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By email: priceprotectionpolicy@ofgem.gov.uk

Response to Ofgem's review of additional wholesale costs in the default tariff cap

Dear Dan

Thank you for the opportunity to respond. We appreciate Ofgem taking more time on this review but we remain very concerned by the direction of travel as Ofgem appears to be planning to implement an effective clawback. In short:

- Clawbacks in general are bad regulatory practice and, when introduced retrospectively, are bad for investor confidence. Given the sector needs investment for net zero, the timing of this review is concerning.
- This proposal misunderstands the nature of the cap and could end up changing it from a "ceiling" to a "target" that no-one ever prices below. Given c. 90% of customers are now on SVT products, this is a terrible outcome for customers.
- Other options are available. We urge you to move away from working on a one-off adjustment and instead look at the wider context of the price cap, including a proper review of the wholesale allowances if necessary.

In this cover letter we set out our concerns with the overall approach. Your letter also indicates you are looking at backwardation (though there are no specific questions on this): in our experience the backwardation allowance running over 6 months has worked well.

We think this adjustment approach is misguided for four main reasons:

1. **This adjustment amounts to changing the rules of the game retrospectively, which cuts across your important goal to improve financial resilience.** Ofgem's approach amounts to backwards rationalisation: examining outturn financial results for differences to its forecast allowance and then attempting to "match" those differences to some external events. This amounts to Ofgem taking a kind of "true-up" approach, even though no such true-up was ever in contemplation when suppliers made decisions.

   As we said in August, a clawback mechanism is bad regulation. Retrospective changing of the rules has a chilling impact on investment and encourages suppliers to be more risk averse and less innovative, including with the prices they offer

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customers. These do not even happen in network regulation where they have only ever achieved through voluntary engagement with companies on a bilateral basis. It is particularly inappropriate at a time when Ofgem is expecting suppliers to improve their financial resilience through a combination of retained earnings and new investment into the retail business. This type of regulatory uncertainty and unpredictability makes this significantly more difficult and expensive.

We endorse the points EnergyUK raises in its response about this approach being non-transparent. Although Ofgem is terming this to be a one off adjustment, it seems that this is more like a reopening of the wholesale costs allowances. If Ofgem considers that the price cap wholesale costs methodology is wrong, and you want to include learnings from the energy crisis, we would support you in reviewing it, with the expectation that it is implemented on a forward looking basis. This would need a detailed review, a RFI that is based on a longer timeframe and an impact assessment.

2. **This move would represent a very considerable change in the nature of the cap and how suppliers expect Ofgem to operate it.** The cap was designed to create an ex-ante price ceiling - not to provide suppliers with a precise revenue allowance (as in networks) nor a regulated rate of return (as in US style regulation). In the retail cap, ex-post "true ups" are very much the exception, not the rule (for example when introducing the new covid bad debt allowance, and being considered now for additional ASC debt). This proposal could change the way suppliers see the cap from a “ceiling” to a “target”, which will not help consumers. In addition, it could lead to a situation where Ofgem is forced to create a rolling “float and true-up” arrangement for wholesale costs, providing upward adjustments where costs are above the allowances and clawbacks where they are below. This will create uncertainty, undermine incentives, and ultimately result in consumer detriment as a result of a less efficient, less investable, market.

3. **One-off retrospective adjustments like this discourage pro-consumer pricing and a competitive market.** As we set out in our August response, clawback will cause significant consumer detriment as it will kill off strategies like Octopus’ decision to price below the cap. Octopus Energy has always priced below the price cap - with an annual average saving of ~£50/customer versus the cap. This pricing strategy has delivered at least [redacted] in bill savings to our customers since 2019. If - as proposed through this adjustment - you are going to reduce supplier certainty over the revenues they can make in the cap, you will undermine diversity in pricing. Prudent suppliers would be forced to treat the cap as a target and ultimately this will not benefit consumers. Given the potentially significant impact of these changes, we would expect Ofgem to accompany this with a full impact assessment, including quantitative analysis of the impact on competition and on the cost of investment.

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To be consistent, any downwards adjustment to the wholesale allowance, would have to look at supplier specifics and look at the entire period of the price cap, not just 2023/24. For Octopus, this would mean looking at the outsized impact of roll to SVT on us, and our pricing strategy of pricing below the cap. Taking a supplier specific approach is very difficult - if not impossible - given the cost stack price cap. But equally taking a "one size fits all" approach to adjusting the allowance now is highly detrimental to some suppliers, penalising them for doing the right thing for customers.

4. **It is part of a wider piecemeal approach to retail regulation which, taken together, could be framed as "death by a thousand cuts" for the GB retail market.** We don't believe this is Ofgem's intention - but we are concerned that it will be the result. Ofgem is proceeding with this workstream in isolation from the many other significant changes it has already introduced or are under consultation this year. The financial resilience reforms already mean Octopus will hold significantly more in regulatory cash or capital over the next two years.[1] In addition, Ofgem has published 15 price cap consultations in 2023 - almost double the monthly rate in 2022. It is difficult for suppliers to prudently manage and prepare for all these actual and possible changes at the same time. For example, we are currently seeking to estimate the combined effect of this consultation and the debt-related costs allowance consultation on our business, yet both could impact the price cap negatively in April 2024, [redacted].[2] This piecemeal approach reduces regulatory certainty and investor confidence but is not supporting moves to a competitive, resilient retail market. If you are going to proceed to consultation, Ofgem must ensure that it fully understands - and has assessed - the impact of these proposals, alongside other changes Ofgem has made.

Other options are available to Ofgem which avoid these risks. The retail energy sector is only just beginning to emerge from the unprecedented crises of Covid and the energy crisis. In the post-crisis context, it is important for Ofgem to make consistent efforts to move to a more stable "peace time" setting, including in relation to how it sets the cap.

If Ofgem wants to review wholesale cost allowance, this should be done through a prospective, deeper review of the wholesale costs allowances, similar to (and ideally alongside) the approach it is taking with operating costs. This approach would increase regulatory certainty - and investor confidence - by being consistent with Ofgem's powers and previous approaches.

[1] This refers to the collective impact on new cash or capital we will need to hold to meet regulatory obligations due to changes relating to RO ringfencing, the Credit Balances "Cash Coverage Trigger" and the capital adequacy framework in 2025.
[2] Note that Ofgem's Additional debt-related costs allowance policy consultation has a number of possible outcomes including reductions in cap allowances alongside a range of potential increases in cap allowances.

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In such an approach, we would expect Ofgem to set out specifically and up front, a hypothesis of what risks the price cap, in combination with external events has created, along with a hypothesis as to how this may have resulted in under- or over-compensation for a notionally efficient supplier. We would also expect the accompanying RFI to look at more "normal" times under the cap and not just exclusively focus on a crisis period.

We would be happy to discuss any elements of our response with you in more detail.

Yours sincerely

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Responses to consultation questions

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.**

We agree with Principle 1 which is an overall principle to protect consumers, but think this needs to be the protection of current and future consumers. Doing so would require a balance that gives due regard to (i) a suppliers' ability to recover efficient costs and operate with confidence, and (ii) the impact on competition of any adjustment or intervention. So we disagree with how Ofgem has sought to limit this principle in the open letter and think this should be revised.

We also support Principle 2 that a "one size fits all adjustment" must be appropriate. However, we think this principle alone should knock out an intervention along the lines proposed. As set out in the cover letter, the proposed adjustment does not meet this test because this would penalise actors like Octopus that have passed some of this benefit on to their customers.

We think Principle 3 is highly problematic. Ofgem's proposed framework is based on attempting to judge a distinction between 'external events' and 'commercial actions'. Ofgem states it will 'most likely' seek evidence of a common perceived 'external event' to justify a wholesale cost adjustment. Though, the letter does not rule out an adjustment against an outcome involving commercial action. Such a distinction rarely exists, as commercial decisions are normally made with reference to external events (for example, anticipated weather or demand patterns). What such an approach appears like to amount to is a backwards rationalisation. We think this is a problem for the reasons set out in our cover letter and further in response to question 2. As set out in question 4, this principle also encourages Ofgem to use the cap to assess the riskiness of supplier business strategies. This is not the role of the cap - reviews in this area can and should be done under Ofgem's new financial resilience framework and powers.

We suggest that Ofgem should consider an additional principle: *Any adjustment must be consistent with the purpose of the price cap:* As set out in the cover letter, we are concerned that an effective clawback/unanticipated true-up misunderstands and changes the function of the cap from a ceiling to a more precise target.

2. **Given that Ofgem must exercise its functions under the Act 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 (eg in SVT demand or price driven demand destruction), that are outside of their control?**

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b. **commercial decisions (eg 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?

In relation to (a) market movements outside suppliers control, we consider that this is part of the overall balance of the cap which was deliberately not structured as a precise revenue allowance (as in networks) nor a regulated rate of return (as in US style regulation). As we flagged in our August response, we have absorbed significant costs on behalf of our customers in FY22 and FY23 as a combination of the roll to SVT that happened as wholesale prices rose in the crisis and our investment in customers by holding prices below the cap.

In relation to (b) if a supplier's commercial decisions (eg hedging strategies or a decision to buy or not buy weather insurance) deviate from the cap result in them bearing costs/benefits compared to the assumed margin in the price cap, suppliers should keep/bear them. We have illustrated this clearly with our decision to price below the cap. This decision is at least partly based on a consideration that there will not be an effective clawback/true-up.

If Ofgem is concerned that a supplier is not managing their risks prudently then it can and should use its financial resilience powers to examine this and act. The cap is not the appropriate leverage point.

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?**

Consistent with past price cap methodology and previous wholesale cost reviews, we think Ofgem should set out, specifically and up front, what risks the price cap, in combination with external events has created, along with a hypothesis as to how this may have resulted in under- or over-compensation for a notionally efficient supplier. Where there is no clear hypothesis, no adjustment should be made, as originally intended, outturn costs will differ from the price cap allowance in any given period for both the market as a whole, and for any given supplier, but that over time, this will even out. If Ofgem purports to take a markedly different approach, we would expect to see a detailed impact assessment of its approach, including a clear consideration of alternative options and a quantitative competition analysis. We would expect to see analysis of how regulatory risk and cost of capital future lead to future consumer detriment versus the short term price reductions Ofgem might have in its sights.

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In previous wholesale consultations, Ofgem has also not made changes to the cap which are applied retrospectively and "benefit" suppliers. For example, we have raised a number of times a monthly shaping risk in price cap period 11a ("Q4") (see our August response to your open letter) and been informed Ofgem will wait and see. We also note that, as also flagged in August, roll to SVT in the future remains a possibility that would be costly but is not although there is not addressed through the cap. In this context, we are unclear about the strength of a position built on the need for symmetry. The crisis context of wholesale decisions made last year should also not be ignored. In the post-crisis context, it is important for Ofgem to make consistent efforts to move to a more stable "peace time" setting, including in relation to how it sets the cap.

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

We do not think that the price cap is the appropriate place for Ofgem to be arbitrating on supplier risk management strategies. The enhanced financial responsibility principle gives Ofgem considerable levers to assess, understand and address issues with supplier risk management. Any Ofgem concerns should be addressed at a supplier level, rather than through a retrospective "true up" "one size fits all" approach via the cap.

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?**

No. We think this approach is highly problematic. We have set out further answers in response to questions 1 and 2.

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.**

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

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

Overall we do not think that Ofgem should be proceeding with this adjustment for the reasons set out in the cover letter. If Ofgem is going to proceed, we would expect (i) a detailed impact assessment and (ii) more detailed and substantive consideration of benchmarking approaches, similar to the approach Ofgem is taking to the reviews of the operating costs allowances. This is even more important for review of wholesale costs allowances given their size and impact on the price cap and on suppliers.

9. **Please also provide any additional views that may not be captured by the outlined questions.**

Please see the points raised in the cover letter.