

Response to Ofgem Adapting Price Cap Methodology for Resilience in Volatile Markets

January 2022

Introductory comments

We welcome Ofgem's commitment to review the price cap methodology. Price regulation will be needed for several more years to protect customers from unfair pricing, and recent events have shown that the current methodology is not fit for purpose in an evolving wholesale market.

This paper sets out our initial reactions to Ofgem's suite of alternative amendments to the current price cap methodology as set out on 15 December 2021. In recognition of the tight timeframes you are operating within, we have submitted our preliminary views as early as possible. However, we have had limited time to formulate our views and ideas and would appreciate the chance for further engagement and discussion with Ofgem in the months ahead.

We continue to favour a relative price cap (based on the gap between each individual supplier's acquisition tariffs and the price they charge for default SVTs) and believe it is the best way of addressing the risk of wholesale volatility while protecting customer interests. We request that Ofgem keeps this option on the table, assessing it against alternatives, as you develop new arrangements for October 2022 onwards. In the annex to this paper we have provided some details on how this option might work in practice and would be happy to assist Ofgem to develop this option further.

Overall, the recent wholesale market spikes and the spate of retailer failures might mean your review focuses on reducing risks to retailers at the expense of other price control objectives. Throughout the review we would like Ofgem to ensure:

- the cap is made more effective in protecting customers from excessive pricing and in driving continued efficiency improvements;
- The methodology leaves retailers to manage the risks and costs they can control. We are concerned that recent adjustments to the methodology have resulted in customers carrying costs that retailers should be able to bear.

As a practical matter, we note that some of the new price cap arrangements Ofgem is considering would lead a prudent supplier to change their hedging strategies for SVT customers. The observation window for Winter 2022/23 cap opens on 1 February and under the current methodology, we like many other retailers, would normally begin to hedge for our SVT customers from that point onwards. Ahead of that date we ask that Ofgem provides clarity on arrangements it will put in place to allow retailers to unwind their hedging positions

and manage their hedging risk from October 2022 onwards. Without this, a change in methodology could perversely add to, not alleviate, the risk that retailers are facing.

Below we set out:

- Our views on the case for a change to the methodology;
- the benefits of a relative price cap;
- our initial reactions to the specific methodologies Ofgem is considering.

Annex 1 provides some initial ideas on how a relative price cap might work in practice.

The case for a change of methodology

We agree with Ofgem that a “do nothing” approach is not viable if wholesale prices continue to be volatile. In normal wholesale market conditions, retailers can protect themselves from wholesale volatility by hedging in line with the price cap wholesale allowance. In periods of extreme volatility, this risk management approach breaks down. In recent months, retailers have faced¹:

- The cost of buying energy for many thousands of extra SVT customers as the cap has become divorced from and been overtaken by the cost of Fixed Term Contracts in the market. In future months, and as wholesale markets fall, retailers could be exposed to the cost of carrying SVT hedges for customers who have left to take up more competitive FTCs; and
- Backwardation costs which are unlikely to be offset by contango benefits in future periods unless prices fall as sharply as they have risen.

Unlike other retailers, we have argued that rather than passing these extra costs through to customers in the April price cap, suppliers should be left to carry the costs accumulated in recent months and seek to recover them through competition in the market. However, we agree with others that it is not sustainable for retailers to continue to be exposed to this risk. If the methodology is not improved in the light of recent experience, it could lead to further retailer exit and have an impact on investment and competition in this market.

There are other issues with the current methodology, beyond the risk to retailers, which Ofgem should also be seeking to address at this time. In particular, we would like Ofgem to ensure:

- the cap is made more effective in protecting customers from excessive pricing and in driving continued efficiency improvements. With this in mind, we note:
 - The back office costs in the methodology exceed the costs of an efficient retailer and we would like this to be considered if Ofgem is looking to make adjustment for other cost items (like BSUOS) which have been increasing

¹ We have provided Ofgem with an estimate of the additional costs Octopus Energy expects to bear over the period to end March 2022.

- Methodology changes that reduce volume/price risk to retailers should be reflected in a lower assumed margin and headroom in the cap.
- The impact of other regulatory changes being made in parallel (such as the proposals for short term emergency measures to stabilise the market when wholesale prices fall) to reduce retailer risk and increase the passthrough of costs should also be taken into account.
- The methodology is less, not more complicated to administer and leaves retailers to manage the risks they can control. We are concerned that the current “cost stack” approach leaves Ofgem open to lobbying for repeated price control adjustments - as has happened with Covid-19 bad debt and adjustments to account for additional risks during the period of high wholesale prices. The outcome is that risks and the cost of shocks that retailers should be able to bear are being passed to customers.

The case for a relative price cap

We ask Ofgem to assess the case for a relative price cap alongside alternative price cap methodologies. This approach - where a cap is placed on the spread between a retailer's own acquisition tariffs and the price it charges SVT customers - directly tackles the “loyalty penalty” highlighted by the CMA and which led Government to legislate for a price cap. Compared to alternatives, it has the advantage of:

- Being more effective in containing the prices experienced by all SVT customers across the market. Large legacy retailers will need to price close to the acquisition tariffs of companies with a leaner cost base. Their own SVT customers will therefore benefit directly from these efficiencies to an extent which is not achieved by the current methodology.
- Containing built-in flexibility as costs change over time, thus reducing the level of Ofgem intervention and the need to make frequent adjustments to the cap to cope with unanticipated costs and volatility.
- Limiting the wholesale basis and other regulatory risks which retailers are unable to manage.
- Providing a strong driver for retailer efficiency and service improvements which will benefit all customers, and encourage the innovation needed for net zero. It will expose retailers to the risks they can manage and put the primary onus on retailers, not Ofgem, to ensure they can make returns.
- Having a stabilising impact on the market. A relative price cap would make it less attractive for retailers to offer unsustainable acquisition tariffs.

In the annex below we have set out our initial thoughts on how a relative price cap might work in practice. These are high level ideas to demonstrate that there are practical ways to set a relative price cap. We would like to develop these further if Ofgem is open to keeping the option of a relative price on the table.

Ofgem has offered two grounds for rejecting a relative price cap option, neither of which are conclusive:

- Concerns that a relative cap will not be effective in protecting SVT customers in all instances.
- Uncertainty over whether a relative cap is consistent with the legislative requirements.

Protecting SVT customers of legacy suppliers

A relative price cap has been floated before and rejected on the grounds that the SVT customers of large legacy retailers in particular would not be protected from high prices. This rests on the assumption that because they have a high proportion of customers on SVTs, legacy retailers do not need to offer competitive acquisition tariffs in order to survive. Instead it makes sense for them to “game” the cap and keep their SVT prices high.

Experience over recent years calls this assumption into question. Ofgem’s data shows that the market share of these retailers has dropped to less than 70% in Q1 2021. With some low cost new entrants now at scale and able to place pressure on these companies, their market shares continue to decline quarter by quarter and two legacy retailers have exited the market.

Our hypothesis that legacy retailers have a commercial imperative to acquire new customers is backed up by observed acquisition prices. Ofgem’s data shows that over 2020 and until wholesale market instability in 2021, the legacy retailers’ cheapest tariff was on average within £25 of the Ofgem cheapest tariff basket, and exceeded £30 only in 4 months of the year². When compared with our own acquisition tariffs over 2019 and 2020, large legacy retailers’ cheapest FTCs were on average £33 cheaper and cheaper in all but 4 of those months³. We note that this period was characterised by some unsustainable prices from many of the retailers who have subsequently exited the market. Following this readjustment and with the other measures Ofgem proposes to take, we might expect to see acquisition prices from the legacy retailers trending very close to those offered by a basket of challenger retailers.

If there is nervousness about the effectiveness of a relative price cap then one option would be to continue with an absolute cap on SVTs as a backstop for a period of time while the relative price cap beds down.

² <https://www.ofgem.gov.uk/retail-market-indicators>

³ In contrast, Octopus Energy SVTs were more than £150 cheaper than the SVT of the large legacy suppliers.

Compliance with legislation

Para 2(2)(b) of the Tariff Cap Act 2018 states that the tariff cap conditions may not “make different provision for different holders of supply licences”. Our interpretation is that a provision which places the same cap (absolute or in percentage uplift terms) on the gap between acquisition and SVT tariffs on all suppliers would be compliant with this condition. We would be keen to understand Ofgem’s interpretation or other parts of the legislation it considers would be problematic.

We would be happy to work with Ofgem to further develop the relative price cap design and to consider measures to address concerns that Ofgem or consumer groups might have with this option.

Comments on specific proposed amendments

We do not support measures that allow Ofgem to re-open the cap in-period. Either a quarterly cap or a SVT contract type arrangement could represent an improvement on the current methodology, with the SVT contract arrangements offering the best protection for retailers from volume risk in unstable markets. However, we note there are implementation challenges with both these options and the application of exit fees for SVT customers cannot be justified. Both options could be adjusted to rely on a relative price cap rather than a bottom up “cost stack” to constrain prices and this would make the cap more effective in protecting customers without placing unmanageable risks on retailers.

Enhancing Ofgem’s ability to re-open the cap in-period

We do not favour this option. It adds, rather than removes risk from retailers. With any variant of an absolute price cap, the prudent strategy is to hedge in line with the wholesale allowance in the cap. If Ofgem is granted the right to reopen the cap in period, this strategy becomes less viable. Retailers will be open to the risk of Ofgem reducing the price cap, leaving us exposed to out of the money hedges.

We are not confident that this approach would be workable, either technically or politically, in periods of high wholesale prices. Looking back over the past few months, it isn’t obvious that Ofgem would know by how much to adjust the cap without harming customers or continuing to expose retailers to risks, and several adjustments might have been required. These adjustments might very quickly have become politically difficult.

Thirdly, we are concerned that this would open Ofgem to pressure from failing retailers to make price cap increases, and expose Ofgem to legal challenge and blame for supplier failure where they resisted such pressure. Overall, any cap should leave risks with retailers that they are able to absorb, influence or control and leave them responsible for managing their business in the most profitable way within the cap. We do not think this balance would

be easy to retain where it is open to Ofgem to adjust the level of the cap within price cap periods.

Quarterly price cap

A move to a quarterly price cap would represent an improvement on the current six monthly price cap. Although it would still expose retailers to some of the risks suppliers currently face during periods of high wholesale market volatility, it should reduce the period over which the market is distorted by the lag in SVT levels reflecting wholesale price movements.

There are several issues to address with this option:

- There is an implementation challenge associated with changing the observation window for wholesale costs under this option. As above, we ask Ofgem to consider a transition period that would allow retailers to manage their hedging risks;
- this option would double the opportunities for retailers to argue that particular cost items should be added or inflated. This would exacerbate the information asymmetry and the tendency for the “cost stack” methodology to be overly generous to retailers. Any move to adjust the current methodology to a quarterly cap should be accompanied by a review of the appropriateness of cost, headroom and other risk allowances in the methodology
- It could lead to greater price volatility for SVT customers. We would like Ofgem to consider how it might encourage retailers to smooth this volatility, noting the tendency for retailers to use the cap as a target rather than a ceiling for SVT prices.

SVT contract

The use of a “contract” approach for the SVT cap would represent a further improvement on the current methodology, and would significantly reduce the unmanageable volume risk arising from wholesale market instability that retailers have faced in recent months - including removing the risk of backwardation. However, we are opposed in principle to any option which allows retailers to charge exit fees on SVT customers. This is not in customer interests and is anti-competitive. In normal market conditions, retailers can influence customer churn through providing good service and through offering competitive FTC deals which mean that customers looking to fix are less likely to move to another retailer. We recommend that Ofgem amends this option to remove the application of an exit fee⁴.

Along with the hedging transition issues for suppliers associated with this approach, we ask that Ofgem considers the implementational challenges for customers. There are many millions of customers who are long term default tariff users. From a market stabilisation

⁴ If the SVT contract is introduced without exit fees, it may be necessary for Ofgem to amend regulations so that it is possible to prevent customers from migrating from one SVT to a cheaper one.

perspective, it does not seem wise to require retailers to take a hedge out for all these customers in September 2022 (the month before the first SVT contract would start). Equally an approach that staggered the move to the SVT contract for these customers would add a degree of arbitrariness to the SVT prices that different customers are on, and which SVT customers could not control.

More generally we are concerned that it may be difficult to explain this approach to customers or to justify its arbitrary nature - in that the price a customer faces will depend on when they roll onto the SVT contract. This might be particularly problematic for people going onto a default tariff after moving house. We note that some of the concerns about arbitrariness would be mitigated by ensuring that customers do not face an exit fee if they move onto a fixed deal and can move to a FTC without penalty if they find themselves on a high SVT.

ANNEX 1 - Initial Ideas On Designing A Relative Price Cap

At a high level, the relative price cap works by constraining the price retailers can charge for a default tariff customers by reference to the price charged for acquisition tariffs.

In designing a relative price cap, we have considered two key questions:

1. What is the acquisition price “benchmark” against which the default tariffs are set?
2. What costs and considerations go into defining the regulated gap between acquisition and default tariffs?

The information below is offered to show that there are ways to implement a relative price cap. Further thought is required on each of these questions, with details still to be worked through.

The FTC benchmark

As above, we consider the appropriate benchmark is the acquisition tariffs of the individual supplier⁵, not a basket of acquisition tariffs across the market. In this option SVT prices are likely to differ slightly across retailers depending on their acquisition pricing strategies. However, this approach will be more effective in constraining the level of SVTs across the market than a benchmark based on a basket of FTCs across all retailers.

⁵ One matter still to be considered is whether this benchmark also includes the tariff charged to FTC renewals.

Within this approach we have considered a number of different potential approaches for the FTC benchmark, including where:

- The retailer's FTCs open to new customers at any particular time (t) defines the benchmark for the SVT cap at the same time (t) - *parallel matching*;
- The weighted average price of acquisitions onto FTCs over say the 6 month period before (t-6m) defines the benchmark for the SVT cap over the price cap period (t) - *sequential matching*

The first of these, *parallel matching of SVTs and acquisition tariffs*, does a good job of protecting retailers from wholesale price volatility, with the cap automatically adjusting depending on wholesale conditions. However, it could result in significant price volatility for SVT customers - especially if the period of time was set as a day or another short duration - and might be difficult and onerous to monitor and enforce. This could be addressed either by:

- Applying the SVT contract approach (without exit fees). In this approach, every time a retailer offered a new acquisition tariff into the market it would need to adjust its SVT to new SVT customers to match the acquisition tariff plus the agreed differential. This approach seems worth pursuing further as it achieves both objectives of protecting retailers from wholesale basis risk while protecting customers from unfair/excessive pricing. Though note our concerns above about the difficulty of getting customer acceptance that their SVT price will depend when they roll onto it; or
- using a weighted average FTC over a period of several months, as the benchmark. In this option, the retailer would set the SVT for the period in advance and then place acquisition tariffs into the market over that period so that the weighted average price of acquisitions fell within the capped differential. This would require retailers to take a view up front on where to place the SVT based on a forward look of wholesale prices over the period ahead and to closely monitor how the weighted average is evolving over the period and tailoring their acquisition tariffs accordingly. This could be very complicated to implement which might rule it out.

In the second option, *sequential matching of SVTs and acquisition tariffs*, the weighted average acquisition price in the previous period (say minus a month) would be the benchmark for the default tariff in the price cap period ahead. This would require less forecasting for suppliers than the previous option and it would be easier to observe and check that the SVT for the period had been properly set based on reported weighted average price of sales in the prior period.

To protect retailers from wholesale price volatility in this approach, it would be possible to take either of the approaches that Ofgem is considering with the "cost stack" price cap - namely either:

- Set the period at 3 months, not 6 months, so that SVT prices more quickly reflect prices in the prior period; or
- Apply the monthly SVT contract idea (without exit fees), except use the weighted price of the supplier's FTC acquisitions in the previous month as the benchmark for SVT prices for each month, rather than the cost stack as present.

Defining the regulated differential

In principle the regulated gap between acquisition and SVT tariffs should reflect the differential cost to serve between SVT and FTC customers. We think it is important to define the FTC benchmark approach first in order to understand what these additional costs and risks might be from serving SVT customers according to a cap. However, the differential is likely to involve looking at:

- The additional cost of hedging for SVT customers
- The remaining volume risk
- Any other features - such as the bad debt and payment terms associated with SVT customers over FTC customers.

There should not be a cross subsidy from SVT customers to the competitive part of the market and so the cost of acquisition should not be included in the regulated differential.