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By email only

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Dear Dan,

OVO response to Update on Review of additional wholesale costs in the default tariff cap

Thank you for the opportunity to respond to the open letter sent on 3 October which provided an update on Ofgem's thinking with regard to the review of additional wholesale costs in the default tariff cap. We have some significant concerns with the approach being considered for this review.

1. Executive summary

Ofgem's review of additional wholesale costs in the default tariff cap in relation to the period October 2022 - September 2023 provides yet another signal of instability in the sector. Retrospectively amending the approach used to set the wholesale allowance in the price cap would create further uncertainty for suppliers and remove the ability for suppliers to efficiently manage their wholesale costs in the context of both the price cap and their wider business.

Uncertainty leads to inefficient risk management and therefore additional costs and risks for suppliers, and ultimately consumers. As such, we believe that any action taken by Ofgem in respect of this review would have a long-term detrimental impact on the industry as a whole. In our response to the Call for Input earlier this year, we expressed our concern that there has been no indication for suppliers of the conditions that would trigger a post-event reconciliation, meaning that suppliers cannot determine risk minimising strategies due to the uncertainty around whether allowances will be subject to ex-post reconciliation and what methodology might be used. We remain of the view that, for costs which suppliers are expected to risk manage, there should be no post-event reconciliation of allowances against actual outturn costs - suppliers should be expected to both bear the risk and retain the benefits of their commercial decision making.

As we set out in our response to the Call for Input, we would be supportive of a wider review of the wholesale allowance methodology applied to future cap periods to the extent that this would provide greater certainty for suppliers in terms of the risks that they are expected to manage and the budget (cap allowances) within which they are expected to manage them.

2. Risk management under a price cap

For any future version of the default tariff cap to be efficient, it must (amongst other things) satisfy the following key criteria:

1. Costs for which suppliers have no or limited ability to control are sufficiently passed through to consumers.
2. Risks which suppliers can, and are expected to, risk manage must be clearly specified.
3. Where suppliers are expected to manage known risks, there must be sufficient allowances within the cap for recovery of the associated costs of risk management.
4. Suppliers must be able to make a return sufficient to attract investment into the sector.

Ofgem's proposed retrospective review of wholesale costs will undermine the price cap and cause further divergence from the above criteria.

It is already clear that there are a number of areas within which the price cap, in its current form, does not allow for full recovery of costs for which suppliers have no or limited ability to control. For example CfD costs, unidentified gas (UIG), gas transportation costs, bad debt, ECO, plus many others. These are outside the scope of this review but should not be ignored or receive less attention as a consequence of any time invested in this review.

In addition to this, removing clarity on the risk management expectations for the costs which suppliers are able to risk manage could have significant detrimental impacts on the market. In this example, given the fall in wholesale prices in December 2022, an unhedged supplier would have made large profits in Q1 2023. Any clawback of these profits from sufficiently hedged suppliers would lead to further uncertainty around the definition of an efficient supplier and the risk management policies that one would be expected to follow.

Clarity from Ofgem on the risks that suppliers are expected to manage is critical in creating an efficient sector. However, this only holds when there are sufficient allowances in the price cap for suppliers to cover the costs of managing said risks. In many examples, this has not been the case and therefore market wide intervention from Ofgem (in the form of retrospective cap allowances) has been required. The proposed retrospective review of wholesale costs, in this instance, would simply be an example of the risks that suppliers were expected to manage changing after the event, leading to wider uncertainty regarding expected future behaviours.

3. Impact on investment in the sector

It is well documented that the industry has been significantly loss making for many years, culminating in more than 30 supplier failures and a disastrous impact on investor sentiment.

However, it is noted that the positive commentary regarding a return to profit in 2023 has provided the first step in repairing some of this damage.

A retrospective review of this kind would rapidly reverse any progress made in presenting the industry as an attractive investment. Regulatory uncertainty is a natural deterrent for any investor, thereby increasing the cost of capital at which any such investment can be obtained. This is detrimental to the sector from both a cost perspective and from an innovation perspective.

Uncertainty regarding past, present and future earnings makes it impossible for suppliers to optimise their capital structure and make the level of investment required for the UK to meet its net zero targets.

4. Recommendations and next steps

We believe that continuing with the proposed ex-post adjustment to the wholesale allowance would lead to greater uncertainty for suppliers and make the sector significantly higher risk for suppliers and therefore less attractive for investors. As such, we strongly oppose the continuation of the retrospective element of this review.

However, we would be supportive of a wider review of the wholesale allowance for future cap periods with the view to providing greater certainty regarding the risk exposures which suppliers are expected to actively manage.

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