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Price Protection Policy Team
Ofgem
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By email only

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Dear Price Protection Team,

OVO response to Operating cost review benchmarking working paper

Thank you for the opportunity to respond to this Working Paper. We are supportive of the Review of Operating Costs. As we have noted in our response to other consultations, we urge Ofgem to ensure that the sector can return to reasonable, sustainable profitability and investability through setting a cost reflective price cap that balances the drive for efficiency with recognition that regulatory change and uncertainty, alongside unpredictable exogenous factors, require flexibility and adaptability to ensure suppliers can recover costs in a timely manner.

We note that the review does not currently include an adjustment to reflect the costs suppliers incurred in administering EPG and EBSS. Suppliers introduced systems and processes to manage these schemes in extremely short timescales, delivering much-needed government support to households. Systems and processes that are now rather obsolescent and which suppliers have no long term benefit from. It appears somewhat perverse that these costs, over which suppliers had no choice and little control, would not be recoverable and we urge Ofgem to include a one-off allowance to remedy this either under the remit of this operating cost review or through a separate adjustment.

Our detailed responses to the questions and issues raised in the working paper are provided in the below Appendix. We would be happy to discuss our response further, and should you have any questions please contact policy@OVOenergy.com.

Kind regards,

Nicola Roberts
Senior Regulation Manager, OVO

APPENDIX

Overarching objective

Q1: What is your view on how benchmarking options will lead to different outcomes?

Q2: In terms of achieving those overarching objectives, what outcomes should we focus on through the operating cost review?

Q3: Are there any other outcomes that we should consider achieving through the choice of benchmarking options?

Q1 - Q3
The first outcome suggests a "strict efficiency driving cap that will set a high efficiency expectation and maximise customer price protection" set through a Frontier to Lower Quartile benchmark and indicated as being the status quo approach. Experience of operating under the price cap over recent years has demonstrated the flaws in the "status quo" approach. We would therefore have concerns around setting the benchmark between Frontier and Lower Quartile, or at Lower Quartile, it is apparent that allowances under the current price cap have not been sufficient to ensure reasonable, stable and sustainable profitability for the retail energy sector and setting overly stretching allowances will do little to support the financial resilience of the sector.

Table 2 demonstrates that three of the four outcomes could be delivered through a weighted average benchmark and whilst these are presented in the paper as being, to a degree, mutually exclusive it is clear that this is not the case. Using a weighted average benchmark to set a looser cap delivers in the round against the outcomes as demonstrated in Table 3. Further, as we note below, a looser cap can provide some protection against regulatory change provided there is an accompanying true-up to ensure the magnitude of cost impacts are recoverable.

A stringent cap is not the only means through which to ensure customer price protection, and Ofgem has a raft of measures in its regulatory toolbox through which to achieve this. The outcomes delivered via different benchmarking options should be viewed in this context.

The working paper suggests that the benchmarking sample could potentially exclude suppliers who do not deliver "acceptable levels of customer service". It is not clear however, how this would be defined or measured and as such whether this would be an appropriate adjustment to the benchmark sample.

Methodology

<u>Treatment of cost lines</u>

Q4: Are there groups of costs captured within the operating cost review that are cross correlated and therefore those costs should be considered and benchmarked together?

Q5: How should we treat costs (ie debt-related cost) that may be more uncertain than other costs

Q6: Are there any other costs that we should isolate from the total core operating costs?

Q4 - Q6
It is clear from the most recent consultation on the Debt-related costs allowance that not all elements of debt-related costs are sufficiently comparable across suppliers meaning that it is difficult to justify how these would be benchmarked together. Administrative costs and working capital costs are more subjective and there is a likelihood that variability is driven by differences in how data has been prepared as much as, if not more than, in underlying operational efficiency, thus demonstrating the degree of cross correlation between the elements would be challenging.

As we noted in our response to the Debt-related costs allowance consultation, it would be simpler for the bad debt allowance to be stated as a single building block of the price cap, which would allow for direct comparison against the bad debt expense recorded in suppliers' P&L. Debt-related administrative costs should be included within the operating cost review, but there is an argument to consider working capital costs within EBIT to ensure consistency across all cost of capital assumptions.

The working paper also suggests that the methodology may include potential adjustments to cost lines due to internal and external shocks. While supplier-specific events such as mergers and acquisitions could be justifiably adjusted for, we are concerned with the extent to which Ofgem are considering adjusting for external shocks such as the energy crisis. The impact of ongoing energy and cost-of-living crises are likely to have a long tail, with energy prices not forecast to return to pre-2022 levels until 2030. Therefore while they may be "one off events" those events, and the resultant impact on suppliers' costs, are ongoing. Isolating and excluding their impacts from reported costs and the benchmark would likely result in setting the allowance at a level which results in enduring under-recovery for suppliers.

Benchmarking parameters

Q7: What are your views on setting separate core operating cost allowances for smart meter and traditional meter customers, given the risks we discussed in this section?

In principle we believe there may be merit in further consideration of setting separate cap levels for smart versus traditional meter customers. Further incentivising the take up of smart meters would enable customers to reap the benefits from MHHS and innovative tariffs. However, we recognise that there may be distributional impacts that could impact some customer groups, particularly those who cannot have smart meters installed, and their treatment would need careful consideration.

Q8: What other benchmarking parameters do you think we should consider setting separate allowances for?

We do not have a view on this at this time.

<u>Non-efficiency factors</u>

Q9: What analysis do you think we should carry out in assessing the materiality of non-efficiency factors using the RFI data?

Q10: What other approach do you think we should take in how we account for non-efficiency factors?

Q9 & Q10

[✄] We refer you to OVO's response to Q9.7 of the Operating Cost Review RFI where we set out our high level thoughts on the costs impacted by non-efficiency factors and where more nuance may be required, e.g. the impact of single fuel electricity customers' on cost to serve may vary depending on whether electricity is the sole household energy source vs those with alternative heating sources such as oil.

Q11: What is your view on the proxy for suppliers' proportion of high-cost-to-serve vulnerable customers? Would you suggest an alternative approach?

It is clear that there is no single perfect data set that will provide an accurate assessment of the proportion of high-cost-to-serve vulnerable customers.

Whilst PSR data does have its limitations, as set out in the working paper, it has the benefit of being a mature data set that captures a broad range of consumer vulnerabilities that could impact cost to serve.

As noted in the working paper, suppliers will not have historic data for all 'Do not install' categories as this is a new requirement, additionally it is not clear the extent to which this would be a more robust proxy for high-cost-to-serve vulnerable customers than PSR data. Similarly there are also weaknesses with applying the WHD data set as eligibility criteria have changed over time making comparison more difficult and as noted in the working paper, not all those who are eligible will claim and some vulnerable customers with disabilities will not be eligible.

<u>The stringency level of the cap</u>

Q12: What level of stringency of the cap do you think we should consider?

We have set out in response to Qs1-3 a weighted average approach would be appropriate, to ensure the market on average is able to recover its costs. We note that the sector has been structurally loss making since the introduction of the price cap, and so repeating past practice is likely to lead to similar results and deliver a similarly uninvestable sector.

The Price Cap has operated primarily through a period of crises, introduced in 2019 there has only been one year of operation where suppliers have not dealt with higher costs caused by events outside their control - Covid 19, the energy crisis, the cost of living crisis. By contrast, the price cap was originally set during a relatively benign operating environment for suppliers (notwithstanding the irrational pricing in the market at the time). The higher level of complexity and variability in costs in recent years adds further rationale to the logic of departing from the previous supplier-hampering methodology. Ofgem does recognise this in the working paper, observing that there have been a number of regulatory changes of which the impact on suppliers' costs is not yet fully understood.

Q13: How should we account for the impact of the expected regulatory changes mentioned above?

Q14: Which option of accounting for the uncertainties in costs driven by upcoming regulatory changes do you agree with? What other options do you think we should use to account for these costs?

Q15: How should we account for the limitations in our methodology and the associated uncertainty?

Q13 - Q15
We would support a combination of Options 2 and 3 - including a forward looking adjustment to the benchmark to address "known unknowns", and setting a looser cap to account for future uncertainties. Of course applying both these options would, as noted in the working paper, address the direction of impact but not necessarily the magnitude and therefore we would support a potential true-up (or down) in future years. In order to reduce the regulatory uncertainty arising from this true up/down there should be a clearly set framework including for example triggers, timing and methodology, that is defined during this Operating Cost Review.

<u>Benchmarking approach across operating allowances</u>

Q16: What approach do you think we should take to set the benchmarks for different operating cost allowances

For the reasons set out above regarding stringency of the cap, and on benchmarking options, we would be concerned about a methodology that used different benchmarking metrics across components. There is a risk that Ofgem are seen to be "cherry-picking" efficient benchmarks across each different segment of costs, which could ultimately result in allowances being set below achievable costs.
The working paper notes that Ofgem may consider adjustments to the benchmark for each cost component - any such adjustments must be supported by clear and transparent analysis and methodology.