July 2022

Dear Mr Jones

Thank you for the invitation to provide written evidence to the BEIS Select Committee on the proposals from Ofgem on ringfencing credit balances, and specifically the assumptions made in the impact analysis (conducted by NERA) that underpins these proposals.

In the context of rising energy prices and extreme market volatility, it is critical that the future structure of the energy retail market protects consumers from the costs of market failure by promoting greater financial sustainability, and ensures that the retail sector plays its part in achieving net zero.

Whilst we support Ofgem's consideration of how consumer credit balances are better protected going forward, the financial requirements to ensure greater stability must be carefully balanced with the risk of imposing excessive burdens which could undermine the financial stability of well-run suppliers.

Our view is that the impact assessment conducted by NERA and used by Ofgem to justify this intervention has been inadequately prepared and risks justifying an intervention that will represent poor value for customers.

Our specific concerns are twofold:

1) **The impact assessment underestimates the cost of ringfencing customer credit balances:**
    a) It assumes a cost of debt of 1.12% which has been benchmarked and referenced incorrectly.
    b) The credit balances to which the cost of capital is being applied are expected to be much greater this winter than in 2021 (the period reviewed by the NERA paper) as a result of rising commodity prices. Basing the analysis on a pre-2022 commodity environment is inaccurate and produces misleading conclusions.

2) **The analysis significantly overestimates the forward looking cost of mutualisation.** It assumes the supplier failure rate seen between 2016-2021 will continue in the future. However, the mutualisation costs were largely driven by a large number of unhedged and unsustainable energy suppliers, who have now exited the market.

We would be happy to discuss this evidence in more detail with you and the Committee.

Yours sincerely

Vincent Casey
Group CFO, OVO

OVO's response to the impact assessment conducted by NERA:

1) **The impact assessment significantly underestimates the cost of ringfencing customer credit balances**

a) <u>Cost of Capital</u>

Equity capital is required

- Under the proposals, our analysis shows that in practice, an independent energy supply business would need to raise a blend of debt and equity to support this funding requirement.
- There is limited market data of the valuation of standalone energy suppliers, but OVO's acquisition of SSE's retail energy business in 2020 represents a direct comparable transaction. SSE's retail division was acquired for £500m in 2020 and on a standalone basis will have a capital requirement of £450m under these proposals (implying a ringfence requirement of 90% of company value). It is wholly unrealistic to issue a bond of that proportion in a retail business.

Reference cost of capital

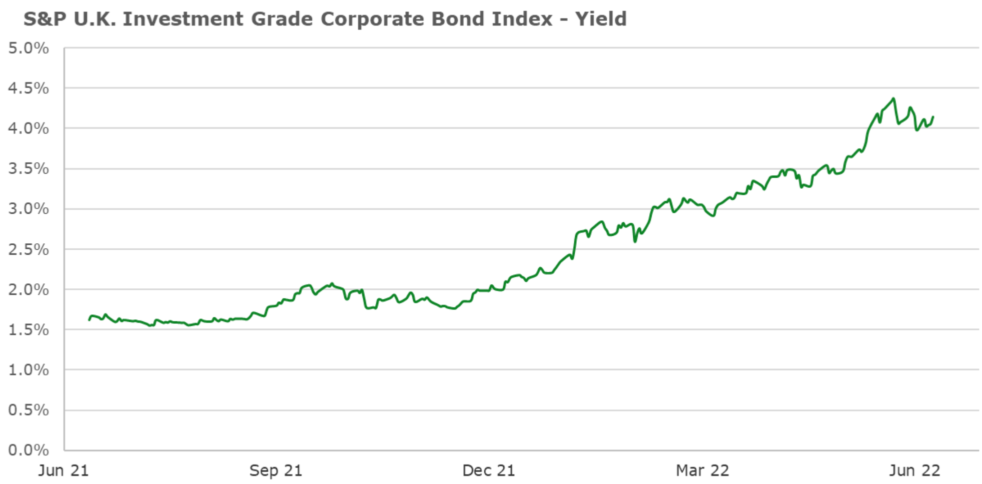
- The NERA analysis references a BBB- credit rating of a number of energy conglomerates such as Centrica, EDF, Iberdrola, E.On and SSE plc.
- However, this set of companies are not comparable with an energy supply model and their credit ratings are supported by lower risk, regulated infrastructure assets, rather than retail supplier operations.
- **We propose that a credit assessment should be taken on the standalone retail business, rather than assuming that another business entity in a different part of the value chain will subsidise the UK's energy retail market. This will significantly increase the implied cost of debt.**

Incorrect reference period

- Putting aside the incorrect credit rating, the wrong reference period has been used to assess the cost of debt.
- The additional capital requirements proposed by the paper would need to be raised in the current market conditions.
  - However, the analysis adopted the average bond yield for a BBB- rated company over 2016 to 2021. Whilst this is the period over which many

suppliers exited the market, this is coincidental and there is no rationale to use a historical period for a forward looking requirement.

- We note that the yield on the UK Investment Grade Corporate Bond Index has increased from ~1.6% in mid 2021 to over 4% today.



- his error in the analysis has led to an underestimation of the cost of this policy by a factor of 3x.

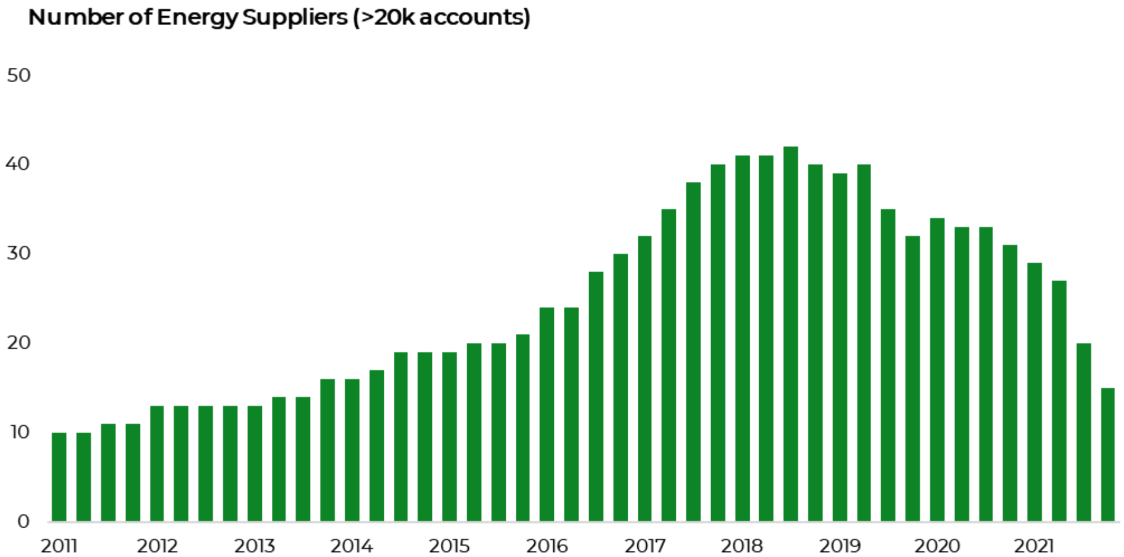
<u>Amount Insured</u>

- Commodity prices have increased significantly since the start of 2022 and current forward curves indicate that higher pricing is going to remain for the foreseeable future.
- NERA's analysis is based on credit balance positions from September to December 2021.
- Credit balances are primarily a function of commodity prices, and we expect credit balance positions to be 3x greater this winter than in 2021 as a result.
- **With such a fundamental change in commodity pricing dynamics it is a significant oversight by NERA to ignore the impact in their cost benefit analysis.**

2) The impact assessment overestimates the forward cost of mutualisation

- NERA's analysis assumes that the average annual credit balances mutualised from 2016-2021 continue to be mutualised (via the SoLR levy) across the market each year on a forward looking basis.

- However, the cost of supplier failure to consumers by mutualisation is likely to be much smaller now that unsustainable suppliers have already exited the market.
- The recent wave of supplier exits was a predictable outcome of a prior regulatory approach several years earlier which lowered the barrier to entry for the retail energy market and encouraged extreme competition.
- Although the recent volatility in wholesale commodity prices accelerated the rate of supplier failure, the number of energy suppliers has been reducing since 2018 as unsustainable business models have been exposed.



- The impact of other policy changes that have already been effected, such as fit and proper person checks for directors, market stabilisation charges, restrictions on suppliers' ability to offer certain tariffs, and other regulatory tests have not been taken into account.
- Had these been in place from 2016 onwards, risky energy suppliers would not have been able to grow in the way that they did, and mutualisation costs would have been significantly lower.
- **Over-insuring the issue will result in a larger cost to consumers overall.**

3) Other considerations:

a) The impact assessment is focused on one side of the issue

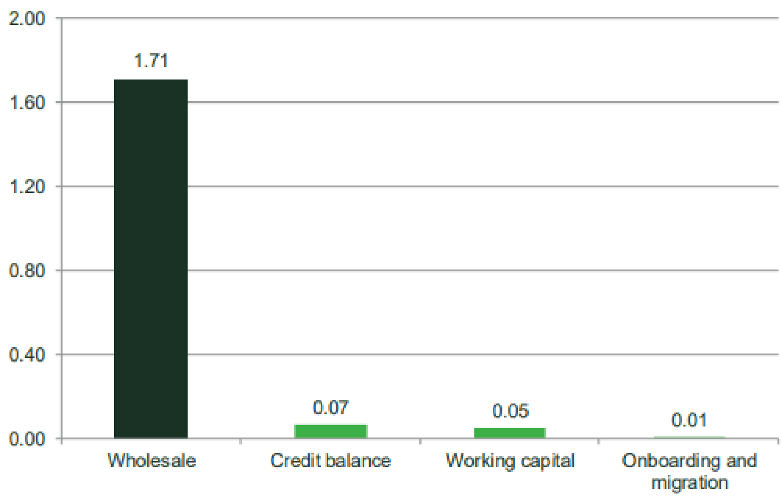
- The analysis is overly focused on the benefits of the policy, but ignores the market risks or the risks of the policy itself.

- The policy will create a significant capital requirement on the sector which will deteriorate free cash flow, the most important underpin of financing costs and supplier stability.
- Relative to the scale of the business the capital requirement is significant, which will impede or restrict the ability to raise capital and to invest in net zero policies.
- Deteriorations in free cash flow will also increase the risk of supplier failure (and hence mutualisation), rather than decrease the risk of supplier failure.

b) Simplified moral hazard

- The analysis assumes that the sole cause of supplier failure results from the moral hazard of utilising credit balances for working capital, and that this policy alone will remove the moral hazard, improve credit worthiness and prevent supplier failure.
- In reality supplier failure is caused by:
  - Unhedged wholesale costs;
  - Inexperienced or incompetent management teams; and
  - Unstable/ unsustainable regulatory conditions.
- The utilisation of credit balances for working capital exacerbates the cost of supplier failure but does not cause it.
- As shown below, wholesale commodity costs have been a much larger proportion of SoLR levy claims.

Figure 3.2 SoLR levy claims from September 2021 (£)



Source Fig 3.2: [Review of Ofgem's regulation of the energy supply market](), prepared by Oxera

c) Administration costs

- NERA's analysis also does not include the administrative cost for suppliers of implementing Ofgem's proposed policy to protect credit balances.

Conclusion

While we support the overall thrust of the reforms, the way in which consumer balances are protected needs to be carefully considered in order to ensure that it promotes, rather than undermines, the sustainability of the energy retail market.

Due to the significant gaps in the financial modelling provided by NERA, Ofgem's proposals risk determining a risk reward balance based on flawed analysis. Ultimately this will lead to higher bills for consumers.

We strongly recommend that the BEIS Select Committee further interrogates NERA's economic analysis and the way in which Ofgem has used this as the foundation for its proposals.

Accurately understanding the financial impact for energy suppliers of protecting consumer credit balances is pivotal to ensuring that the nature of any policy change and the way in which it is implemented supports a more resilient and sustainable retail market in practice.