3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

5 January 2023

Dear Marzia and Shai,

Further consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance

We continue to support this review of supplier profit margin (EBIT)[1] allowance within the retail price cap. We still believe the allowance of 1.9% of costs should be reduced to reflect the series of decisions Ofgem has taken that have reduced the risk on suppliers and generally transferred that risk onto consumers[2].

We remain of the view that:

- Increasing the cost of capital to reflect a view that suppliers might be temporarily exposed to greater systematic risk is not justified. Indeed, we believe the current cost of capital is likely to be too high.
- The implied capital employed is now too high. This is because many elements do not increase in line with costs increasing, including as a result of the Ofgem decisions.
- It is not in the interest of consumers to risk significantly overcompensating parties covering most of the market by defining an 'independent' supplier as the efficient theoretical supplier.

These points are covered in more detail in our response[3] to the previous consultation. We now have a number of additional concerns arising from this further consultation:

- The level of fixed assets proposed to be included appears to be too high. Our expectation, given the relatively asset-light nature of energy supply compared to other parts of the energy industry, is that the level of capital related to fixed assets should generally be low. The consultation states the implied capital employed when the price cap was implemented in 2018 was around £200 per customer. This means the

[1] Consultation explains the EBIT can be thought of as profit margin
[2] Due to the interaction with the Energy Price Guarantee, consumers may, in practice, mean taxpayers
[3] Citizens Advice response to Ofgem consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance

suggested level of £85 for fixed assets would have accounted for nearly half of the capital employed. This does not appear to be credible.

- The previous consultation was published before the government announced the Energy Price Guarantee (EPG). With the EPG significantly below prevailing market rates, the incentive for customers to switch suppliers is massively reduced. This means the risk around the volume of unexpected SVT demand is currently very low, reducing risk capital. However, the consultation does not recognise the EPG as a mitigant against unexpected SVT demand and the modelling proposed does not appear to take the potential impact into account.
- Collateral should not be included as part of capital employed. Suppliers covering the vast majority of the market will be using letters of credit and parent company guarantees instead of lodging collateral. This must be reflected in the capital employed or suppliers will be over-remunerated at the expense of consumers.
- Suppliers already have protection against inflation risk. By applying the profit margin as a percentage of the costs allowed under the price cap, supplier profits automatically adjust. Indeed, some cost elements within the price cap are indexed to inflation.

Answers to selected consultation questions are provided below.

Yours sincerely,

Andy Manning

Principal Economic Regulation Specialist

Question 2: Do you agree with our assessment on the case for change?

We agree that the energy market is materially different to when the price cap was first designed and so Ofgem is right to review the allowance for profit margin. The mitigations put in place have ensured that risk levels have increased by a smaller percentage than the costs covered by the retail price cap and so the profit margin. The mitigations have directly reduced risk and also set the clear expectation that further interventions will be made if the need arises. Suppliers have been the direct beneficiaries of repeated policy interventions, generally at the expense of consumers. For consumers to fund additional profits on top of this is not acceptable or sustainable.

We do not believe that the full impact of mitigations has been recognised in the consultation. In particular, the Energy Price Guarantee has had a significant impact on volume risk by delivering a high degree of certainty over the SVT demand (as underlying market costs are above the EPG, reducing the level of switching).

Question 3: Do you agree with our proposal to include fixed assets as a component of capital employed and the suggested level?

It is reasonable to include fixed assets as a component of capital employed, However, we believe that the suggested level is too high. Our expectation, given the relatively asset-light nature of energy supply compared to other parts of the energy industry, is that the level of capital related to fixed assets should generally be low. Scottish Power agrees with this, stating in their response to the original EBIT consultation that fixed assets *'will typically account for a very small proportion of the total capital employed'*. The consultation states the implied capital employed when the price cap was implemented in 2018 was around £200 per customer. This means the suggested level of £85 would have accounted for nearly half of the capital employed. This does not appear to be credible.

As this level has been derived from the depreciation and amortisation costs under the operating cost allowance, this suggests that those costs should not be relied upon for estimating the level of fixed assets. Moreover, it suggests that the depreciation and amortisation costs should be reviewed and potentially adjusted downwards. This review is necessary in any case to allow for the trend towards asset light energy suppliers and infrastructure as a service. Suppliers covering most of the market have announced moves towards 'software-as-a-service' solutions[4]. This is a clear driver for a reduction in fixed costs since the price cap was first introduced.

Question 4: Do you agree that our estimate of fixed assets for a notional supplier is representative of current market conditions?

[4] For example: Centrica signs strategic partnership with ENSEK to accelerate digital transformation and help position the company for growth; E.ONnext – E.ON and Kraken Technologies form strategic partnership for E.ON's UK residential and commercial customer business; https://www.edfenergy.com/media-centre/news-releases/edf-strikes-deal-move-its-5-million-customers-octopus-energy-groups;

We do not believe the estimate of fixed assets for a notional supplier is representative of current market conditions. As described in our answer to Question 3, the estimate does not capture the trend towards asset light energy suppliers that will be reflected in current market conditions.

Question 7: Do you agree with our proposal to include wholesale cost volatility and unexpected demand shock as key drivers of volume risk when calculating suppliers' risk capital requirements?

We do not believe that risk of changes in expected SVT customer numbers is currently adding significantly to suppliers' risk capital requirements. Under current market conditions, where the level of the Energy Price Guarantee is significantly below prevailing market prices, levels of customer churn can be seen to be severely dampened [5] and so volumes on SVT are currently more predictable than under standard conditions.

So, reflecting current market conditions should mean that risk capital is reduced to reflect the highly predictable SVT customer numbers. We recognise, however, that current market conditions may change. Due to the binary nature of this situation (where the impact on risk capital will be very different depending on whether prevailing market prices are above or below the level of the EPG) this will be difficult to capture in a single model. As the models referred to all pre-date the EPG, we are concerned the impact of the EPG will not be captured by the modelling leading to risk being overstated. The consultation does not outline how the possibility of highly predictable SVT customer numbers will be reflected in risk capital.

Question 8: Do you agree with our assessment that backwardation, bad debt, and shaping and imbalances costs are accounted for in the existing cap allowances and that their inclusion within the EBIT allowance could lead to double counting?

Yes.

Question 9: Do you propose an alternative approach for measuring risk capital which is preferable to the approach we describe in this section and Appendix 1? In your approach, how do you model the relationship between wholesale price volatility and risk capital under stress test scenarios?

Our understanding is the modelling described is designed to estimate capital employed needed for a well-hedged notional supplier. However, in practice, suppliers are not generally expected to hold that level of capital for some time. This is because suppliers

[5] Energy supplier switching slips back to average rate after October spike - ElectraLink

are to be allowed a transition period to reach capital adequacy levels. 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.

Question 10: Do you have a view on a preferred approach with regards to the treatment of collateral under the cap?

Collateral should not be included as part of capital employed. This would not be representative of the market. Suppliers covering the vast majority of the market will be using letters of credit and parent company guarantees instead of lodging collateral. This must be reflected in the approach to estimating capital employed, by excluding collateral, or suppliers will be over-remunerated at the expense of consumers.

Providing security cover could be viewed as an operational cost. However, it is unclear whether this is already covered within the existing allowance for operational costs and so no additional, separate allowance would be required. The definition of operational costs for the existing allowance is based upon suppliers' indirect costs as reported through the Consolidated Segmental Statements. The relevant CSS guidance does not cover security cover costs, so we do not know whether they have been categorised as indirect or direct costs.

Question 11: How are the collateral requirements calculated? Is it possible to quantify the relationship between collateral, wholesale prices and volatility?

Only an efficient level of collateral should be considered. It should not be assumed that actual collateral levels are efficient.

Question 14: Should the cost of capital allowance compensate for inflation risk?

Suppliers already have protection against inflation risk. By applying the profit margin as a percentage of the costs allowed under the price cap, supplier profits automatically adjust. Indeed, some cost elements within the price cap, such as network charges, are indexed to inflation. This existing protection needs to be allowed for.