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28 June 2023

Dear Marzia and Shai,

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

We do not believe these proposals are in the interest of consumers. Whilst we support ensuring financeability and market stability, these proposals are not properly justified or evidence-based, with the weight of evidence indicating a *reduction* in profit margin would be appropriate. We are particularly concerned that the proposal to increase profit margin does not reflect the relevant evidence in the following ways:

- Ofgem has taken a series of decisions that have reduced the risk on suppliers and generally transferred that risk onto consumers. This has also set the clear expectation that further interventions will be made if the need arises.
- Comparisons to airlines have been preferred to clear evidence regarding the lower systematic risk in the energy sector.
- Proposals are based on how Ofgem *wishes* suppliers to behave, particularly with regard to capitalisation, rather than how it *requires* them to or how they behave in practice.
- Reliance has been put on *'narrative stakeholder arguments'.* These stakeholders are the suppliers who will benefit from increased profit margins.
- Evidence from the independent assessment provided by CEPA has been used selectively. CEPA does not conclude that profit margins should be increased.

In previous responses we have raised concerns that remain valid. We highlight some of these, and additional concerns arising from this consultation, in answers to selected questions below.

Your sincerely,

Andy Manning, Principal Economic Regulation Specialist

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

We continue to believe the EBIT allowance of 1.9% of costs should be reduced. This is necessary to reflect the series of decisions Ofgem has taken that have reduced the risk on suppliers and generally transferred that risk onto consumers[1]. This means that the risks faced by suppliers have not increased in line with costs, due to these extra protections provided, and so increasing the profit margin in line with costs is not justified. Consumers cannot be asked to bear more risk on behalf of suppliers and also compensate suppliers for that risk.

Decisions that have transferred risk from suppliers to customers or provided separate remuneration include:

- Market stabilisation charge: manages the risk of having to sell energy at a loss if wholesale prices fall back and customers switch before consuming the energy that had been bought for them
- Quarterly price cap updates: manages the risk of the differential between the cap price and the market price (Ofgem estimates a 74% reduction[2])
- Inclusion of backwardation costs: risk removed by instead including an allowance
- Balancing costs: manages the risk of volatile balancing costs by applying a cap on supplier liabilities for some high-cost periods[3] and moving to setting prices in advance for balancing costs[4]. Code modifications to further de-risk balancing costs are ongoing.

We have also seen much reduced switching rates which are likely to continue. This means the risk around the volume of unexpected SVT demand is low, reducing risk capital.

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

Proposals appear to be based on how Ofgem *wishes* suppliers to behave rather than how it *requires* them to (or how they behave in practice).

We previously raised concerns about the disconnect between the level of resilience being proposed for estimating working capital and actual requirements for capitalisation arising from the work on Strengthening Financial Resilience. It is in consumers' best interest to ensure suppliers are financially resilient but providing funding for a certain

[1] Due to the interaction with the Energy Price Guarantee, consumers may, in practice, mean taxpayers
[2] Price cap - Decision on changes to the wholesale methodology | Ofgem
[3] Industry code modifications CMP345 and CMP381
[4] Minded to decision to approve industry code modification CMP361

Patron HRH The Princess Royal **Chief Executive Clare Moriarty**
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level of resilience, without an obligation to meet that level of resilience, does not provide consumer benefit. Ofgem has set the actual minimum capital requirement on an entirely different basis and, in any case, the requirement does not need to be met until the 31st March 2025. We are concerned that suppliers could be over-rewarded as a result. The definition of the notional supplier should reflect the transition to capital adequacy (to be representative of the market). The modelled results of capital employed should be adjusted as necessary.

The working capital estimate also assumes that customer credit balances will average out to zero. Ofgem offers no evidence that this is the case, stating this reflects *'…our anticipation that the notional supplier should not finance its activities through systematically high direct debit charges'.* If balances are in credit on average in practice this provides suppliers with 'free' working capital that should be reflected in the working capital estimate. The notional supplier needs to be representative of the market and not simply reflective of how Ofgem would prefer suppliers to behave.

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

In general, as we have previously noted with regards to network company price controls, the proposed approach to setting cost of capital contains a number of simplifications that will result in too high a value. For example, the estimate of Total Market Returns should be set on a broader set of assets than UK equities[5]. The CMA has previously agreed with this: '*We agree with Citizens Advice's argument that, theoretically, the TMR should reflect the return on all assets in the economy, and that there is some evidence suggesting that total returns across all asset classes are lower than those on equities alone, and potentially materially lower'.* [6]

Specifically with regards to this consultation, we do not believe that an increase in systematic risk, reflected in the higher asset beta, is justified by the evidence provided. There does not appear to be any direct evidence to support increasing the asset beta range from 0.7-0.8. The asset beta estimate values provided for the energy sector have a highest average value of 0.66[7]. This is clear evidence that the asset beta range is not too low and is more likely to be too high. Ofgem prefers to rely on less relevant airline estimates.

[5] Citizens Advice response to ED2 Draft Determinations (Finance Annex)
[6] CMA Final determination: Volume 2A: Joined Grounds: Cost of equity §5.200
[7] Statutory consultation Table 3: CEPA beta estimates over different estimation windows (April 2012– April 2022)

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Ofgem notes that, for the original proposal to maintain a 0.7-0.8 beta range, the fact that not even the two independent suppliers for whom asset beta estimates were available exceeded the existing range was a key observation. Ofgem now has a third independent supplier, Good Energy, where the beta estimate is available. The Good Energy asset beta estimate does not go above 0.7[8] and so is further clear evidence that the existing range is not too low and more likely to be too high. Instead, Ofgem chooses to construct an argument that this supports a higher range.

Part of Ofgem's rationale for the proposal to increase the asset beta is *'CEPA's independent judgement'*. Whilst CEPA's estimate of short-term asset beta estimates is higher, its estimate of long-term asset beta estimate remains at 0.7-0.8[9]. We also note CEPA's overall view on the cost of capital: *'In conclusion, we can see a plausible narrative that would support Ofgem continuing to use 10% as a longer-term / 'normal' market conditions estimate of an energy retailers' cost of capital…'.*[10] Whilst we recognise that CEPA also conclude that a higher cost of capital *'could be appropriate'*, it is clear that their independent assessment does not support an increase to the asset beta or the cost of capital.

The rationale also cites '*narrative stakeholder arguments'.* The vast majority of stakeholder feedback has been from suppliers who will directly benefit from an increase in profit margin. A high level of caution is required when assessing such stakeholder feedback. We note that Ofgem views responses as '*convincing in setting out robust qualitative arguments that risks faced by suppliers are higher now than they were in 2019 when the allowance was first set'.* We are concerned that qualitative arguments are being preferred to factual evidence, such as the interventions Ofgem itself has made to support suppliers and the lower switching rates which reduce the risk of unexpected SVT demand (as we set out in our response to Q3).

[8] Statutory consultation Figure 3: Ofgem estimates of Good Energy's asset beta
[9] Default Tariff Cap cost of capital Table 1 cost of capital ranges
[10] Default Tariff Cap cost of capital Pg 7