutory consultation, we noted 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). We said that, as we were 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.[19]

3.43. The direct debit benchmark proposed in the statutory consultation was therefore too high. It included an EBIT margin based on all payment methods (ie implicitly including the cost of the weighted average working capital requirement across these payment methods), rather than specifically based on direct debit customers, who provide a working capital benefit.

3.44. In the statutory consultation, we calculated the cost of the additional working capital required for standard credit customers relative to direct debit customers. We proposed adding this to the direct debit benchmark. As the direct debit benchmark was

[16] See, for example, CMA (2016), Energy market investigation: final report. Appendix 9.10, paragraph 95.
https://assets.publishing.service.gov.uk/media/576bcc23ed915d3cfd0000bb/appendix-9-10-analysis-of-retail-supply-profitability-roce-fr.pdf
[17] Ofgem (2018), Default tariff cap: policy consultation. Appendix 9, paragraph 5.5.
https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_ebit.pdf
[18] 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
[19] Ofgem (2018), Default tariff cap: overview document. Appendix 9, paragraph 3.33.
https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_9_-_ebit.pdf

overstated, using this as a starting point also means that we overstated the standard credit benchmark.

3.45. We said in the statutory consultation that "we cannot calculate the size of this effect, but we would not expect it to be large".[20] This view was overly pessimistic. We have estimated this effect. While not large, this error is material enough that correcting it will improve the accuracy of the cap.

3.46. We consider that this better meets our overall policy intent. For example, our statutory consultation said: "For each component of a customer's bill we propose to provide an allowance for efficient costs".[21] In this context, and taking into account the other cost components, the payment method uplift should make an appropriate adjustment to take into account the different costs of direct debit and standard credit. For working capital, this means that the payment method uplift needs to take into account the reduction in costs from direct debit, as well as the increase in costs from standard credit.

3.47. We have made a correction to avoid double counting and improve the accuracy of the cap. We set out our methodology in Appendix 8 – Payment method uplift.

General views on the margin

3.48. One supplier said that it **did not consider a 1.9% EBIT margin was appropriate**, especially given the low level of headroom proposed. Another stakeholder said that it did not understand why we had adopted a much **lower EBIT plus headroom number than included in the prepayment meter cap**.

3.49. Another stakeholder said that it still **considered that an EBIT margin of 4-6% was required**, based on the evidence provided previously by it and other stakeholders.

3.50. One supplier said that a **1.9% EBIT margin was too low**. It cited several reasons, including: political risk, regulatory uncertainty (including high penalties for non-compliance), the margins allowed for industry bodies, and the cyclical effect of wholesale prices on profits.

3.51. A small number of suppliers said that a 1.9% EBIT margin was not sufficient to support **investment** in industry changes and innovation.

3.52. One stakeholder said that it did not understand why we had allowed a 1.9% EBIT margin, **instead of a 1.25% EBIT** margin.

[20] Ofgem (2018), Default tariff cap: overview document. Appendix 9, paragraph 3.33. https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_9_-_ebit.pdf
[21] Ofgem (2018), Default tariff cap: overview document, p7. https://www.ofgem.gov.uk/system/files/docs/2018/09/statutory_consultation_-_default_tariff_cap_-_overview_document.pdf

Considering overall views on margin

3.53. In general, we received limited new information or arguments to justify a higher EBIT margin. We have generally sought to address specific points under the relevant headings above. We consider below the points which do not fit clearly under those headings.

3.54. The normal rate of return is a separate question to the level of headroom. We do not consider that the level of headroom should influence the choice of the normal rate of return. In addition, any comparison between the default tariff cap and the prepayment meter cap should consider the choice of benchmark, not just the headroom allowance. This is because our headroom allowance takes into account our decision not to use a frontier benchmark. Without affecting the level of the cap, we could alternatively have used a frontier benchmark and a larger headroom allowance.

3.55. In relation to the specific reasons cited why the EBIT margin was too low:

- The CMA already considered the theoretical impact of political and regulatory risk on the cost of capital.[22] Under the ROCE framework, we have not identified a reason why political or regulatory factors (including the introduction of the default tariff cap itself) would have increased the WACC or significantly affected the amount of capital that suppliers require.

- We do not consider that suppliers should receive an additional return to allow them to fund penalties for non-compliance.

- We do not consider that comparing EBIT margins between energy suppliers and industry bodies is a helpful exercise. As discussed above, an approach based on ROCE has theoretical advantages over an approach based on benchmarking ROS.

3.56. We have adopted a 1.9% EBIT margin because 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. This does not mean that we are increasing the overall cap level, relative to including a 1.25% EBIT margin and an intermediary trading fee – the working capital costs are just included in different ways.

Considering investment

3.57. We consider arguments about the costs of delivering mandatory industry changes as part of our work on operating costs. (See Appendix 6).

3.58. We do not consider that a higher return on supplying default tariff consumers is needed to allow suppliers to make discretionary investments in areas beyond energy supply. Instead of investing through retained profits, suppliers could instead raise

[22] CMA (2016), Energy market investigation: final report. Appendix 9.12, paragraph 92. https://assets.publishing.service.gov.uk/media/576bcc3c40f0b66bda0000b4/appendix-9-12-the-cost-of-capital-fr.pdf

money from investors. Furthermore, even if we provided suppliers with a higher return, this would not guarantee that they used the money to make investments.

Process

3.59. One supplier said that the CMA's analysis was **not carried out for the purpose of a default tariff cap**. It told us that the sensitivity of the analysis is much greater in this different context.

3.60. One supplier said that we **should use up to date information**. It said that the 1.9% figure was based on the period 2007-2014, when energy market conditions were different and there were fewer domestic suppliers.

Considering purpose of analysis

3.61. In principle, analysing the normal rate of return is a standalone question, rather than one shaped by the intended purpose. The normal rate of return does not change based on whether it is used for profitability analysis or to set a price cap – or based on the proportion of customers covered by a price cap.

3.62. In practice, the default tariff cap will have a greater financial impact on suppliers than the existing safeguard tariff. However, this does not change our consideration of the points above (in relation to the use of ROCE, and whether to revise the WACC or capital employed). We have considered these points in relation to the Act's objective and the matters which we must have regard to – in this context, we consider that the 1.9% EBIT margin is the best available approach.

Considering timing of analysis

3.63. As discussed above, the CMA's analysis was relatively recent. While its analysis covered the period between 2007 and 2014, there are potential advantages from looking over a longer period, even if this means the start of this range is a number of years ago. For example, this could take into account any impact on working capital from the business cycle and variations in wholesale prices.

3.64. We have not received a clear explanation of why the changes mentioned since 2007-2014 (energy market conditions or the number of domestic suppliers) would change the validity of the 1.9% EBIT margin. However, we have considered each of these points in turn.

- **Energy market conditions:** Wholesale prices have increased recently (which may increase the amount of collateral required for wholesale market trading). However, they are not significantly out of line with historical prices. In the round, we consider looking at EBIT on a long-term basis is more likely to be robust.

- **Number of domestic suppliers:** We have not seen a reason why trends in the level of competition (such as the number of suppliers) will affect the WACC. We recognise that there could be some impacts on the amount of capital employed, if suppliers have to spend more on acquiring customers. However, we have not seen evidence that this is significant. Furthermore, increased competition could push suppliers to become more efficient, including by reducing the amount of capital employed in their businesses.

Interactions between EBIT and headroom

3.65. A couple of suppliers said that the **margin on fixed tariffs** would likely be lower than 1.9%. One supplier therefore said that the proposal would not allow suppliers to make a 1.9% EBIT margin across their tariffs as a whole.

3.66. One supplier said that we should include additional headroom to account for **uncertainty** around the EBIT estimate (if we did not change the EBIT value itself). It said that failing to do this contravened the Act's provision on financeability and was inconsistent with our approach to other elements of the cap methodology.

Considering profitability across a supplier's tariffs

3.67. This appendix considers the EBIT allowance of the default tariff cap – ie as applied to default tariffs. We consider the overall impacts of the cap level, including the impact on fixed tariffs and the requirements of the Act, in Appendix 2 (Cap level analysis and headroom).

Considering uncertainty around the EBIT estimate

3.68. We have decided to adopt the 1.9% EBIT margin. We consider that this is the best available estimate for the normal rate of return in energy supply. We therefore do not consider that there is a known bias, which needs correcting through the use of headroom.

3.69. We do not agree with some suppliers' estimates of EBIT, which in some cases are much higher than 1.9%. However, we recognise that there is a degree of uncertainty around any cost estimate – the EBIT margin is no exception. It is worth noting that any uncertainty could lead to EBIT being either higher or lower, depending on a number of factors.

3.70. We do not consider that we should set the cap on the assumption that each source of uncertainty materialises in the same direction. We have not identified a reason why any uncertainty around the EBIT margin would generally be correlated with other sources of uncertainty. We therefore consider uncertainty, including about EBIT, in the round. The headroom allowance provides some flexibility for suppliers to manage inherent uncertainty in their costs, including the EBIT margin, without unduly increasing the cap in a way which does not reflect how suppliers manage their risks in practice. We discuss this further in Appendix 2.