OVO Energy
1 Rivergate
Temple Quay
Bristol BS1 6ED

policy@OVOenergy.com
www.OVOenergy.com

Dan Norton
Price Protection Policy, Ofgem
priceprotectionpolicy@ofgem.gov.uk
By email only

17 January 2024

Dear Dan,

OVO response to Ofgem's consultation on the additional debt costs review

Thank you for the opportunity to respond to this consultation. OVO strongly supports the implementation of an adjustment to the price cap to reflect additional debt-related costs incurred by suppliers between April 2022 and March 2024. However, upon review of Ofgem's latest proposed approach to implementing the adjustment, we have identified a number of concerns that we believe must be addressed in advance of the final decision, without creating further delay to implementation from 1 April 2024.

Summary of key concerns

1. ***Stringency in setting the float*** - we support the float and true-up approach that Ofgem has proposed, but consider the use of a lower quartile benchmarking approach over a median or weighted average benchmark to be irrational and unbalanced. Such an approach (i) will drive significant supplier under-recoveries, (ii) contradict other regulatory policies such as ensuring financeability of the sector, the PPM moratorium, and the increased expectation of supplier leniency in debt collection under the new Consumer Standards, and (iii) risk introducing an unpalatable true-up value and process, as detailed below.
2. ***Risk to an effective true-up process*** - whilst we support a true-up process by April 2025, the overly and unnecessarily stringent approach to setting the float for April 2024 is likely to result in a significantly more complex, drawn out, and unpalatable true-up process. The expected value of a true-up under the current proposed approach is significant, and will likely be extremely complex to calculate. The lower quartile benchmarking approach alone reduces valid recovery by as much as £23 per customer versus a weighted average benchmark, generating material under-recovery over the period of the float that will need to be accounted for as part of the true-up process. This will undoubtedly lead to significant consumer bill volatility, while also risking further lagged recoveries for suppliers and hence further damaging investor confidence in the sector.
3. ***Risk to market financeability*** - further delaying the supplier recovery of efficiently incurred debt-related costs will present significant challenges for the sector as a

whole. Suppliers will be further limited in their ability to invest in best in class customer service and operations, and will be hampered in their ability to meet minimum capital requirements. This is likely to further damage the attractiveness of the sector, limiting investment in much needed innovation, products, and propositions that support the nation's pursuit of net zero. Further, the approach could create an inappropriate incentive for suppliers to avoid debt-risk customers, who are often more vulnerable and depend on enhanced levels of supplier support.

4. ***Lack of appropriate cost allocation*** - the proposed approach fails to address the distortionary impacts of the way in which debt-related costs are allocated under the price cap mechanism. Debt-related costs are materially higher on average for Standard Credit customers than Direct Debit customers. The smearing of these costs across both payment methods within the price cap results in a material over-recovery of costs by suppliers with higher proportions of Direct Debit customers, and significant under-recoveries for suppliers with higher proportions of Standard Credit customers. This distortion must be addressed.
5. ***Technical concerns with Ofgem's calculations*** - there are a number of areas of concern within the calculation approach that has been adopted, such as the sample approach to calculating the lower quartile benchmark, the distinction between tariff and payment types, the assumptions in relation to customer consumption, and the treatment of inflation / cost of capital. These concerns are further compounded by a lack of transparency over the model used in the calculations.

Within this response we have provided more detailed views on each of the key sections of Ofgem's proposals.

1. Scope of the adjustment

OVO are supportive of Ofgem's proposed approach to provide a float that includes estimations of bad debt costs over the current winter period. However, we note that no adjustment has been considered for estimated costs beyond March 2024. Despite the fall in wholesale energy prices since the peak of the energy crisis, energy bills remain significantly higher than pre-crisis levels. With the absence of government energy bill support going forward, levels of bad debt are expected to continue rising. We therefore believe that **any adjustment to the price cap should be extended to cover estimated costs until such time that the Operating Cost Review can implement enduring changes to the debt-related costs allowance**.

Further, we note Ofgem's decision for the adjustment to include administrative and working capital costs. It is our view that these costs are substantially more prone to subjectivity and differences in the basis of preparation between suppliers - as evidenced by the material movement in the proposed working capital adjustment between the October and December consultations and Ofgem's acknowledgement that *'bad debt was the only debt-related cost suppliers were able to consistently break down'* . As a result, we do not consider these costs to be separately identifiable and comparable between suppliers, and therefore believe that **administrative and working capital costs should be considered as part of the wider operating cost review <u>only</u>** (particularly given the fact that Ofgem has relied upon different sources of data to estimate the allowances). In order to avoid a price cap cost base that is unachievable in practice for an efficient supplier, Ofgem must ensure that allowances are not set at the efficient frontier within both this review and the Operating Cost Review. The proposed approach risks the allowance for administrative debt costs being set at the efficient frontier through this review, and at the efficient frontier for another category of operating costs through the Operating Cost Review, when in reality the differences in operating costs reported by suppliers are likely to be a reflection of differences in supplier accounting practices rather than underlying efficiencies. Setting the allowances to the efficient frontier in both cases will result in a price cap cost base that is unachievable for suppliers.

It has been proven through the large volume of supplier failures, the structural loss making nature of the industry, and the EBIT consultation that the EBIT allowance (which includes a working capital element) was too low during the majority of the assessed period. This has not been reflected in any retrospective adjustment, hence **Ofgem including a negative adjustment for working capital would be inconsistent and extremely one-sided**. Similarly, the clear dependency between the calculation of the net debt-administration costs and the Operating Cost Review requires absolute consistency from Ofgem in terms of their treatment. Including a negative adjustment for 'over-recovered' debt-administration costs would set a precedent for Ofgem to investigate each individual operating cost item and apply a retrospective adjustment covering any over or under recovery of said item covering the period from April 2022 to the conclusion of the Operating Cost Review. This would contradict Ofgem's fundamental principle of assessing such costs in the whole.

In addition to the above, we note the proposal not to uprate the adjustment for either inflation or cost of capital, despite the resounding support for this in the responses to the October consultation. It is clear that suppliers will need to be compensated for the time value of money and the cost of the working capital that has been required to fund this shortfall over a sustained period, hence we do not see any reason to exclude any such uplift from the initial float value. **The cost of any under-recovery should be valued at the cost of capital (12.3%) since this will best reflect the cost to suppliers of temporarily funding the industry's bad debt issues as a result of under-recovery via the price cap**.

Ofgem's counterargument that *'the cap is not intended to to align the timing of revenue and costs'* and that *'suppliers should have sufficient facilities to manage working capital as part of their normal business'* is highly damaging to the investability of the sector due to the largely unpalatable P&L volatility that it introduces. Similarly, the working capital allowances within the price cap are designed to reflect business as usual operations, not to reflect the funding of structural industry-wide under-recoveries of over £250m per quarter - as we have observed in the last two assessed cap periods (10a and 10b). We specifically note that the EBIT model which was designed to determine suppliers' working capital requirements did not account for lagged recoveries of costs - and hence any lagged recoveries of costs are necessarily marginal (i.e. additional) to that which the EBIT allowance is designed to fund.

2. Benchmarking methodology

The lower quartile benchmarking approach is overly cautious. By definition, applying a lower quartile benchmarking approach implies that 75% of suppliers are expected to under-recover their costs and therefore be theoretically structurally loss making (after servicing costs of capital).

Another major concern that we have with Ofgem's approach to benchmarking costs is in the lack of distinction between Direct Debit and Standard Credit customers / costs. This issue is inherent within the existing price cap methodology and would only be worsened by the proposed allowance. Fundamental differences between suppliers and their customer mixes in terms of both payment and tariff types make the lower quartile benchmarking approach inapplicable and highly dangerous in terms of the signals that it conveys to the market.

The issues with the lower quartile approach are exacerbated in this scenario due to the following reasons:

- The differentials between the debt-related costs associated with different payment types are so vast that benchmarking against *'representative'* suppliers is not sufficient. Ofgem acknowledges a number of data limitations within their analysis, including the fact that *'suppliers were not able to consistently breakdown'* either working capital or debt-related administration costs by payment type. The absence of sufficiently granular analysis makes it impossible for the lower quartile approach to be fairly and reliably applied (as the lower quartile suppliers will be those with the highest proportion of non-standard credit customers), and hence highlights the need for a weighted average approach with the appropriate allocation by payment type (discussed later).

- Targeting the lower quartile supplier for the working capital element implies that suppliers will be penalised for acting in the best interests of customers and being less aggressive in their Direct Debit setting and debt collection policies. This is in stark contradiction to recent policies set by Ofgem, such as the PPM moratorium, expectations around availability of Additional Support Credit, and the increased expectation of supplier leniency in debt collection under the new Consumer Standards. It also creates a detrimental incentive for suppliers to avoid higher debt-risk customers - customers who are often vulnerable and in need of enhanced support from their supplier. We strongly believe that this is a dangerous message for Ofgem to convey to the sector.

Further, the setting of an overly stringent adjustment now generates significant risks for the planned true-up process in 2025. The value of the true-up adjustment will be extreme, complex to calculate, and likely unpalatable as a result of the significant consumer bill volatility that it will drive. In the event that supplier recovery of reasonably incurred costs is further delayed as part of the true-up process, as a result of setting an overly stringent allowance now, the strength of both supplier financeability and sector-wide investor confidence will once again be materially damaged.

Whilst we acknowledge that Ofgem are proposing a lower quartile benchmarking approach in order to minimise the impact of any uplift on consumers at this stage, it would not be fair to expect the industry, as a whole, to carry such significant losses as a result. **Ofgem should adopt a weighted average benchmarking approach when setting this adjustment** (as per Option 2 in para 5.23 of the consultation)**.**

Recent falls in wholesale prices provides an opportune moment for Ofgem to correct for prior under-allowances and introduce a more balanced float allowance. The level of the underlying price cap in April 2025 (the point at which the true-up adjustment is expected to be implemented) is largely unknown at this point in time, hence April 2024 provides an opportunity to allow prompt recovery, whilst reducing the risk of an exceptionally high price cap in April 2025 caused by the need for a significant true-up.

3. Calculating the allowance

Whilst we appreciate the opportunity to provide feedback on Ofgem's calculation methodology, it is difficult for us to sufficiently do so in the absence of access to the underlying model(s) used. **Ofgem should share the underlying model(s) with suppliers immediately, to allow adequate review and feedback in advance of any final decision**.

However, following review of the consultation document (in particular Appendix 1 & Appendix 2), we note the following:

- **The use of Q3 2023 as the basis of the estimate for the Winter 23-24 under-recovery is too conservative, and a more central estimate should be adopted to avoid further risk to an effective true-up process:**
    - Continued inflated prices through a winter period without any consumer affordability government support schemes is expected to drive further divergence from the existing cap allowances versus the Q3 2023 period
    - Debt-related costs are typically higher during winter than in the summer, in particular, debt costs trend to lower values toward the end of the summer period following months of lower customer bills
    - The observed Q2 2023 under-recovery was greater than that observed in Q3 2023
    - Hence all of the evidence points towards Q3 2023 being a too conservative baseline for the Winter 23-24 estimate. Clearly there is uncertainty around the exact levels of under-recovery that will occur, however with a true-up mechanism to follow, we believe that Ofgem should include a more central estimate as opposed to the overly prudent one proposed.

- Further to the above concerns over the use of Q3 2023 as an observation period to set the forward adjustment, we note that the reintroduction of Involuntary PPM activity in January 2024 will lead to a sharp increase in administrative costs, as suppliers seek to clear the backlog caused by the moratorium whilst also being required to spend more in order to comply with new regulations. **Using a period during which no involuntary PPM activity was being conducted across the sector to set an allowance that should be accounting for increased levels of debt administration costs represents a flawed methodology that must be corrected**. In addition, any benefit arising from the reduction of bad debt costs through the restart of involuntary PPM activity will not be realised until after the adjustment period.

- In calculating the net working capital costs, Ofgem applies a 10% cost of capital. It has since been shown that this rate was too low and was not representative of the cost of capital actually incurred by suppliers - hence the subsequent increase to 12.3% as part of the EBIT consultation. As such, **when calculating suppliers' cost of capital, 12.3% should be applied, as opposed to 10%**.

- The failure / inability to perform the calculations for working capital and debt-administration costs by payment type is a fundamental flaw in the analysis (given the significant differences between them); this is discussed further in the next section.

- In the absence of a breakdown between payment types, **the assumption that per customer working capital and debt-related administrative costs are *'equal between default and fixed tariff customers'* is fundamentally flawed**. The proportion of fixed tariff customers who pay via Direct Debit is typically much higher than the equivalent proportion of default tariff customers. Direct Debit paying customers incur significantly lower debt-related costs for a number of different reasons. Similarly, in the absence of quarterly price changes, it is easier for suppliers to set customer direct debits and manage working capital for a fixed tariff customer compared to a default tariff customer.

- The net costs are all calculated at a £ / account level. However, to convert these £ / account values into unit rate uplifts, Ofgem applies the legacy TDCVs of 3,100kWh and 12,000kWh for power and gas respectively. The current TDCVs are 2,700kWh and 11,500kWh, hence failure to adjust for this in the final calculation would result in suppliers, on average, under-recovering by a further 13% and 4% for power and gas respectively. **The assumed consumption values should be updated to reflect the current TDCVs**.

4. Allocation of the allowance

It is clear that there are material issues with the existing price cap methodology in relation to the allocation of costs by payment type. The market distortion caused by these issues needs to be addressed as soon as possible. We welcome Ofgem's minded-to position to introduce levelisation of debt-related costs in Winter 24-25 and are supportive of this required change. However, the proposal to apply the float allowance evenly across Direct Debit and Standard Credit tariffs would represent a backwards step on this, and further worsen the situation caused by the historical misallocation.

We acknowledge that the timing of the proposed uplift in April 2024 does not align with the proposed implementation date for debt levelisation of October 2024. However, we believe that there are more appropriate measures that Ofgem could take to bridge the gap in the meantime:

- Standard Credit and PPM customers typically pay less than Direct Debit customers during the summer due to seasonality. As such, with an October 2024 implementation date for debt levelisation, Ofgem could apply the Reported Cost Allocation method to the April 2024 uplift without exposing vulnerable customers to the higher prices during a winter period.

- The initial float allowance does not need to be in place for 12 months. Under an equal allocation approach, the longer the duration of the allowance, the bigger the aggregate misallocation between payment types and therefore the greater the level of market distortion. This will only enhance the requirement for a more material and sophisticated true-up approach in the future. Instead, Ofgem could set an initial 6 month allowance to cover the period until the implementation of levelisation, followed by a more appropriately allocated allowance beginning in October 2024 - from which vulnerable customers will be protected anyway via the levelisation mechanism.

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