

**Firmus Energy Supply: Profit Margin
Prepared for the Utility Regulator****29 April 2026****1. Introduction**

This paper examines the profit margin that ought to be factored into the Utility Regulator's calculation of Firmus Energy Supply's (FES') gas supply price control.

It is structured into four main parts:

- section 2 outlines our methodology for estimating the required margin;
- section 3 provides a reminder of the calibrations that were used previously to set FES' current margin of 2.0% of turnover;
- section 4 gives a brief summary of the submissions made by FES; and
- section 5 sets out our analysis.

2. Methodology

FES' price control provides for a maximum average price calculated as the sum of allowances for wholesale gas purchase costs, network costs, allowed supply operating costs and an allowed profit margin.

A supplier's allowed profit margin can be expressed as a margin on forecast turnover (e.g. the aforementioned figure of 2.0%). However, on each occasion since 2013 that the Utility Regulator has undertaken a full review of a NI supply business's profit requirements (i.e. the 2013 and 2025 Power NI price reviews, and the 2016 and 2022 resets of the FES and/or SSE Airtricity gas supply price controls), the Utility Regulator's underlying calculations have come to focus on the amount of financial capital that a supply business requires and the annual cost of that capital, i.e.:

$$\text{profit in } \text{£m} = \text{capital base} \times \% \text{ cost of capital}$$

The thinking behind this approach is that profit is first and foremost a return that can be distributed to investors, either in the form of fees and/or interest payments (in the case of debt obligations) or as potential dividends and/or capital appreciation (in the case of equity investments). To calibrate the appropriate amount of profit, it makes sense to think in terms of the percentage return on any debt that a company is taking and/or the percentage return on the equity capital that shareholders have agreed to put behind a firm.

This aligns with the way that investors view investments in companies. If the percentage return that is factored into the Utility Regulator's supply price controls is set so that it is in line with the risk-adjusted returns that are available elsewhere on other similar-looking investments (i.e. in line with the opportunity cost of capital), it ought to be that providers of capital will look favourably on the regulated supply businesses as investments and exhibit a willingness to supply the facilities and equity capital base that the businesses need in order to provide services to customers. We can also say that mistakenly setting returns above the opportunity cost of capital will result in customers paying more than they strictly need to. Conversely, if the returns on offer lie below the opportunity cost of capital, there is a danger that the investor community might shun a supplier – i.e. a licensee will not be 'financeable' – thus presenting an avoidable risk to service.

For the avoidance of doubt, it can still be that the profit margin factored into price controls is ultimately presented in regulatory documents and in price control formulae as a percentage of turnover, as has been the Utility Regulator's practice historically. Following the thought process that we have just outlined, what is important is not the presentation per se but that the regulator is confident that the allowed £m profit is sufficient to provide a fair and reasonable return on the capital that the business will need.

This requires detailed consideration, in turn, of both the scale of a company's financial capital requirements and the cost of the capital.

In the case of the capital base, it is necessary to work through the size of requirements under the following headings.

- Fixed assets: energy retail businesses might wish to have their own premises and their own office/IT equipment. There may also be upfront investments in software and systems for billing and customer service activities.
- Working capital: the nature of an energy retail business is such that companies can make payments to upstream suppliers and networks before they collect revenue from customers. There can also be situations in which price control arrangements recognise costs with a lag. This creates a working capital requirement.
- Collateral and security deposits: suppliers buy gas from wholesale counterparties. These trades can require a supply business or its owner to put up some form of collateral to underpin their commitment to paying for purchases. Retailers may also lodge security deposits, collateral or guarantees with the market operator and with the networks that they use to transport energy to the consumer.
- Standby risk capital: it may also be appropriate for suppliers to have an amount of money on standby to deal with unforeseeable day-to-day deviations to cashflow.

As far as the cost of the above capital is concerned, it for the most part makes sense to apply the methods that regulators typically use when calculating allowed returns for regulated companies more generally. This entails, in particular, the use of the capital asset pricing model (CAPM) to estimate the cost of equity.

One additional challenge is that a supply business need not necessarily take monies from investors upfront but rather can obtain undertakings that capital will be made available (up to a certain amount) in specified circumstances. It is necessary to ask what rate of return this 'contingent' capital ought to be rewarded at, as distinct from the rate of return on actual, upfront investment, so as to recognise any difference in the opportunity cost that is imposed on the provider.

Our take on all of the above matters in the case of FES is set out in section 5 below.

3. Current Margin

Before turning to our calculations, we think it will be helpful to first summarise the Utility Regulator's thinking in its previous reviews of FES' required margin, as well as the submissions that FES has made to the Utility Regulator on its required margin for the 2027-30 price control period.

The last full, clean-sheet assessment of FES' profit margin took place in 2016 as part of the Utility Regulator's SPC17 review of FES' price control for the period 2017-19. There was subsequently a review of the margin that emerged from this work as part of the 2022 review of FES' price control for the period 2023-26.

FES' submissions during these reviews used the capital base x cost of capital methodology that we described in section 2.

In its 2016 submissions, FES identified that:

- FES would likely need access to financial capital worth up to £12.3m;
- the Utility Regulator should make allowance for a valuation of the customer book of £1.3m;
- the cost of equity capital would likely be 8.7-11.2%; and, as a consequence
- the required margin was in the range 6.0% to 7.7%.

The Utility Regulator commissioned First Economics to review FES' 2016 costings. For the most part, we accepted FES' sizing of its potential capital requirement. The only adjustment we made was to remove cash balances from FES' calculated working capital requirement and to provide instead for an explicit and appropriately sized allowance for standby risk capital. We also removed the addition that FES made for the value of its customer base, on the grounds that the costs of acquiring customers had been separately allowed for elsewhere. We proposed a cost of equity of 10.0% at the mid-point of FES' range. Finally, we advised the Utility Regulator that the 'contingent' capital in FES' capital base would not impose the same cost as an upfront cash injection and could be remunerated at a lower rate of 2.0%.

Table 1 reproduces our final margin calculation.

Table 1: First Economics' margin calculation, 2016

	<u>Capital amount</u>	<u>Cost</u>	Total
Actual capital			
- Fixed assets	£0.6m	10.0%	£0.06m
- Working capital requirement	£1.9m	10.0%	£0.19m
Contingent capital			
- Collateral for gas purchases	£3.8m	2.0%	£0.08m
- Collateral for network charges	£3.6m	2.0%	£0.07m
- Standby risk capital	£0.4m	2.0%	£0.01m
Required margin			£0.41m
Forecast revenues (B)			£19.7m
% profit margin (i.e. A / B)			2.1%

Source: First Economics (2016), SPC17 profit margins.

We benchmarked the above 2.1% figure to a similar capital base x cost of capital calculation for SSE Airtricity, the margin in Power NI's electricity supply price control, and to the Competition & Markets Authority's work on margins in the GB energy retail market, among other reference points. These comparisons led us to conclude that the SPC17 margin should fall in the range 1.0% to 2.1%.

The UR's final determination provided for a figure towards the top end of this range of 2.0%.

In 2022, FES asked the Utility Regulator to look again at its margin ahead of the SPC23 reset of price controls. It submitted a paper by Frontier Economics which calculated a required margin of 4.1% to 5.2%. The paper used the same methodology that FES had applied in its 2016 submission. In particular, Frontier Economics, like FES: included an allowance for the value of FES' customer

base; and costed all capital requirements at the cost of equity (i.e. it did not provide for a lower cost of contingent capital).

The Utility Regulator asked us to review Frontier Economics' work. We recommended that the Utility Regulator should continue to apply the framework that it used in SPC17 and, hence, that it should i) remove the valuation of the customer base and ii) cost collateral and standby risk capital at a lower 2% rate. Upon making these adjustments, the estimate of FES' required margin fell to less than 2.0%.

In its SPC23 decision document the Utility Regulator concluded that FES had not provided sufficient justification for a change to the allowed margin.

4. FES' SPC27 Submissions

FES said in its response to the Utility Regulator's initial SPC27 consultation document that it agreed that it would be necessary to conduct a brand new assessment of the business's capital requirement and cost of capital.

FES provided the Utility Regulator with a report by Frontier Economics in January 2026 identifying forecast capital requirements for the years 2027 to 2030 and the cost of that capital. Frontier Economics' margin calculation is reproduced as table 2 below.

Table 2: Frontier Economics' proposed margin calculation

	<u>Capital amount</u>	<u>Cost</u>	<u>Total</u>
Working capital	£2.40m	10.2-10.8%	£0.24-0.26m
Intramonth cash requirement	£2.08m	10.2-10.8%	£0.21-0.22m
Non-current assets	£3.45m	10.2-10.8%	£0.35-0.37m
K-factor correction	£2.89m	10.2-10.8%	£0.29-0.31m
Minimum cash covenant requirement	£1.55m	10.2-10.8%	£0.16-0.17m
Trading collateral	£9.20m	10.2-10.8%	£0.94-0.99m
Standby risk capital	£0.27m	10.2-10.8%	£0.10-0.10m
Required margin (A)			£2.30-2.43m
Forecast revenues (B)			£48.59m
% profit margin (i.e. A / B)			4.8-5.1%

Source: Frontier Economics (2026), Retail supply margin – Firmus Energy Supply price control 2027.

During an exchange of information requests, responses and meetings that followed during February and March, FES subsequently proposed several changes to Frontier Economics' calculations. In particular, FES:

- submitted amendments to Frontier's assessment of FES' working capital requirement, non-current assets; K-factor correction, trading collateral; and standby risk capital;
- requested that the requirement for trading collateral be entered as contingent capital at a lower cost than the full cost of equity;
- acknowledged that the cost of financing K-factor balances is covered at least in part by the allowance that the Utility Regulator makes for interest during the annual reconciliation process; and

- identified that the revised provisions for the minimum cash covenant requirement and standby risk capital would generate an interest receivable at a rate of around 2.0% per annum.

Table 3 sets out our understanding of FES' request of the Utility Regulator as at 2 April 2026.

Table 3: FES' proposed margin calculation

	<u>Capital</u>	<u>Cost</u>	Total
Actual capital			
- Working capital	£3.86m	10.49%	£0.40m
- Intramonth cash requirement	£2.08m	10.49%	£0.22m
- Tangible assets	£0.72m	10.49%	£0.08m
- Intangible assets	£3.02m	10.49%	£0.32m
- K-factor correction	£2.89m	10.49%	£0.30m
- Collateral posted with Gas Market Operator	£0.31m	10.49%	£0.03m
- Minimum cash covenant requirement	£1.55m	10.49%	£0.16m
Contingent capital			
- Trading collateral	£9.48m	2.0%	£0.19m
- Standby risk capital	£1.03m	2.0%	£0.02m
Required margin			£1.72m
Interest on K balances			(£0.15m)
Interest receivable			(£0.05m)
To be recovered via M_t (A)			£1.52m
Forecast revenues (B)			£51.49m
% profit margin (i.e. A / B)			3.0%

Source: emails from FES to the Utility Regulator on 2 and 28 April 2026.

5. Our Analysis

Our perspective on FES' submissions is as follows.

5.1 Capital base

5.1.1 Overview

We are grateful to FES for the constructive way in which they have worked with us as we have sought to understand the demands that they face as a business.

Given the short time available to us to complete our work, and the number of revisions that FES has made to its original submission, there are still some areas in which we consider that we do not have a complete understanding of FES' position. However, we can make the following high-level observations:

- first, we agree with FES that all but one of the named line items in table 2 give rise to a potential requirement for capital, with a resulting cost that ought to be recoverable through FES' price control;
- the one exception is the line for 'trading collateral', which, as we explain below, is based on the requirement that Frontier Economics and FES believe a hypothetical stand-alone supplier would face rather than FES' real-life capital base; and

- this one issue of principle aside, the main question that we have considered in our work is whether FES' forecast capital requirement is sized appropriately in light of historical experience and the specific circumstances the business faces going into the new regulatory period.

5.1.2 Minimum cash covenant and trading collateral

FES purchases the gas that it supplies to its customers from Bord Gais. As is typical in any commercial relationship between a shipper and a supplier, Bord Gais requires FES to post collateral to cover the trades that FES enters into. FES has told us that this collateral currently takes the form of a letter of credit from its parent company's bank. In order to obtain this letter of credit Yuno Group must place a specified amount of cash on deposit at the bank and must pay specified annual fees.

The 'minimum cash covenant' line in table 3 is intended to recognise the capital that shareholders provide in support of this arrangement. Specifically, FES has told us that Yuno Group's bank provides a group letter of credit facility. In order to give this cover:

- the bank requires Yuno Group to hold a minimum cash balance; and
- FES' share of this capital requirement is €6.11m or £5.3m, of which the portion attributable to FES' regulated activities is £1.55m.

The 'trading collateral' line also relates to the wholesale purchase of gas. Specifically, the amount of £9.49m is FES' estimate of the cash that a hypothetical stand-alone supplier would have to place with Bord Gais instead of a letter of credit. This higher amount arises because FES assumes that a stand-alone supplier would not have the financial strength to obtain a letter of credit from a relationship bank and, hence, would have no choice but to meet its shipper's collateral requirements using cash.

The 'minimum cash covenant' and 'trading collateral' lines in table 3 thus represent two alternative depictions of the capital requirement that a supplier might face. The former is based on FES' real-life experience. The latter constitutes a second possible way of conducting business.

It ought to be self-evident at this point that FES' capital base can contain either the amount of £1.55m or the amount of £9.49m but not both. That is to say, we can size FES' capital base in line with the real-life capital requirement that FES faces or the capital requirement that an alternative hypothetical stand-alone supplier would face, but that making allowances for both of the claimed amounts would constitute a double count.

The Utility Regulator put this to FES in an information request in March 2026 and asked FES to provide a justification of its approach. FES responded by saying only that "FES is happy to treat the minimum cash covenant of £1.55m as equity funded, and the £9.5m LC as contingent capital". This is not a justification of its approach. As such, in the absence of any clear reasoning from FES as to why it has included two duplicative components in its submitted capital base, we have moved to consider which item we should retain and which item we should remove.

5.1.3 Real-life supplier or hypothetical stand-alone supplier

Questions about whether to focus only on a company's real-life capital requirements or to view capital requirements through the lens of a hypothetical stand-alone supplier have arisen in previous NI supply price control reviews of each of Power NI, FES and Airtricity.

The first time we were asked to comment on the topic was in 2016 during the SPC17 review of gas supply price controls. We made the following comments:¹

We observe first of all that FES and Airtricity have offered a very extreme depiction of the hypothetical competitor. Most of the retail firms that we observe in Northern Ireland, and more widely in other markets like in Great Britain, are part of larger ownership groups and/or have large shareholders behind them, through which the suppliers can obtain guarantees and covenants in a not dissimilar way to the way that FES and Airtricity make use of their owners' strength. While it is possible to conceive of an entirely stand-alone new entrant with a diverse equity ownership base who may not be able to rely on a parent or a shareholder in this way, it would strike us as odd, for the reasons set out earlier, if the contention is that this kind of business requires higher margins and that the Utility Regulator ought to be increasing the margins earned by incumbent firms so that a seemingly less efficient hypothetical new entrant can profitably compete for their customers.

We also observed that a hypothetical stand-alone entity need not necessarily be deprived of the kind of financial backing that a company within a wider group obtains from its parent:

We also note that the CMA has been considering the construction of a hypothetical stand-alone company in its energy market inquiry and has observed how small suppliers can enter into agreements with 'trading intermediaries' to take on hedging and default-related risks for a fee. The CMA's analysis is that this form of arrangement presents a far lower cost to suppliers than FES' and Airtricity's proposed approach of taking large amounts of cash from investors. While we have not investigated if the parties that operate in this market are willing to enter into similar agreements with suppliers in Northern Ireland, the existence of this model heightens our unwillingness to countenance the suggestion that other suppliers will have no choice but to take large amounts of contingent capital from investors in the form of an upfront cash injection. Instead, the evidence is that even if there isn't an owner or shareholder that is able to insure against risks, there can be unrelated third parties who are willing to step in and perform a similar role.

Taking these two points together, we remain very cautious about countenancing a wholly hypothetical or notional 'stand-alone' way of calculating a supplier's financing costs. While the Utility Regulator should be watchful of the use that suppliers make of a parent's financial strength, and ensure that it does not treat explicit or implicit parent company support as coming for 'free', we could not go as far as to say that it is improper to factor in any form of outside backing from a larger, more creditworthy shareholder or partner.

We therefore consider that it is realistic and in the interests of consumers to proceed in the way that the Utility Regulator has approached previous price reviews and to make allowance, where it is cost-efficient, for the actual capital provided by either related or unrelated persons. In this particular instance, this entails assuming that FES is able make maximum use of facilities, letters of credit, parent company guarantees, etc. before looking to injections of cash.

Accordingly, insofar as the real-life FES has chosen to and been able to meet Bord Gais's capital requirements by posting a letter of credit, we retain the £1.55m minimum cash covenant requirement and remove the wholly notional £9.49m allowance.

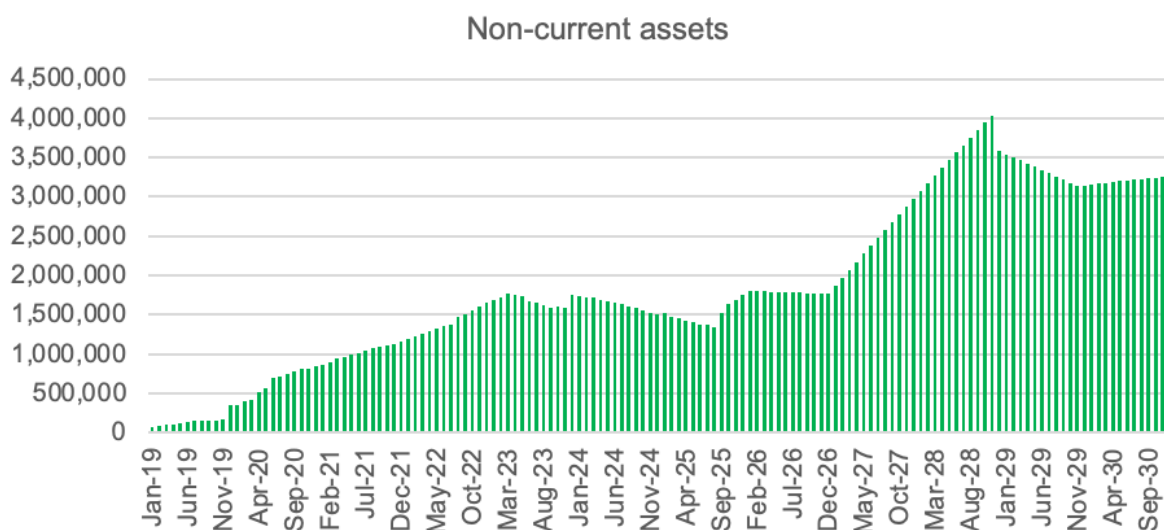
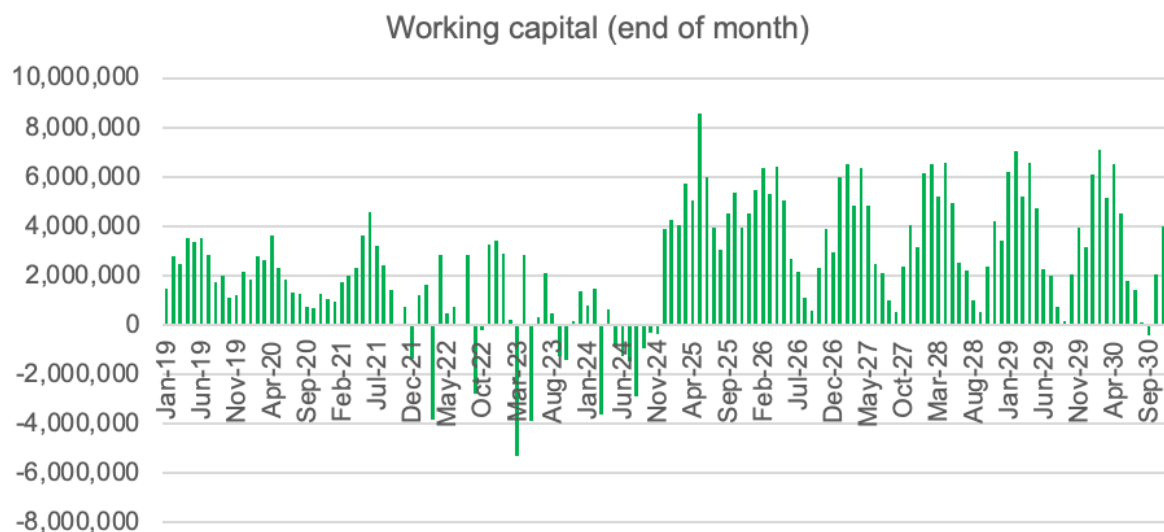
5.1.4 Size of projected capital requirements

On previous occasions when we have sought to size the different items in a company's capital base, we have found it helpful to put a supplier's projected capital requirements next to its actual

¹ First Economics (2016), SPC17 profit margins.

historical capital base and to look at the continuity or discontinuities in amounts over time. In this review, FES has been able to provide us with a full backward and forward look for two of the items in its submitted total – non-current assets and end-of-month working capital. Figure 1 gives the relevant figures.

Figure 1: FES’ historical and forecast capital requirements, £m



Source: FES spreadsheet submission and First Economics’ calculations.

Note: the figures in the charts are for the whole of the FES business rather than regulated tariff customers only.

The first chart shows a marked change in FES’ working capital requirement in 2024 when the business was sold by Equitix and bought by the Yuno Group. FES has explained that from October 2024 it has had to pre-pay network charges for the first time, in place of an arrangement in which FES was previously able to post collateral and pay in arrears. FES also informed the Utility Regulator that there have been a number of other changes to intra-group money flows which have impacted working capital requirements.

We acknowledge that there has been a change of circumstances since we last looked at the business four years ago. Consistent with our overarching approach of looking at the real-life financing requirement that a supplier faces, we take the business as it is and do not seek to overlay a different ownership or operating model.

There are, however, two places in which we consider that it may be necessary to amend FES' figures:

- Buffer / standby risk capital – FES' estimates of its working capital requirement include a cash buffer of £1m to cover unforeseeable variations in cashflow timing. We do not object in principle to the provision of headroom. However, we note that FES has also included a similarly sized amount of 'standby risk capital' as a separate line item in its calculations. Consistent with our advice to the Utility Regulator in previous reviews, including the SPC17 review of FES' price control (see section 3), we think it is better to remove any cash buffer from the working capital line and to provide explicitly for a suitable amount of standby capital to cover all risks. We continue to size the overall layer of standby risk capital at 2% of turnover, in line with the CMA's approach in the 2016 energy market investigation.
- Intangible assets – FES' projections in the second chart provide for a significant amount of expenditure on upgrades to its IT systems. We understand that the Utility Regulator is not proposing to make upfront allowance for this investment in its SPC27 draft determination because the need and costing for the project has not yet been validated. The regulator will instead allow for the possibility that FES' price control can be amended in-period if there is agreement on the proposed expenditure. It follows that it is not necessary for us to make upfront allowance for the associated financing within the margin calculation.

Without a full run of historical and bottom-up forecast data, we have been able to conduct only a more superficial examination of the other items in FES' submitted capital base. This has led us to identify one further anomaly:

- K correction – this line in FES' submission reflects FES' view that it is likely to have to accommodate a persistent under-recovery of its permitted revenues throughout the 2027-30 regulatory period. We appreciate that from late 2021 until early 2025 FES built up a sizeable positive K-factor balance, and that events during March 2026 mean that suppliers could again start the new price control period in a not dissimilar place. However, it is not clear to us that it is appropriate to assume that there will be a systematic under-recovery of costs for the full four-year period. We have considered various ways of resizing FES' projections, including, but not limited to, the possibility that the projected value of K should be zero in years 2, 3 and 4. In the analysis that follows, however, we make only a minor adjustment by aligning capital required to the average K balance in the period 2021-25 rather than FES' chosen period of 2021-24.

5.1.5 Summary

The analysis and adjustments set out above point to the following initial capital requirement (i.e. before considering the financing for any new IT investments).

Table 4: Capital base

Category	Amount
Non-current assets	£0.72m
Net working capital	£3.86m
Intra-month	£1.08m
K correction	£2.30m
Gas market operator collateral	£0.31m
Trading collateral	£1.55m
Standby risk capital	£1.03m

5.2 Type of capital

FES' submissions identified that its real-life capital requirements typically take the following forms.

Table 5: Capital types

Category	Type of capital required
Non-current assets	Cash
Net working capital	Cash
Intra-month	Cash
K correction	Cash
Gas market operator collateral	Cash
Trading collateral	Letter of credit
Standby risk capital	Contingent capital

We take this financing structure as a given and move directly to consider the appropriate costs of capital.

5.3 Cost of equity capital

The pricing of equity capital can proceed in the same way as a standard regulatory cost of capital assessment.

The capital asset pricing model (CAPM) estimates the cost of equity as a function of values for the expected market return, the risk-free rate and beta, i.e.:

$$\text{Cost of equity} = \text{risk-free rate} + \text{beta} \times (\text{expected market return} - \text{risk-free rate}).$$

NB: In the case of a regulated supply business, the values of the risk-free rate and the expected market return should be computed in nominal terms.

A. Expected market return

The Utility Regulator undertook a detailed evaluation of the expected market return in its review of NIEN's RP7 price controls. Its assessment was that it is appropriate to set the expected market return in line with the returns that investors have historically taken from stock market investments. The Utility Regulator's preferred estimate of this long-term benchmark is 6.75% after inflation.

An expected market return of 6.75% real converts to 9.0% in nominal terms.²

B. Risk-free rate

The estimate of the risk-free rate should also align with the figures that the Utility Regulator applies elsewhere in its price control work. The Utility Regulator's chosen methodology involves taking readings of the yields on a basket of proxies for the riskless asset. As at February 2026, these readings pointed to a risk-free rate of around 4.75% in nominal terms.

This reading pre-dates the market turbulence caused by the war in the middle east. At the time of writing, it would be premature for us to form any judgement as to where the risk-free rate might settle during the 2027-30 regulatory period when market conditions settle. However, it may be that the Utility Regulator will need to return to this matter prior to issuing its final price control decision.

C. Beta

A firm's beta is a measure of the riskiness of a firm's cashflows in the eyes of shareholders.

In its submission, FES provided for a beta of 0.7 to 0.8, in line with the beta that the CMA identified in its 2016 investigation into the workings of the energy market in Great Britain. This 0.7 to 0.8 range is lower than the beta of 1.1 that Ofgem used in its subsequent 2023 reset of GB suppliers' margins but matches the beta that the Utility Regulator used in its 2025 price control determination for Power NI.

When comparing risks in NI to risks in GB, it is important to note that:

- the Gt term in the NI suppliers' licences permits NI suppliers to recover from customers any amounts that they pay for the purchase of electricity and gas; whereas
- Ofgem's energy price cap holds GB suppliers to an Ofgem-calculated benchmark for wholesale purchase costs, based on the costs that a notionally efficient supplier would incur if it adopted a particular purchasing strategy that is devised and costed by the regulator.

The different exposures to risk that these different regulatory approaches produce was clearly demonstrated during the 2022-23 energy price shock. The NI suppliers' ability to pass-through its actual purchase/hedging costs meant that, ultimately, they neither made money nor lost money on their electricity and gas purchases even in the face of a sudden and unforeseen spike in wholesale prices and consequent dislocations in the market. GB suppliers, by contrast, were frequently unable to match Ofgem's purchasing benchmark and made very substantial losses.

An expert report³ that we wrote for Energy UK at the end of 2022 sets out in more detail the issues that GB suppliers have faced recently, including:

- withdrawal of hedging counterparties from the market, leaving some suppliers unable to replicate Ofgem's notional forward purchasing strategy;
- intraday price variation vs the reference that Ofgem makes in its benchmark calculations to a single daily price reading at a specific point in the day;
- mismatch between the six-month periodicity of the price cap and Ofgem's setting of a cap on annual p/kWh prices ("backwardation"); and

² Assuming 2.1% per annum CPIH inflation, in line with long-term market inflation expectations, and using the Fisher equation: $(1 + \text{nominal return}) = (1 + \text{real return}) \times (1 + \text{inflation})$

³ First Economics (2022), GB energy retail businesses: risk profile and cost of capital.

- uncertainty over regulated volumes, and hence the required amount of hedging, due to opportunistic switching by customers between unregulated and regulated tariffs.

It is primarily these factors, alongside the general entanglement that there has been between energy prices, inflation, and the overall health of the economy, that prompted Ofgem to move to a new beta of 1.1.

Importantly, none of the above-mentioned factors have any direct relevance to the price-regulated NI energy suppliers. Insofar as the Gt term enables Power NI, FES and SSE Airtricity to pass their actual costs on to customers and hence presents the companies with a very different exposure to risk, there is not the same case for ascribing a similarly high beta to the NI suppliers' equity capital.

We therefore agree with FES' proposed estimate and use a beta of 0.75 in our CAPM calculation.⁴

D. Tax

The return that shareholders are offered on their investment needs to cover corporation tax payments (i.e. we need to calculate a pre-tax cost of capital). The UK corporation tax rate is 25%.

E. Overall cost of capital calculation

Table 6 brings the preceding inputs into an overall cost of capital calculation.

Table 6: Cost of capital calculation

Parameter	FES	First Economics
Expected market return	9.0%	9.0%
Risk-free rate	4.3%	4.75%
Beta	0.7 to 0.8	0.75
Cost of equity	7.6% to 8.1%	7.94%
Tax rate	25%	25%
Pre-tax cost of equity	10.2% to 10.8%	10.6%

Our estimate of the prevailing cost of equity is 10.6%. We note that this figure is broadly aligned to FES' submission.

5.4 Cost of contingent capital

We do not consider that it is necessary to apply the 10.6% rate of return to the whole of FES' capital base. Specifically, we do not propose to use a 10.6% costing for contingent capital – i.e. in the case of FES' standby risk capital.

Commitments to provide capital to a business on a contingent basis do not entail the same cost as an upfront capital injection, in that no money actually changes hands and the provider of capital is not initially required to divert funds from other return-generating investments. As such, there is not the same 'opportunity cost' as there is in an actual equity raise, and it would be wrong to ask customers to pay the cost of equity in full.

However, at the same time, it would also not be right to suggest that commitments to provide contingent capital can be obtained or provided without any cost given that the provider of capital is undoubtedly taking on risk and needs to be compensated for that risk.

⁴ The average equity beta of 1.0 converts to an asset beta of 0.7 to 0.8 after accounting for the average level of gearing exhibited by UK listed firms.

Unlike CAPM, we are not aware of any widely accepted model or tool that would enable us to price the contingent capital that sits behind FES' business. However, we have identified the following points of reference:

- suppliers have previously informed the Utility Regulator that the costs they have paid for letters of credit issued by banks can work out to up to 2% of the amount of credit offered;
- FES has suggested a cost of contingent capital of 2%;
- Power NI put forward a costing of 2% to 3% in their submissions to SPC25 electricity supply price review;
- in the Utility Regulator's recent reviews of SONI's price controls, the regulator allowed for a 2.5% return on the parent company guarantee that SONI has procured from its shareholders, EirGrid;
- the CMA priced letters of credit and other contingent capital at 2% in its GB energy market inquiry;⁵ and
- the CMA has also identified that the fees charged by trading intermediaries to take on upstream purchasing risks are quite small. The relevant numbers are redacted from the CMA's published report, but the text makes it clear that the amounts involved are "significantly" lower than the full cost of capital.⁶

This does not provide a definitive answer to the question: what is the cost of contingent capital? But the evidence does point clearly in the direction of a costing of around 2%.

Specifically as regards the letter of credit that supports FES' trading with Bord Gais, the Utility Regulator has informed us that it is minded to provide an allowance under the Gt term to cover a claim that FES has made for bank fees and the cost of the parent company guarantee that the Yuno Group is effectively providing to FES. We take the resulting annual cost of £0.23m directly through to our calculations.

5.5 Amounts recoverable elsewhere

FES' submitted margin is a gross margin – i.e. FES identifies the total amount of revenue that FES will need to collect in order to finance its business. The UR's price control arrangements provide for two alternative/additional ways in which some of this cost can be met, in addition to the margin included in the price cap formula:

- as mentioned above, there is an allowance for the 'cost of credit' in the Gt term in FES' price control; and
- during the annual K factor reconciliation of under- and over-recoveries against FES' price cap entitlements, the Utility Regulator rolls up any balances owed to or by the company with interest.

We must therefore deduct the amount of £0.23m from our gross margin calculation.

The allowance for interest in the annual reconciliation process is equal to the Bank of England base rate plus 1.5%. The Office for Budget Responsibility's March 2026 forecasts project that the base rate will average 3.7% during the period 2027 to 2030. We must therefore allow in our calculations

⁵ CMA (2016), Energy market investigation: final report, appendix 9.10, para 139.

⁶ CMA (2015), Energy market investigation: provisional findings report, appendix 10.3, para 91.

for the way in which FES will automatically recoup interest at a rate of 5.2% on its projected K factor balance.⁷

5.6 Overall margin calculation

We showed in table 3 that FES calculated a required margin of 3.0%. The preceding analysis requires us to make a number of adjustments to FES' numbers. Specifically, we think we need to:

- delete FES' claim for the trading collateral that a hypothetical stand-alone supplier would have to post in order to be able to make wholesale gas purchases (see section 5.1.2);
- right-size FES' working capital requirement and non-current assets (see section 5.1.3);
- set the cost of equity at 10.6% (see section 5.3);
- allow for the recovery of the cost of the letter of credit via the Gt term in FES' licence (see section 5.5); and
- allow for the interest on K correction balances (see section 5.5).

Table 7 makes these corrections.

Table 7: Revised margin computation

	<u>Capital amount</u>	<u>Cost</u>	Total
Actual capital			
- Working capital	£3.86m	10.6%	£0.41m
- Non-current assets	£1.08m	10.6%	£0.11m
- Tangible assets	£0.72m	10.6%	£0.08m
- K-factor correction	£2.30m	10.6%	£0.24m
- Collateral posted with Gas Market Operator	£0.31m	10.6%	£0.03m
- Minimum cash covenant requirement	£1.55m	as per Gt allowance	£0.23m
Contingent capital			
- Standby risk capital	£1.03m	2.0%	£0.02m
Required gross margin			£1.13m
Recoverable via G _t			(£0.23m)
Interest on K balances			(£0.12m)
Required net margin			£0.78m
Forecast revenues (B)			£51.49m
% profit margin (i.e. A / B)			1.5%

The final row of the table suggests that a margin of turnover of 1.5% ought to be sufficient to enable FES to provide a fair return to the providers of forecast actual and contingent capital.

We note that the Utility Regulator's current margin is 2.0%. Bearing in mind the uncertain nature of many of the figures feeding into our analysis, we would not go as far as to say that the Utility Regulator should reduce FES' allowed margin in its upcoming price control determination. Instead,

⁷ When put alongside the cost of equity of 10.6%, this means that K balances impose financing costs of 10.6% - 5.2% = 5.4%.

we suggest that it would be appropriate for the Utility Regulator to roll forward the allowed margin at broadly its current level.

5.7 Cross checks

We can cross-check this recommendation in the following way.

SSE Airtricity's SPC27 submission

SSE Airtricity in its submission to the SPC27 process has sought a margin of [X].

We are still in the process of reviewing SSE Airtricity's analysis. [

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Cross-check to current margin

Looking back to the calculations that we put forward in 2016, and comparing to the new analysis set out in this paper:

- FES' projected regulated turnover is approximately 2.5 times higher than 2016 forecasts;
- FES' capital requirement has increased by less than 2.5 times; and
- the estimated cost of capital has remained broadly unchanged.

These things together suggest that the required margin, when expressed as a percentage of turnover, need not be materially different from the Utility Regulator's previous assessment.

Cross-check to Ofgem's GB margin

Ofgem in 2023 increased its allowed margin within the GB energy price cap from 1.9% to an indicative, projected value of 2.4%.

This was driven primarily by an increase in Ofgem's estimate of the GB suppliers' cost of capital from 10% to 12.2%. Had Ofgem left its estimate of asset beta unchanged, there would have been a small reduction in the calculated percentage margin requirement.

We explained in section 5.3 why we do not consider that FES has encountered the same change in its risk profile and, hence, its required return. Our recommendation that FES' allowed margin should be held constant is therefore consistent with Ofgem's assessment of the change in GB suppliers' required allowance, if we adjust for the different levels of risk / betas.

Cross check to NI electricity supply margin

The Utility Regulator in its 2025 review of Power NI's supply price control arrangements held the allowed margin unchanged at 2.2%.

Summary

All of the above pieces of evidence support a margin of around 2.0%.