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By email only

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Dear Dan,

OVO response to Ofgem's Call for Input on the Operating Cost Allowances Review

Thank you for the opportunity to respond to this Call for Input (CFI). We agree that there should be a review of operating cost allowances, however we are not convinced that this is the appropriate time for such a review. As noted in our response to the associated draft RFI, we believe it would be prudent to delay the review until there is a period of greater stability within the retail energy market. Such a delay would allow for a more effective assessment of operating costs in a post-COVID and post-energy crisis environment.

The CFI notes, in a number of places, that correction factors will need to be applied to the baseline data to account for the recent and ongoing market conditions, as without them the original approach cannot be effectively replicated. Correction factors add uncertainty, and will themselves require post-implementation review to understand whether they were set at the right level, and whether they may have led to an over- or under- correction. The need for correction factors alone underlines the fact that there are significant issues in undertaking a review at this time.

Further, there has been under-recovery, and in some cases no recovery, of a number of cost elements under the price cap which must be prioritised ahead of this review. In particular, suppliers have incurred additional operating costs associated with the administration of EBSS and EPG which we believe warrant an ex-post adjustment. As noted in the letter and paper we submitted to Ofgem on 12 June, there has been significant under-recovery related to gas network cost allowances and CfD levy costs under the price cap. For gas network allowances and CfD under-recovery, we believe that not only should there be an ex-post adjustment to allow suppliers to recover reasonable costs incurred over 2022/23, but also note that the circumstances which have resulted in these under-recoveries are ongoing and therefore the methodology should be reviewed ahead of Winter 2023/24 to provide certainty that these costs will be properly reflected in the price cap going forward.

Upcoming regulatory changes are also likely to impact suppliers' operating costs in the period ahead of implementing any changes resulting from the operating cost review. We therefore consider it appropriate for Ofgem to ensure that costs associated with, for example, new requirements arising from the consumers standards framework are included within operating cost allowances on an ex-ante and true-up basis ahead of implementation of the outcome of the review. Ensuring that suppliers are able to recover costs within the period in which they are incurred will better support a return to market stability, providing a more sustainable footing and increased certainty to investors that regulatory uncertainty can be mitigated through timely cost recovery.

We are supportive of Ofgem's suggestion to provide working papers on elements of the operating cost allowance review. Given the complexity of the subject matter, and the relatively short timeframe we have had to consider this CFI, our responses represent our high level initial thoughts. As such, we believe that the publication of working papers will support a more transparent and robust approach that will allow for detailed consideration of price cap elements in a staged and managed process that can be aligned with the Government's wider review of the price cap, whilst allowing time for the post-COVID and post-energy crisis "new normal" to be better understood.

Our initial thoughts on the issues raised in the CFI 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 Energy

APPENDIX

Introduction

We broadly agree with the intended scope of the operating cost review. We note that there is no intention to true-up operating costs for past cap periods within the scope of this review. We believe that there should be an ex-post adjustment to ensure that suppliers can recover the costs of administering EBSS and EPG but we would prefer for this to take place outside of this review and to take place over a shorter timeframe than implementation of changes resulting from this operating cost review.

Case for review

Whilst it is clear that there has been a period of significant market change since the operating cost allowances were set, we do not believe that this is the appropriate time at which to conduct a review. In the last few years the energy retail sector has been subject to material change, with large numbers of supplier failures, COVID, and the ongoing energy and cost of living crises. Whilst we recognise and agree, that the data underlying operating cost allowances in the default tariff cap is out of date, we believe that it would be prudent to delay the review until there is a period of greater stability from which to assess operating costs in the context of the "new normal" environment, post-COVID and post-energy crisis.

Furthermore there are, as noted in the Call for Input, a number of ongoing and upcoming regulatory changes that will impact suppliers' operating costs. As such there is a risk that data collected now will also be out of date by the proposed implementation date, or soon thereafter, requiring additional RFIs and reviews of allowances, adding to the regulatory burden on suppliers. We believe therefore that ensuring that the costs associated with the regulatory changes expected in the short term are recoverable should be a priority workstream ahead of the longer-term operating cost review.

Main areas for consideration

Core operating costs

Drivers of changes in cost lines
Our initial thoughts are that the cost lines currently included within the operating cost allowance are broadly correct and at this time we have not identified any additional cost lines which should be included.

The operating cost review should also recognise the increased regulatory burden that suppliers have experienced in recent years associated with responding to and complying with the material increase in Ofgem's RFIs, stress testing, and consultations. These are unlikely to have been budgeted for as they are ad hoc, and will only have shown up in actuals in the last 12 months. Although we recognise that In fact, the actuals might not even show additional costs as teams may have worked harder in the short term to accommodate the increased workload, but long term there is a cost associated with this increased regulatory burden.

The setting of operating cost allowances should be sufficiently flexible to ensure that these can be updated and reviewed to reflect the impact of change in a timely manner. The degree to which increased costs are potentially off-set by corresponding benefits is more difficult to assess in the short-term, but could be captured effectively over time as could the impact on costs of any unintended consequences resulting from regulatory change. However, in order to determine whether and to what extent this may be the case would require cost / benefit analysis, not only at the time of implementation of change, but also at clearly defined points thereafter to deliver an understanding of the net position, including unintended consequences. Any methodology to achieve this would need to be consistent at all points of review with clear guidance and definitions to ensure comparability across suppliers.

Baseline data
We do not believe that it would be appropriate to use data from the last three to four years for setting the updated baseline for operating costs. Given the significant change and extraordinary circumstances the energy retail market has faced over this period we believe that it is more prudent to delay updating the baseline until a period of greater stability has been reached from which to assess costs associated with operating in the post-COVID and post-energy crisis environment.

Additionally, since operating costs were originally set, the price cap has moved from seasonal to quarterly updates, this drives additional operating costs across a number of areas of suppliers' businesses. Operating cost observations prior to the move to quarterly price cap setting would therefore not be reflective of current costs and would need to be disregarded or uplifted.

Baseline data would also need to be uplifted to reflect the impact of other regulatory changes such as the Involuntary PPM Code of Practice - debt collection, particularly warrant activity, is now more expensive than it was previously. The additional cost of this should be factored into the review, and samples of operating costs prior to the recent changes would need to be adjusted to account for the additional cost.

In our response to the draft RFI we noted that an alternative approach would be to develop clear guidance and methodology for the data request for the operating cost review review as a first stage, allowing suppliers to build the necessary reporting and start collating data with submission to Ofgem in Summer 2024 for implementation into the cap for Winter 2024/25. Whilst it is unclear whether we have moved to a period of stability, this would minimise the impact of the energy crisis and COVID on the baseline period, and allow Ofgem to establish clear data requirements to allow the baseline data to be updated on a defined timeframe to mitigate the impacts from the COVID / energy crisis tail.

We do not believe that the methodology should seek to incorporate significant correction factors at the outset to set the baseline. Correction factors add uncertainty and will themselves require post-implementation review to understand whether they were set at the right level and whether they may have led to an over- or under-correction. That they are required to correct for a number of significant exogenous factors demonstrates that there are inherent weaknesses in undertaking a review at this time.

Overall approach (Bottom-up vs Top-down)
On initial consideration we support Ofgem's proposal to retain a top-down approach. We agree that it is likely to be more proportionate, and share concerns that a bottom-up approach that set benchmarks for each cost line could have unintended consequences leading to the overall operating cost allowances being unachievable by a notionally efficient supplier. There may however be benefit in further understanding of the trade-offs through inclusion in a working paper.

Benchmarking approach
We agree that Ofgem should consider a range of benchmarking options and that a balance needs to be struck between consumer protection, incentivising efficiency and setting an achievable benchmark. The approach to benchmarking should be included within the working papers proposed as part of policy development.

Allocating costs across different parameters
We broadly agree with the parameters identified in the CFI and associated draft RFI. As noted in our response to the draft RFI, whether a customer is on the PSR is not necessarily the best measure for understanding the proportion of customers in vulnerable circumstances and Warm Home Discount data may be a better proxy.

Setting the allowance on an enduring basis
Given the significance and ongoing nature of recent events that are impacting suppliers' costs, we do not believe this is the appropriate time at which to determine allowances on an enduring basis. The review of operating costs should be postponed until there is a period of greater stability within the retail energy market. In the interim, Ofgem should ensure that allowances are adjusted to ensure that suppliers are able to recover the costs of administering the EBSS and EPG. Further, an ex-ante allowance and true-up approach should be applied to ensure that suppliers can recover the costs of regulatory changes such as the PPM Code of Practice and potential new requirements under the consumer standards framework. Ensuring that these costs are recovered in a timely manner, and preferably within the period they are incurred, will support restoring suppliers to reasonable profitability and making the sector more attractive for investors.

<u>Payment method differential</u>

Drivers of the payment method differential
We agree that given the regulatory changes that have been implemented and are forthcoming, and impact of numerous exogenous factors since the baseline data was collected, there is likely to have been an impact on operating costs. However, as per our responses to other sections, we note that as we are not yet in a period of stability following covid, the energy crisis and the cost of living crisis - the latter two being ongoing to some degree - it is difficult to determine the degree of permanence of the impacts of any drivers

of change in the payment method differential or indeed to attribute change to a specific cause. As such it is not clear that this is the appropriate time at which to make such an assessment. Given also that there is limited data available for the costs of new measures, both PPM Code of Practice and any forthcoming consumer standards review, these impacts should be included in an ex-ante and true-up adjustment to allowances to ensure suppliers can recover costs, or a portion of costs, in a timely manner but that longer term impacts can be considered in time with true-up (or down) as required.

Other payment methods
Our initial view is that the current payment methods are sufficient. [✄] As noted in our response to the associated draft RFI, we therefore believe that Ofgem should provide clear guidance for suppliers in how they expect this to be undertaken.

Benchmarking approach
Applying varying benchmarking methods to different elements of the allowance should only be considered where there is evidence to justify such an approach. Using different methods increases complexity and could result in the overall benchmark not being achievable by a notionally efficient supplier. This should be considered in any working paper on the benchmarking approach.

Costs allocation
The CFI notes that cost allocation would usually be based on assumptions for the proportion of customers on each payment method and that using recent data for this may not be possible given the impact of the energy crisis on the number of customers on default tariffs. We agree that using current data is not likely to be a reliable indicator across future payment methods, nor is it likely that past data will be entirely representative either. It is plausible that, as the energy crisis has driven increased focus on consumer energy bills, we will see an uplift in the numbers of customers who are engaged with the retail market as it re-opens, particularly while the cost of living crisis is ongoing. As we have noted several times throughout this response, we believe that this uncertainty in the fundamental building blocks needed for the operating cost review reinforces the case for a delay.

<u>Smart metering costs</u>

As noted in the CFI, the smart meter rollout has progressed since the baseline was set, and we are supportive of ensuring that rollout costs incurred so far are included within the allowances. We recognise that the SMNCC model is complex and that there may be benefit in reviewing whether it remains appropriate or if an alternative approach would be preferable. Given the interaction between changes to the allowances and potential implications on the incentives to switch to smart, we think this should be included in the proposed working papers for the operating cost review.

<u>Industry charges</u>

As noted in the CFI, while there have to date been some changes to industry bodies and charges, there are further significant changes on the horizon such as Market Wide Half

Hourly Settlement. We would expect the costs of these to be included within updated allowances. Whilst we recognise that proportionality is required in terms of complexity, we agree that pass-through of charges would most accurately reflect underlying costs and as such this should be the preferred approach.

Implementation approach

Updating the allowances over time

Any future price cap methodology must provide certainty for suppliers and investors that costs will be recoverable within a reasonable timeframe. Ideally within the period in which they are incurred, but otherwise there should be clarity around when ex-post adjustments will be considered, and the circumstances under which an ex-ante allowance and true-up mechanism will be deployed. Where Ofgem are introducing new regulatory requirements that are likely to result in increased costs for suppliers, an ex-ante / true-up mechanism would be preferable in order to ensure timely cost recovery. Where costs have been incurred as a result of exogenous factors and unforeseen events, such as COVID and the energy crisis, ex-post mechanisms are more appropriate and should take place to a prompt timetable.

Allocating operating costs across the standing charge and unit rate

We are not convinced that it would be appropriate to implement the solution proposed in option 2, that would see an increase in the standing charge as this will disproportionately impact low income households and customers with low consumption. We have, in the past, called for the abolition of standing charges due to the confusion they cause for customers and the degree of animosity towards them. Further, given the recent amendment to the Energy Bill placing a mandate on Ofgem to prioritise the UK's 2050 net zero target we do not believe it would be appropriate to implement an option that would potentially dilute energy efficiency messaging, a key pillar of delivering net zero.

In the absence of abolishing the standing charge, our initial thoughts are that it would be preferable to maintain the current approach. However, we note that Ofgem would not be able to gather new tariff data to replicate the original approach as most customers are currently on the default tariff. As we have noted throughout our response, this further demonstrates that this is not the appropriate time at which to conduct this review of operating costs and it may therefore be prudent to delay until there has been a period of stability from which a robust assessment of costs can be made without the need for significant regulatory intervention in the form of correction factors.

Next steps

We are supportive of the proposal to publish working papers, we believe that development of all elements of the price cap methodology should be a transparent process. Whilst we are concerned that the timing of this review is not appropriate, we believe that developing the methodology over time and in consultation with suppliers is the right thing to do. The views provided in our responses above are our initial thoughts - the publication of working papers will support openness and scrutiny, and will allow for more detailed consideration of operating cost elements in a staged and managed process that can be aligned with the Government's wider review of the price cap. We have noted throughout the response some specific areas where we feel a working paper may support policy development.

A staged and managed process would also be beneficial for data collection for benchmarking purposes - as we noted in our response to the associated draft RFI we do not believe it is appropriate to request data at this time so far ahead of implementation. We would support an approach whereby a clear methodology, guidance and data request is developed allowing suppliers time to build the necessary reporting and start collating data with a view to submitting data tables to Ofgem in Summer 2024 for implementation into the cap for Winter 2024/25. This approach would be more likely to result in data that is more comparable across suppliers and would require less interpretation and correction factors.