Sent via email to PriceProtectionPolicy@ofgem.gov.uk

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23rd October 2023

Ecotricity Response to Ofgem's Review of Additional Wholesale Costs in the Default Tariff Cap

Dear Colleagues,

Ecotricity were the world's first green energy company when we established in 1995 and we now have over 165k domestic and non-domestic supply accounts, alongside over 100MW of self-developed renewable generation capacity. We continue to invest in new sources of renewable generation, with our first green gas mill recently commissioned and an energy storage site currently under construction.

We welcome Ofgem's engagement on this matter and note that our response will help support the formulation of the consultation direction moving forward.

We support measures that help to protect consumers through fair and transparent pricing mechanisms, however, fundamentally disagree that macro-economic factors can be uncoupled from individual commercial decisions, when calculating wholesale allowance provisions. Our hedging strategy operates under a risk-based framework, designed to absorb, and smooth any macro-economic changes as much as possible, however in some instances, the extent of the macro-economic change does require a change in commercial decision making. Under the principles of financial responsibility this is not only a prudent approach for the business, but also a duty.

The change in calculation methodology introduced when moving to a quarterly cap period is one that we see as fundamentally challenging. Historically, it is our understanding that many suppliers have adopted an approach to hedge wholesale products over a long period (12 months plus) to de-risk the impact of macro-economic changes and provide a price point for consumers reflective of longer-term market trends. The current methodology favours a much shorter hedging window of 3 months, which limits the ability to de-risk against the macro-economic environment, hence requiring more frequent commercial decision making and tweaks in direction.

As a small supplier, we also hold concerns with the approach to date. The RFI (Request for Information) published in July considered us out of scope. If a notional, efficient supplier is one based on a certain scale then there is a risk that the evaluation of allowances will not fully consider the cost impact borne by smaller or emerging suppliers. Wholesale trade premiums are often higher and access to market products can be challenging due to illiquidity in the market.

Our responses to the stakeholder questions detailed in the document are provided below:

5.1 *To what extent do you agree or disagree with the overarching principles we have set out? Are there any additional principles you think we should consider when making a decision?*
Please fully explain your answer.

Ecotricity agree that any change made needs to protect customers and be fair across suppliers. We would, however, disagree with the principle that it needs to disaggregate macro-economic factors from commercial choices that suppliers make. We very much believe that the two things are intertwined and are difficult to distinguish. We would instead propose an alternative principle that adjustments should be made to take account of external factors which are low in probability and highly unlikely, thus no supplier would make a rationale commercial choice to manage them.

5.2 *Given that Ofgem must exercise its functions under the Domestic Gas and Electricity (Tariff Cap) Act 2018 with a view to protecting existing and future customers on standard variable and default tariffs, to what extent should suppliers be able to retain benefits or bear costs from (relating to principles 1 and 3):*

a) *overall market movements (e.g., in SVT (Standard Variable Tariff) demand or price driven demand destruction), that are outside of their control?*

Suppliers have a duty to follow a strategy which provides certainty in pricing to customers and maintain their duties under the financial responsibility principles. When following such a strategy any benefits or costs arising from following it should be borne by the supplier. Removing these benefits and costs will potentially lead suppliers to follow behaviours which then fall outside of these principles or reduce participation in the market because there is no incentive for suppliers.

b) *commercial decisions (e.g., hedging strategies), that deviate from the assumed behaviour in the price cap? Does your answer differ whether the impact is a cost or a benefit to suppliers? If so, why?*

We believe that suppliers should be incentivised to follow strategies that provide certainty of pricing to customers and financial stability. We would highlight that the price cap currently leads suppliers to follow a 3-month hedging strategy. Should suppliers take a longer-term approach to provide certainty of costs and deliver financial stability (e.g., ensure liquidity in the market etc) by hedging over a longer-term basis, then these benefits and costs of following such a strategy should be borne by the supplier. This is similar to our own experience where we have seen benefits in early 2023 which are now reversing in later 2023 due to the decline in wholesale price and how this is reflected in both the price cap and through our hedging.

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5.3 To what extent should we align to the approach taken for previous wholesale decisions? Has suppliers' ability to mitigate risks changed over time, or are there other relevant changes in circumstances which would impact suppliers' ability to mitigate risks?

The introduction of the backwardation allowance methodology when moving to a quarterly price cap, does create challenges with de-risking against macro-economic market impacts, as the hedge window is shortened and could lead to a more volatile pricing structure for consumers. The purchase of quarterly wholesale products to hedge in line with the price cap methodology has proven challenging for medium and small suppliers due to liquidity constraints and high trade execution premiums. The seasonal cap approach, adopted prior to the change, enabled a greater ability to purchase seasonal products, which had far greater liquidity with lower premiums attached to the trade execution.

5.4 *Are there other considerations we should have when differentiating between an overall market movement (e.g., customers remaining on SVT tariffs), as opposed to an individual supplier's risk management strategy (i.e., between systemic and idiosyncratic risks)?*
To what extent should this include consideration of the number of suppliers who adopted a particular strategy?

We agree that Ofgem must provide an approach that is fair across suppliers and those who deviate from this should be subject to the risk or reward consequences that take place. That said, we would propose that the current approach does prove more challenging for medium and small suppliers due the points raised above; and that an adoption of a risk based hedging framework, over a longer period, to smooth out wholesale macro-economic impacts should be supported and would help mitigate the need for an approach to try and disaggregate macro-economic impacts from commercial decision making.

5.5 *Do you agree with our high-level approach to differentiating between impacts caused by commercial decisions and external events? Where we see discrepancies between costs and allowances, what evidence should be considered to distinguish between the impact of commercial choices versus the impact of market movements outside of a supplier's control?*

We disagree with differentiating between commercial and external events. We believe the two things are intrinsically interlinked and difficult to differentiate. We see this as being fraught with complexity and potential legal risks in trying to differentiate the two things.

5.6 *Given the variability in supplier approaches, and that Ofgem can only set one price cap level, how should we weight the commercial decisions made by some, but not all, suppliers?*
For example, if all suppliers benefited from market movements outside their control but only some suppliers also took commercial decisions which created further benefit.

We believe decisions should be weighted towards supporting suppliers who make decisions which ensure they meet their financial responsibility requirements and help bring certainty of prices to customers. This should be mean any decisions should be favourable to suppliers who follow the price cap methodology or take more risk averse approaches to managing wholesale costs and liquidity.

5.7 *Before adjusting for any gains or losses, are there any particular factors that we should consider offsetting through other allowances (e.g., headroom)?*
If suggesting an offsetting allowance, please explain why.

To achieve the UK's net zero targets and help reverse the impacts of climate change, it is imperative that there is a drive towards supporting the build and utilisation of renewable generation. The volatility of this generation can lead to an increased balancing cost, which is currently not adequately provisioned within the wholesale allowance.

5.8 *What benchmark approaches should we consider and why?*
Should the approach differ based on the direction of a potential adjustment?

As detailed through our responses above, we would propose a review of the current cap calculation methodology; in particular the practices that should be adopted with regards to hedging and ensuring this is undertaken over a longer period of time, which in turn would provide greater de-risking of macro-economic impacts and lead to more reflective and less volatile price for the end consumer.

Should you require any further information, please let me know,

Yours faithfully

Nicola

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For and on behalf of Ecotricity