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

citizensadvice.org.uk

23 September 2022

Dear Dan,

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

We welcome this review of supplier profit margin (EBIT)[1] allowance within the retail price cap. We believe the 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[2]. 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.

Recent Ofgem decisions also show that Ofgem will intervene and increase allowances when costs are substantially higher than expected - for example, to introduce an adjustment for the costs of unexpected Standard Variable Tariff demand[3]. We would expect this to continue and believe it may be a more appropriate response, to review the relevant allowances, than increasing profit margins.

Since this consultation was published the government has announced a significant package of intervention to protect consumers and suppliers with an Energy Price Guarantee that will effectively cap the average bill at £2,500 for the next two years. This provides an additional, and even more significant, reduction of risk with guaranteed payment above that level. A radically reduced margin, or no margin at all, should be applied to the element of retail price tariffs that is above the Energy Price Guarantee.

[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] Price Cap - Decision on possible wholesale cost adjustment | Ofgem

Cost of capital

Increasing the cost of capital to reflect a view that suppliers might be temporarily exposed to greater systematic risk is not justified. We agree with CEPA that Ofgem's price cap should not double count the remuneration of those risks[4]. Recent decisions have transferred risk from suppliers to customers or provided separate remuneration:

- 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[5])
- 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[6] and moving to setting prices in advance for balancing costs[7]

All these interventions mean that suppliers have been protected from an increase in systemic risk, generally at the expense of customers or taxpayers, and so the cost of capital should not be increased.

Indeed, we believe the current cost of capital is likely to be too high. 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[8]. 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'.* [9]

Capital employed

As the costs covered under the price have increased, this has increased the profit margin allowance in absolute terms, increasing the implied capital employed. We believe the implied capital employed is now too high. This is because many elements do not

[4] CEPA cost of capital report pg37
[5] Price cap - Decision on changes to the wholesale methodology | Ofgem

[6] Industry code modifications CMP345 and CMP381
[7] Minded to decision to approve industry code modification CMP361
[8] Citizens Advice response to ED2 Draft Determinations (Finance Annex)
[9] CMA Final determination: Volume 2A: Joined Grounds: Cost of equity §5.200

increase in line with costs increasing, including as a result of Ofgem decisions outlined above.

In particular we would highlight:

- Exposure to the differential between the cap price and market price will be diminished by the decision to have more frequent cap updates, reducing working capital requirements
- The risk of unexpected SVT is reduced by the Market Stabilisation Charge, reducing risk capital requirements
- Balancing costs have been capped on occasions and will move to be being fixed in advance, reducing risk capital requirements

We are also not convinced that collateral capital has a linear relationship with costs. Collateral may be lodged with some 'headroom' to avoid the management resource of adjusting collateral level too frequently. In that case, the headroom may be used up before increasing collateral.

Over and above all of this is the impact of the Energy Price Guarantee. With the Energy Price Guarantee very likely to be significantly below prevailing market rates, the incentive for customers to switch suppliers is massively reduced. This means the risk of unexpected SVT demand is now very low, reducing risk capital.

Market representative efficient theoretical supplier

The use of an efficient theoretical supplier as part of the assessment of an appropriate profit margin is sensible. We agree looking at actual company data in extraordinary times may be misleading. However, we believe that the efficient theoretical supplier needs to be representative of the market. 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.

To provide allowances to meet collateral costs reflecting the highest costs in the sector would be in contrast to the approach Ofgem has taken consistently elsewhere. For the proposed cost of debt allowance for electricity distribution companies Ofgem has explicitly aimed to match the *average* costs across the sector[10]. Indeed, Ofgem has directly rejected claims from parties with higher than average debt costs that it was required to provide them with higher allowances[11].

[10] '*Our approach involves broadly matching the cost of debt allowance with the average borrowing costs of networks…*' ED2 Draft Determinations Finance Annex pg12
[11] See chapter 14 CMA Final Determinations - Individual grounds

Implementation

We believe a hybrid approach should be adopted to assessing profit margin allowances. We do not believe that all types of capital employed vary with the level of costs but some relationship with some types will exist. Further, the relationship between capital employed and cost will vary by cost type i.e. capital employed may have a closer relationship to wholesale costs than network costs. An approach that differentiates between cost types should be considered.

It is clear that the element of the retail price cap that sits above the Energy Price Guarantee is significantly less risky. A significantly lower profit margin allowance, potentially a zero profit margin, could be applied to this element to reflect this protection given to suppliers.

Answers to selected consultation questions are provided below.

Your sincerely,

Andy Manning

Principal Economic Regulation Specialist

Responses to selected consultation questions

Question 3: Do stakeholders agree with CEPA's approach to estimating beta? Are there other comparators that stakeholders believe should be used to estimate beta?

We believe that CEPA's analysis overstates the degree of relevance of Centrica as a comparator. This is because CEPA has chosen to combine energy supply with energy services when assessing the extent to which Centrica represents a 'pureplay' supply business, stating for example that *'energy supply and services made up the largest proportion of Centrica's operating income in 2019 and 2020'*[12]. However, the services business has no relevance to energy supply, and so to this assessment of cost of capital, and to include is likely to be misleading.

The services business has contributed more to Centrica's operating profit than energy supply in all years covered by CEPA in table 4.4[13]. To be clear, this means that energy supply (the relevant part of Centrica) did not make up the largest proportion of Centrica's operating income in any of those years. CEPA observes that the proportion of Centrica's operating profit contributed by energy supply and energy services was *'c. 50% in 2019, falling to c. 25% in 2021'*. The appropriate numbers to consider, i.e. the proportion contributed by energy supply, are around 14%[14] in 2019 falling to around 12%[15] in 2021.

Given the relatively small proportion that domestic energy supply contributes to Centrica's overall operating profit, caution is required in using it as a comparator.

Question 4: Do stakeholders agree with CEPA's suggested approach to estimating the other components of the CAPM model?

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[16]. 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*

[12] Centrica refer to operating income as operating profit
[13] From Centrica's results
[14] British Gas Energy adjusted operating profit of £124m out of Group total of £901m - 2019 results as stated in 2020 prelims
[15] British Gas Energy adjusted operating profit of £121m out of Group total of £948m - 2021 prelims
[16] Citizens Advice response to ED2 Draft Determinations (Finance Annex)

suggesting that total returns across all asset classes are lower than those on equities alone, and potentially materially lower'.[17]

Question 5: What are stakeholder views on the appropriate balance between using long-term or short-term market evidence in our estimation of the CoC?

Increasing the cost of capital to reflect a view that suppliers might be temporarily exposed to greater systematic risk is not justified. We agree with CEPA that Ofgem's price cap should not double count the remuneration of those risks[18]. Recent decisions have transferred risk from suppliers to customers or provided separate remuneration:

- 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[19])
- 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[20] and moving to setting prices in advance for balancing costs[21]

All these interventions mean that suppliers have been protected from an increase in systemic risk, generally at the expense of customers or taxpayers, and so the cost of capital should not be increased.

We are also unclear how the CEPA view that current market evidence may support an elevated equity beta of 1.0-1.2% has been calculated. It appears to rest on a judgement that the sector is comparable to airlines. This appears to be largely subjective. This is then supported by comparison to Centrica which, as explained in the response to Q3, we do not believe can be relied upon due to energy supply being a smaller part of Centrica than presented by CEPA.

Question 8: Do you agree with our view on the potential drivers of capital employed by a market representative efficient theoretical supplier?

---

17 CMA Final determination: Volume 2A: Joined Grounds: Cost of equity §5.200
18 CEPA cost of capital report pg37
19 Price cap - Decision on changes to the wholesale methodology | Ofgem

20 Industry code modifications CMP345 and CMP381
21 Minded to decision to approve industry code modification CMP361

As the costs covered under the price have increased, this has increased the profit margin allowance in absolute terms, increasing the implied capital employed. We believe 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 Ofgem decisions outlined above.

In particular we would highlight:

- Exposure to the differential between the cap price and market price will be diminished by the decision to have more frequent cap updates, reducing working capital requirements
- The risk of unexpected SVT is reduced by the Market Stabilisation Charge, reducing risk capital requirements
- Balancing costs have been capped on occasions and will move to be being fixed in advance, reducing risk capital requirements

We are also not convinced that collateral capital has a linear relationship with costs. Collateral may be lodged with some 'headroom' to avoid the management resource of adjusting collateral level too frequently. In that case, the headroom may be used up before increasing collateral.

Over and above all of this is the impact of the Energy Price Guarantee. With the Energy Price Guarantee very likely to be significantly below prevailing market rates, the incentive for customers to switch suppliers is massively reduced. This means the risk of unexpected SVT demand is now very low, reducing risk capital.

Question 11: Do stakeholders agree that using an alternative efficient theoretical supplier-based approach is reasonable?

The use of an efficient theoretical supplier as part of the assessment of an appropriate profit margin is sensible. We agree looking at actual company data in extraordinary times may be misleading. However, we believe that the efficient theoretical supplier needs to be representative of the market. 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.

To provide allowances to meet collateral costs reflecting the highest costs in the sector would be in contrast to the approach Ofgem has taken consistently elsewhere. For the proposed cost of debt allowance for electricity distribution companies Ofgem has explicitly aimed to match the average costs across the sector[22]. Indeed, Ofgem has

[22] '*Our approach involves broadly matching the cost of debt allowance with the average borrowing costs of networks…*' [ED2 Draft Determinations Finance Annex](#) pg12

directly rejected claims from parties with higher than average debt costs that it was required to provide them with higher allowances[23].

Question 15: If the proposed approaches are not appropriate, what alternative approaches not proposed in this policy consultation would be appropriate for setting the EBIT allowance going forward?

We believe a hybrid approach should be adopted to assessing profit margin allowances. We do not believe that all types of capital employed vary with the level of costs but some relationship with some types will exist. Further, the relationship between capital employed and cost will vary by cost type i.e. capital employed may have a closer relationship to wholesale costs than network costs. An approach that differentiates between cost types should be considered.

It is clear that the element of the retail price cap that sits above the Energy Price Guarantee is significantly less risky. A significantly lower profit margin allowance, potentially a zero profit margin, could be applied to this element to reflect this protection given to suppliers.

[23] See chapter 14 CMA Final Determinations - Individual grounds