

FES' Response to the UR's SPC27 Draft Determination
Prepared for the Utility Regulator

26 August 2026

1. Introduction

Firmus Energy Supply (FES) submitted a response to the Utility Regulator's (UR's) draft SPC27 determination at the end of July 2026. This short note records our views on the representations that FES has made on the UR's allowed profit margin.

2. FES' Request

FES' response identifies that its required profit margin is 4.2%.¹ This compares to the figures of:

- 4.8-5.1% put forward by Frontier Economics in a report prepared in January 2026;
- >5% tabled, in effect, by FES via amendments to Frontier Economics' work during discussions with the Utility Regulator between February 2026 and March 2026; and
- 3.0% in FES' final submission in April 2026 prior to the publication of the Utility Regulator's draft determination.

FES' revised capital base x cost of capital calculation is reproduced in table 1 below.

Table 1: FES' proposed August 2026 margin calculation

	<u>Capital</u>	<u>Cost</u>	Total
Actual capital			
- Working capital	£3.86m	10.49%	£0.40m
- Intra-month 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	£2.30m	10.49%	£0.24m
- Collateral posted with Gas Market Operator	£0.31m	10.49%	£0.03m
- Trading collateral	£9.48m	10.49%	£0.99m
Contingent capital			
- Standby risk capital	£1.03m	2.0%	£0.02m
Required margin			£2.30m
Interest on K balances			(£0.12m)
Interest receivable			(£0.02m)
To be recovered via M_t (A)			£2.16m
Forecast revenues (B)			£51.49m
% profit margin (i.e. A / B)			4.2%

Source: email from FES to the Utility Regulator on 21 August 2026.

¹ FES' written response document originally identified a required margin of 4.1%. FES corrected this figure in an email to the Utility Regulator on 21 August 2026.

Compared to its April 2026 position (see table 3 in our April 2026 report, reproduced as table A1 in the annex to this note), FES has:

- accepted a small downward revision that we made to the capital required to support K-factor correction;
- withdrawn its claim for a 'minimum cash covenant' requirement; and instead
- treated its claim for trading collateral as actual capital rather than contingent capital, applying the full cost of equity rather the lower 2% cost proposed in April 2026.

The last of these factors is the sole driver of the increase in FES' calculated margin requirement from 3.0% to 4.2%.

3. Issues List

Trading collateral / minimum cash collateral requirement

In its final April 2026 submission, FES placed a cost of £0.32m per annum on the arrangements that support its purchases of gas from Bord Gais.²

Our April 2026 report, and the Utility Regulator's draft SPC27 determination, made an allowance for £0.23m per annum to be consistent with the 'cost of credit' claims that FES submitted under the G_t term in its licence.

FES' August 2026 response now asks the UR to provide for an allowance of £0.99m on top of the £0.23m G_t amount.

It is important to be clear that there is no dispute here as regards how FES meets Bord Gais' collateral requirements. As we set out in our April 2026 report, and as FES confirms in its draft determination response:

- the collateral that FES posts currently takes the form of a letter of credit from its parent company's bank;
- FES' share of this letter of credit is £30m, of which the portion attributable to FES' regulated activities is £9.49m;
- the bank charges a fee for the letter and requires Yuno Group to hold a minimum cash balance;
- FES' share of the capital that is required to cover this cash deposit is £5.3m, of which the portion attributable to FES' regulated activities is £1.55m.

In its G_t claim, FES identifies first of all the direct costs that Yuno Group must pay to its bank and provides for tariff customers to pay a fair share of these expenses (£0.08m per annum). FES also identifies that Yuno Group's arrangement of a letter of credit is akin to a parent company (PCG), which it costs at 2% of the letter of credit amount (£0.15m per annum).

We have no dispute with these arrangements. Nor do we have any quarrel with the UR's draft decision to allow FES' G_t claims in full. The question is whether the UR should provide for an element of profit over and above the fees plus PCG claim.

² i.e. the sum of claims for a 'minimum cash covenant' and 'trading collateral', less a small amount of interest receivable.

After considering FES' latest submission, we continue to take the view that it should not.

The pass-through of direct fees is, we believe, uncontroversial. Thereafter, the opportunity cost that Yuno Group suffers as shareholder when it has to tie up capital in a minimum cash balance can be costed in one of two ways. We can either:

- apply our SPC27 cost of equity capital to the £1.55m cash amount, and then deduct interest received from the bank; or
- take FES' submitted costing of its implicit PCG.

We note that both of these approaches give a very similar costing of approximately £0.15m per annum.

FES' argument is as follows:

FES does not understand the conclusion reached in the First Economics paper where only £1.55m is treated as capital deployed. It is self-evident that the £1.55m physical cash is accompanied by actual contingent capital in the form of a £9.49m letter of credit, for which FES incurs interest and PCG fees (recovered through the Gt term). This capital is not "notional" as stated in the Draft Determination.

For the avoidance of doubt, our April 2026 report did not ignore the interest and PCG fees (see the final paragraph in section 5.4 of the report). Our approach differs from the approach that FES envisages only insofar as we treat the opportunity cost incurred in funding the £1.55m cash balance and the costing of the implicit PCG as one and the same thing rather than different costs. We are therefore not persuaded that there is an omission in our calculations.

We also disagree with FES' proposed alternative approach, in which the UR would ignore FES' real-life collateral arrangements and instead assume that a notionally efficient company would have no choice but to place the collateral that Bord Gais requires in the form of cash:

FES therefore believes UR's Draft Determination to be incorrect and, in the absence of an agreement on this point, would request that UR apply First Economics' alternative treatment; that is, to "size FES' capital base in line with the... capital requirement that an alternative hypothetical stand-alone supplier would face". To that effect, it is self-evident that a stand-alone supplier operating on such thin margins and volatile working capital would not have sufficient assets from trading activity to enable it to cash-back a letter of credit. Such cash would need to be in the form of equity. FES suggests therefore that the £1.55m is removed from the capital build up and replaced with an equity-backed capital component of £9.49m to represent a notional supplier's capital requirements.

As we said in our April 2026 report:

[W]e 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 to make maximum use of facilities, letters of credit, parent company guarantees, etc. before looking to injections of cash.

We continue to take this view.

We also note that FES' August 2026 addition of a £0.99m costing for trading collateral runs contrary to its April 2026 submission, which provided for an aggregate amount of only £0.32m in respect of FES' arrangements with Bord Gais. We take this to mean that the underlying disagreement that FES has with the UR's draft determination is not as stark as table 1 would suggest.

G_t allowance

FES requests in its response that the cost of credit should in future be treated as a pass-through item rather than be covered by an amount of revenue that is fixed for the duration of the SPC27 price control period.

This is first and foremost a matter for the UR, but we can state that we are sympathetic to FES' request. As FES notes in its response, there are factors that could cause the transaction costs that it and/or Yuno Group incurs when securing collateral to change in the coming years. Our assessment of the SPC27 cost of capital assumes that any higher or lower expenses will ultimately be passed through to customers rather than be borne by FES' shareholders.

We note that Power NI's licence provides for the UR to approve cost of credit claims made by Power NI on a rolling basis rather than a straight pass-through of costs. We think that the same regulatory design would be appropriate for the NI gas suppliers.

Intangible assets – IT system proposals

FES accepts in its response that there should be a new E_t item in its licence that would allow the UR to consider during the SPC27 period whether it is appropriate for FES to invest in new IT. This means that there will deliberately be no upfront cost allowance within the opex term in FES' SPC27 price control.

FES at the same time asks the UR to size its profit margin at a level that will cover the cost of financing an indicative amount of such future expenditure.

These two approaches are difficult to reconcile. Our understanding at the time of writing is that there is no guarantee that the UR will consent to additional new investment. Accordingly, it does not make sense to hard-wire into the calculation of the margin an allowance that will require customers to pay for the cost of financing a project that may not take place.

A far better approach is for the regulator to assess the total cost that customers should pay, inclusive of financing costs, as part of the E_t reopener.

Office costs

The UR has informed us of a discrepancy between the proposals that it made in its draft determination for office costs and FES' sizing of the 'tangible assets' line in its submitted capital base. Pending the UR's final decision on this matter, we do not make an explicit adjustment for the potential overstatement of FES' margin requirement. Rather, we note this as one of the factors that the UR will need to take into account when selecting an appropriate margin figure.

Cash buffer

FES' margin calculation includes two risk buffers: an amount of £1m of cash headroom above its forecast peak intra-month working capital requirement; and a more general pot of standby risk capital of £1.03m.

In our April 2026 report we said that this looked like double counting when compared to the UR's standing policy of providing for a single contingent buffer sized at 2% of turnover.

FES in its response disputed this characterisation, stating that we are effectively assuming that: "FES can operate its intra-month cashflows with absolute certainty and to a precise and balanced position of zero"; and "no additional capital whatsoever is needed to be deployed in the business to cover the risk of cashflow timing uncertainties".

We are not persuaded that we made an error. FES' projections show a pronounced peak in its intra-month working capital requirement in January or February each calendar year. In all other months, FES expects to have a near-zero or negative intra-month requirement. While we accept that FES cannot forecast its working capital requirements with absolute accuracy, any need for additional capital will likely be very short-lived. This strikes us as exactly the kind of eventuality that a pot of contingent capital is designed to cater for.

We therefore see no need to alter our April 2026 calculations. However, we also note that if FES is correct and we have been too aggressive in our approach, this is one of the areas in which our suggestion that the UR should set the allowed margin above the level that a strict capital base x cost of capital calculation would imply will be of benefit. The request that FES is making in this area translates to a required margin of 0.2%, which is well within the 'rounding up' that we allowed for in our work

Cost of capital

We said in our April 2026 report that the UR may wish to update our estimate of the cost of capital prior to issuing its final determination.

Our revised calculation is set out in table 2 below.

Table 2: Cost of capital calculation

Parameter	FES	First Economics
Expected market return	9.0%	9.2%
Risk-free rate	4.3%	4.7%
Beta	0.7 to 0.8	0.75
Cost of equity	7.6% to 8.1%	8.08%
Tax rate	25%	25%
Pre-tax cost of equity	10.2% to 10.8%	10.8%

Our parameter estimates take account of market data up to 31 July 2026. Our values for the expected market return and the risk-free rate align with the methodologies adopted by the Competition & Markets Authority in its March 2026 PR24 price control determinations.

Sensitivity analysis

FES notes in its response that pressures on commodity prices and cashflows have increased in recent months.

Like FES, we do not consider that this necessitates making wholesale revisions to the calculations in table 1. Rather, we note that the FES' £m profit margin scales 1-for-1 with changes in turnover, thereby

ensuring that the business will be able to cover the costs of a higher capital requirement in the event that we enter another period of elevated costs and tariffs.

We also note that the allowed return of 10.8% is meant to compensate shareholders for bearing a degree of risk.

4. Conclusions

Table 3 brings together our final calculation of FES' required margin. We make four adjustments to FES' August 2026 calculation:

- we remove the £1m of headroom from FES' intra-month working capital;
- we remove the upfront provision that FES makes for future IT investments;
- we cost the collateral that FES needs to support its gas purchasing arrangements in line with FES' G_t cost of credit claims; and
- we recognise that monies provided in the G_t term for these claims does not need to be allowed for a second time with the allowed margin.

Table 3: Final margin calculation

	<u>Capital amount</u>	<u>Cost</u>	Total
Actual capital			
- Working capital	£3.86m	10.8%	£0.42m
- Intra-month cash requirement	£1.08m	10.8%	£0.12m
- Tangible assets	£0.72m	10.8%	£0.08m
- K-factor correction	£2.30m	10.8%	£0.25m
- Collateral posted with Gas Market Operator	£0.31m	10.8%	£0.03m
- Minimum cash covenant requirement and letter of credit	£1.55m	as per G_t allowance	£0.23m
Contingent capital			
- Standby risk capital	£1.03m	2.0%	£0.02m
Required gross margin			£1.14m
Recoverable via G_t			(£0.23m)
Interest on K balances			(£0.12m)
Required net margin			£0.79m
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, after once again considering the cross-checks that we identified in section 5.7 of our April 2026 report, we

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

Annex

Table A1: FES' April 2026 margin calculation

	<u>Capital</u>	<u>Cost</u>	Total
Actual capital			
- Working capital	£3.86m	10.49%	£0.40m
- Intra-month 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.

Table A2: First Economics' April 2026 margin calculation

	<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 G_t 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%