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By email only

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Dear Retail Price Regulation Team,

OVO response to Ofgem's Statutory Consultation on amending the methodology for setting the EBIT allowance

OVO exists to power human progress with clean affordable energy for everyone. We are committed to being a driving force in the UK's pursuit of net zero. Our role in this journey is outlined in our company manifesto, Plan Zero.

Delivery of Plan Zero, and the broader industry transition to net zero is dependent on creating an investable market. The draft Strategy and Policy Statement for Energy Policy in Great Britain¹ (SPS), which DESNZ is currently consulting on, recognises this and states that the retail market needs to be more resilient and investable while supporting the transformation of the wider energy system. The outcome of this consultation, and others into the mechanics of the price cap, are critical in achieving these objectives - creating a stable and investable Retail sector that can act as a force for decarbonisation whilst continuing to deliver the high quality service levels which our customers expect.

Impact of amendments to the EBIT setting methodology on suppliers' EBIT

The consultation document (page 5) implies that the revised methodology increases supplier's EBIT by £10 compared with the status quo. However, this is not the case. Our analysis shows that once the impact of Renewables Obligation ringfencing is accounted for, the difference in the absolute value of the allowance is negligible. Under a central forecast for wholesale prices to Q3 2025 the proposed methodology represents a delta to the current position ranging between -£0.18 and £1.24. Under a high wholesale price forecast scenario suppliers could be worse off under the new methodology by between £1 and £5.

¹ DESNZ: Strategy and Policy Statement for Energy Policy in Great Britain Consultation - [link](#)

Work undertaken by Charles River Associates on behalf of OVO

Alongside a number of other suppliers, coordinated by Energy UK, we have commissioned Charles River Associates to review the working capital model and associated outputs which have been used to inform Ofgem's conclusions around the level of capital employed by retailers. The need to commission work from a third party indicates the importance of this review to retailers, and the level of complexity which we believe is embedded in the consultation process.

Inequity between gas and electricity on the recovery of RO ringfencing costs

The consultation proposes splitting the fixed costs of ringfencing renewable obligation certificates equally across gas and power customers. However, renewable obligation costs are only borne by suppliers who supply electricity customers. As such, the proposed methodology will disproportionately benefit suppliers with a high gas penetration percentage, and will disproportionately penalise suppliers who have a low gas penetration percentage. This is both unfair, and also results in a £10 per year per customer incentive for suppliers to not encourage customers to electrify their heating sources. We recommend that this is rectified, and the full recovery for the costs of ringfencing ROs should be removed from the supply of gas, and reallocated to electricity. To not do so would, for the reasons given, appear to run counter to the statutory net zero duty incumbent on Ofgem under the Energy Bill.

Failure to rectify this would result in an over-recovery of costs by suppliers with higher gas customer penetration, running into the millions of pounds per annum, and an essentially equal under-recovery of costs by suppliers with a higher electricity customer penetration. This creates further market distortion and goes against a competitive market.

We appreciate that the price cap cannot and should not be supplier-specific - and that Ofgem needs to be mindful of the market as a whole. However, it is Ofgem's responsibility to avoid introducing distortion into the market. It is fair and reasonable to expect Ofgem to ensure that the costs of delivering schemes are recovered by the same suppliers who incur those costs, and hence the inappropriate allocation of costs should be rectified.

Working capital

We believe that the calculated level of capital employed by the notional supplier is materially understated. We have provided five areas within our detailed responses outlining this, and would also point to the further areas which Charles River Associates have outlined in the report attached to the Energy UK submission.

Our detailed responses to the consultation questions are provided in the below Appendix. We would be happy to discuss any elements of our response further through bilateral discussions. Should you have any questions please contact policy@ovoenergy.com.

Kind regards,

A handwritten signature in black ink, appearing to read 'Vinny Casey', with a stylized, cursive script.

Vinny Casey

CFO, OVO

APPENDIX

Q3: Do you agree with our approach to estimating working capital? If not, why not? Please explain your reasoning.

We do not agree with the approach adopted for estimating working capital, as outlined below.

3.1 Average vs. required working capital

- Suppliers must ensure that they have sufficient capital at all times to fund the low point of the annual cash cycle.
- Suppliers' capital structures don't work like RCFs or concertinas.
- Instead, suppliers must ensure that sufficient equity/ debt capital is injected into the business to cover the max requirement on a 3 - 5 year basis (capital structure changes aren't fully liquid).
- Therefore, working capital employed should be calculated as the maximum requirement over the period, rather than the average.

The model, however, takes into account the average working capital employed by the notional supplier rather than the average. *Tab 'Summary', cell L39.*

Adjusting for this in the working capital model would increase the working capital employed per customer from £127 to £133. Without adjusting for this, the notional supplier would have a negative cash balance for 8 of the 12 months in the reference period.

We recommend that the maximum working capital requirement is included in the EBIT calculation, rather than the average.

We appreciate that this point is addressed in the consultation document in paragraph 4.55. *"We use the average working capital rather than the peak value within that year...we consider using the average working capital metric avoids overcompensation, as suppliers could manage their finances based on predictable direct debit payment seasonality."*

This narrative misconstrues the nature of suppliers' capital structures, and assumes that capital structures can be drawn and paid back on a monthly basis; this is simply not the case. If this assumption isn't corrected, the notional supplier would be insolvent within 10 months of the beginning of the modelled period.

3.2 Reference period for working capital calculation

The model takes working capital output from a reference period which covers only 12 months out of the total 24 months modelled. *Tab 'Summary', cell L39.*

However, the months not included in the reference period have a higher average working capital level (£4 higher than that allowed for), and an even higher maximum working capital employed level (£40 higher than that allowed for).

Without adjusting for this, the notional supplier would effectively have a negative cash balance for 14 of the 24 months modelled.

We recommend that the full modelled period is taken into account in the EBIT calculation, rather than a subsection of the modelled period.

3.3 Solving for a nil cash balance

The model optimises working capital to ensure that the minimum cash balance of the notional supplier over the forecast period is nil. As such, the notional supplier is forecast to have a nil cash balance in April 2024.

Suppliers simply do not plan or set capital structures to have nil residual cash.

This assumption would mean that the notional supplier isn't able to withstand even the slightest non-market risk (operational risks aren't modelled in the model's simulation).

We recommend that the model assumes that the notional supplier maintains sufficient cash to cover at least two months of operating costs.

This is supported by the Charles River Associates report, paragraph 57, which states *"In reality, suppliers would never solve, or optimise in such a way to reach zero cash for operations. It is important that Ofgem reflects that reality in its modelling."*

Correcting for this oversight would increase the assumed working capital employed by £44 per customer.

3.5 Imbalance costs

The price cap is designed to allow retailers to recover the expected value of each of the costs which it faces. In particular, there are specific allowances within the price cap for shaping, forecasting error, and imbalance costs - these are set to allow retailers to recover the average expected level of such costs.

This was noted in Ofgem's further EBIT consultation dated 25 November 2022.

However, in addition to covering the expected value of such costs, retailers must ensure that sufficient liquidity is held at all times to cover a severe but plausible elevated level of imbalance costs which may arise from short term weather or other consumption impacting events. Indeed, Ofgem's stress testing workstream asks suppliers to simulate short term demand shock events (akin to weather events) and seeks to ensure that retailers have sufficient capital to withstand such events.

The requirement therefore to hold cash to cover such risks is real. The only other way

for suppliers to mitigate such risks would be to purchase weather insurance - such products are illiquid and uneconomical, and there is no allowance in the price cap for such costs.

The working capital model, however, ignores this as a component of risk capital and instead only considers customer number movements as a driver of volume risk. This wholly underestimates the volume risks which suppliers face.

Put another way, suppliers grant SVT customers two free options:

- **Free option 1:** Join and leave at will, with no exit costs
- **Free option 2:** Use as little or as much commodity as they choose, with no over/under consumption penalty.

The risk capital simulated in the working capital model only considers the capital required to withstand a plausible variation in the cost of free option 1, and completely ignores the working capital required to withstand a variation in the cost of free option 2.

We note that Ofgem's decision appendix 4 - wholesale costs dated 6 November 2018 paragraph 115 acknowledges that there is a net cost to managing weather volatility and that regard is given to this in the uncertainty and headroom allowance.

However, there is a lack of clarity what level of volatility and working capital burden is factored into such allowance. It would be much more transparent and consistent if the working capital burden which retailers face from such costs is rewarded in the same place as all other working capital burdens in the price cap. Any regard which is given in the uncertainty allowance in respect of such costs should be recalculated and relocated to the EBIT allowance.

We recommend that the working capital model is adjusted to simulate severe but plausible weather and other consumption related events, and that the working capital requirement is adjusted to accommodate the additional capital required to cover such risks.

Over the past 24 months this has been the single biggest risk which retailers have faced. It is unacceptable for Ofgem to not reassess this risk when assessing risk capital.

Without access to the SWPM model which Ofgem has used to simulate price and volume events, it's impossible for us to quantify the impact. However, we believe that this would have a material impact to the modelled working capital level if corrected.

Q6: Do you agree with our proposals on cost of capital? Please explain your reasoning.

We do not agree with the proposals on cost of capital, the level is set too low.

The increase in the assumed cost of capital, has been driven by an increase in the

assumed notional energy retailer's beta.

We note, however, that the cost of capital allowed for under the cap is still low when compared with empirical evidence. Much of the information used to inform the beta is based on outdated market information, which does not take into account the real risks which retailers have faced over recent years.

We recommend that Ofgem compare the output of the theoretical cost of capital calculation with:

- I. empirical data for capital which has been raised in the current market environment, and/ or
- II. reliable proxies through interviews with informed capital allocators for the returns which they would seek when investing capital in GB energy retailers.

**Q7: Do you agree with our approach to setting and scaling the EBIT allowance?
Please explain your reasoning.**

Recovery of RO ringfencing from both gas and electricity customers

The inclusion of the RO ringfencing allowance within a single EBIT allowance applied evenly across electricity and gas (as specified within clause 6.8 of the published consultation) will result in an over-recovery from gas customers and an equivalent under-recovery from electricity customers.

This does not satisfy the criteria of the price cap being cost-reflective, as RO ringfencing costs are incurred from supplying electricity customers only; thus creating an unfair advantage for suppliers with a high proportion of gas only customers who will recover more costs than they will actually incur.

Similarly, this approach would disincentivise suppliers from promoting the electrification of heat as converting a customer from dual fuel to single fuel would halve the fixed element of the EBIT allowance from £19.20 to £9.60, whilst also increasing the costs of RO ring fencing (due to higher power consumption).

We recommend that the recovery of the costs of renewable obligation ring fencing are applied solely on electricity tariffs. This will both ensure that suppliers appropriately recover the actual costs which they incur, and will also remove the dis-incentive to promote the electrification of heat. Failing to change this will result in excess revenues for suppliers who have a high gas only penetration, and under recovery of costs for suppliers who have a high electricity only penetration.