

## **Response to the Consultation on Medium Term Changes to the Price Cap**

### **Non-confidential version**

#### **Summary**

Thank you for continuing to engage with suppliers and other stakeholders constructively since the publication of this consultation document. It is clear that Ofgem's thinking on the best changes to make in the medium term to the price cap methodology continue to evolve, including in the light of these discussions.

Our strong preference is for a relative price cap, rather than a "price stack" cap. We have set out the rationale for this approach and ideas on how it could work in the input we provided in January. We recognise that Ofgem's view is that this option would require changes to legislation and ask that you look for an early opportunity to obtain the ability to make these changes in law and to take other measures to develop this option.

In the meantime, we support Ofgem's objective of revising the price cap as early as possible in order to make it more robust to periods of high price volatility, to the benefit of customers and retailers. Of the options set out in the 4 February consultation, we would prefer the 12 month price cap contract without an exit fee approach. This has the benefit of: removing the backwardation risk in volatile market conditions (and the need for a backwardation adjustment which would add costs to customers); reducing the volume risk associated with a rising wholesale market (and a repeat of the roll to SVT we have seen in recent months); and providing customers with a fixed price for a year, giving them peace of mind and certainty against which they can budget for their energy costs. No other options provide the price stability for customers or the backwardation risk reductions that the 12 month price cap option contains.

There are a number of challenges associated with this option:

1. Further work is required to explore the basis risk that may be associated with the 12 month contract price cap as it has been set out in the consultation document. We would like to engage with Ofgem on the forward products it would use to set the direct fuel allowance.
2. All the medium term price cap options, including the status quo, expose retailers to very significant volume risk exposure in a rapidly falling wholesale market - an exposure which is exacerbated by there being many active, price sensitive customers currently on SVTs. The risk exposure is higher under the 12 month contract than alternatives. For this reason we support the use of a Market Stabilisation Charge as long as it is proportionate and the deadband and sharing factors are calibrated to mitigate exceptional external

risks, not to protect retailers from volume risk in normal circumstances.

3. The 12 month contract could create a perception of unfairness between customer cohorts whenever wholesale market volatility creates a large variation between cohort price cap levels in place at any point in time. This might be mitigated by introducing the price cap contract approach only when markets have calmed down, giving customers a chance to get used to the new contract approach and its benefits when price cap differences across cohorts are relatively small (where there should be no systematic disadvantage to any cohort). However we urge caution in making this decision as industry has no certainty as to how long market volatility will last and indefinite delays in themselves present risk.

The basis risk and unfairness concerns noted above could be mitigated to some extent by a variation on the 12 month price cap approach. We ask Ofgem to consider the variant of splitting customers into 4 cohorts (rather than 12) so there are four 12 month price cap contracts in the market at any time, set in January, April, July, and October of each year. While this approach would expose retailers to greater volume risk in a rising prices market, this variant could be both easier to implement and operate and (because the price cap is set with reference to forward curves in 4, not 12 months of the year) reduce the chance of large variants in the price cap for different cohorts.

We welcome Ofgem's proposal to reduce the notice period for changes to the price cap level to 28 days but see no significant further gain from this being reduced to 14 days. We also welcome Ofgem considering the approach to compensating retailers for backwardation. Our preference is to remove the need for a backwardation adjustment through implementing the price cap contract approach. If Ofgem does not go down this route we consider it essential that the adjustment is made on an ex ante basis. An ex post adjustment approach means that retailers face the risk of never being made whole for the backwardation costs if they lose SVT volume.

Our answers to the questions in the consultation document are set out below.

## **Chapter 2 – The case for change**

### ***Question 1: Are there any other costs and risks to consumers and suppliers that we should consider?***

Ofgem has largely identified the risks associated with the various price cap alternatives. While we favour the 12-month price cap contract option because it removes the backwardation risk - and see the benefits of other options (such as the H1/H2 6-1-6 option recently proposed by another supplier) which reduce, but don't remove, the risk of backwardation - further work is required to explore their basis risk implications. We strongly

advise Ofgem to consider carefully the forward products it will use to set the direct fuel cost allowance for the 12-month price cap contract option, and would welcome the opportunity to engage on the issue further.

Setting the core direct fuel allowance requires an estimation of wholesale costs based on forward contracts for electricity and gas. The “forward view period” in the status quo price cap methodology observes contracts for delivery that align with the delivery period for seasonal NBP and UK Base and Peak power forwards. In this instance gas and, to a lesser extent power, seasonal contracts are liquid and Ofgem has access to a robust third party data source, ICIS, for the calculation of core direct fuel costs. These contracts are shaped to account for the seasonality of customers’ consumption and a weighted average cost of energy over a 12 month period can be established. Because there is no mismatch between the delivery period of the forward contracts and the price cap period this methodology works well.

However, adopting any new price cap methodology with a forward view period that deviates from seasonal contract delivery periods requires the construction of a forward curve. There is no universal methodology for the construction of an arbitrage-free forward curve, and different market participants will calculate them differently depending on their own view of the market.

The status quo price cap methodology does recognise that the valuation of wholesale costs based on forward contracts does not capture all of the wholesale costs that suppliers face. To address this, an additional allowance is made to cover the cost of shaping, forecast error and imbalance (basis risk), transaction costs, additional risk and losses/UiG. However, a flat percentage additional direct cost allowance using forward contracts whose delivery periods do not match the 12 month price cap contract period, without shaping into a forward curve, is unable to correctly reflect the direct fuel costs of a supplier to hedge a price cap cohort, as the basis risk will vary for each monthly cohort.

## **Chapter 4 – Changes to the price cap methodology**

***Question 2: To what extent would a price cap contract without exit fees leave suppliers carrying volume risk in a falling prices scenario? How significant would this risk be? How might it be mitigated?***

In summary, the volume risk that we would face when prices fall from their current high levels is difficult to estimate but will be very material. The difficulty arises from the fact that

the current circumstances are unusual both in terms of the level of prices and the make-up of customers on SVT, many of whom are now active switchers. Historical patterns of customer price sensitivity are likely to significantly underestimate SVT customer response when market prices fall.

None of the medium term price cap methodologies on the table can significantly mitigate this significant volume risk, although we can see that the risk exposure from a 12 month contract approach with no exit fees is greater than some alternative approaches. For this reason, we support the use of a Market Stabilisation Charge, so long as this is calibrated to be proportionate.

***SVT customer losses in a falling market will be significant but difficult to estimate***

The SVT customer losses we would face when prices fall from their current high levels is likely to be very material, but also difficult to estimate. This is because historic observed patterns show the behaviours of SVT customers who were typically disengaged.

A final caveat to any forecasts is that customer behaviours (including the behaviour of normally price insensitive customers) at today's high price levels, and with the current level of media awareness, are unknown. In addition, there could be a sharp reversal of the high prices in the wholesale market and very significant savings encouraging customers who may not have switched for years to choose a fixed tariff.

Once wholesale volatility returns to its normal range we expect customer attrition to return to a similar range to that which we observed prior to September 2021. However until the bubble of price elastic customers that have amassed on SVTs has unwound there is a falling price and forecasting volume risk for suppliers that price cap contracts without exit fees, nor any other price cap option, can mitigate.

***A “proportionate” MSC would help mitigate volume risk exposure from a 12 month contract approach with no exit fees***

Whatever price cap methodology is applied and as long as there is a lag between the price cap level and prevailing market prices, retailers face a very sizeable volume risk especially if markets fall significantly.

None of the proposed medium term price cap options can materially mitigate this built up risk arising from wholesale volatility. However, we note that under the 12 month price cap contract, suppliers will have hedged a higher volume (for 12 months) than under the current price cap methodology (6 months) or the quarterly cap, exposing them to a relatively greater risk than with the current methodology or a quarterly cap. Suppliers also need to forecast SVT volumes further out.

For these reasons, if, as we recommend, Ofgem decides to introduce a 12 month price cap contract without exit fees, we would support the use of a Market Stabilisation Charge, as

long as the parameters are kept proportionate, and the MSC is calibrated only to mitigate abnormal levels of price elasticity and price volatility.

***Question 3: Quarterly updates are a balance between the reduced volume risks and the increase [sic] backwardation risks. Please provide evidence and data on the relative costs and benefits of this.***

The more frequently prices are updated the more reflective of actual wholesale costs, and therefore, suppliers can pass on costs to consumers more effectively in periods of wholesale volatility. Consequently, quarterly updates will reduce rising price volume risk versus the status quo. However, price cap contracts that update monthly will reduce rising price volume risk further still.

With quarterly updates suppliers will hedge three months of physical volumes for each price cap period. As the total SVT volume hedged at any moment in time is lower than the other options the total volume risk for a supplier will be lower. In this sense quarterly updates will reduce the falling price volume risk versus the status quo or price cap contract options.

However, Octopus views backwardation risk with quarterly updates as very concerning. Backwardation risk arises due to volatility in the spreads between forward products used to set the direct fuel cost allowance during the observation period. Historical analysis is insufficient to appropriately quantify this risk as the imminent fundamentals are unprecedented and unknowable. There is uncertainty over the reliance of Europe on Russian gas and storage in winter. Similarly, a material temperature deviation from seasonal norms in either Europe or Asia could drive a sharp increase in volatility. The risks of seasonal spreads (backwardation) this year are tied to these factors, and not historical analysis. Octopus believes that the backwardation risks posed by quarterly updates are uncomfortably high and for this reason we would prefer Ofgem to be replacing the current methodology with the 12 month price cap option.

***Question 4: Please provide further evidence on the impact of quarterly updates and price cap contracts on households and their finances, and how these could be mitigated.***

Quarterly updates will result in more frequent price changes for customers on the SVT. This will result in additional cost being passed on to customers during a sustained rising price scenario, however contrastingly, customers' prices will decrease quicker than now when wholesale prices fall. During periods of wholesale volatility, customers could see significant variations to their energy costs from quarter to quarter, and find it difficult to budget, if the price cap is updated quarterly. However, there are no price cap options available that insulate customers completely from sustained wholesale volatility.

Price cap contracts provide price certainty for customers over a 12 month period and this is a benefit of this approach for customers. With no exit fees customers are free to refix when prices fall. However, as is the case with any methodology, the most price inelastic and vulnerable customers are most at risk of remaining on a price capped product that materially deviates from the best available price on the market. Campaigns to improve customer switching behaviour are one mitigation strategy, but evidence suggests this is unlikely to protect the most vulnerable. The concerns around this could be addressed through a relative price cap approach - which is what we would like to see introduced in the longer term.

***Question 5: Do you think it is unfair that consumers would sometimes have higher or lower prices depending on the wholesale cost at the time their cohort starts the price cap contract? Do you think over the longer run this would even out?***

On one level the 12 month price cap contract will reflect the cost of buying annual energy for each customer cohort and variations between them will therefore be “fair” and justifiable. On the other hand, this is a new approach, customers have no choice over which cohort they are in and - if current wholesale volatility continues - there could be large variations across the price cap each cohort faces during 2023. These factors together mean the approach could be perceived as unfair and face considerable opposition.

The 12 month cap is, in general, a good way to manage wholesale market volatility for both customers and retailers. Over time, as wholesale markets stabilise, we would expect any significant price cap differences between cohorts to reduce and we would not expect the cohort of any month to be systematically disadvantaged.

Ofgem should, however, give consideration to the best way to introduce this new approach. It may be wise to consider the timing of its introduction - and avoid introducing the price cap contract at a time when we know there is likely to be large differences between the caps that customers initially migrate onto. We have also considered a variant to the 12 month contract approach which might help to avoid large differences between the prices for different customer cohorts, which we discuss further in question 10 below.

***Question 6: What opportunity and impact could each proposal have on consumer engagement? And where there may be negative impacts, please provide options to address these. (Please provide evidence.)***

We do not think that there is any easily predicted impact of these different methodologies on customer engagement. The level of price savings available is more likely to influence consumer engagement, than the price cap methodology itself. Other consumer impacts (such as exposure to price volatility and ability to budget) are more important factors in choosing the best medium term methodology.

For example, the quarterly price cap will double the number of price cap announcements, which could trigger increased engagement. Conversely, it is possible that more frequent updates to price cap could result in customer information fatigue. With quarterly updates customers will not know what the price cap will be beyond the short price cap window. Coupled with a shorter period between price cap announcement and implementation, it is possible that the quarterly price cap makes comparison and active engagement more difficult.

The contract approach will give customers a longer horizon of price cap level certainty, and a clearer basis against which to compare against competitive fixes in the market. However, it is possible that because the price updates for each cohort will happen only once a year, customers may become less engaged.

In spite of all the above it is clear that it is the suppliers role to ensure their customers understand the tariff structures available to them. We do not see that consumer engagement should be an overly influential factor to any decision around price cap changes and highlight that the current mechanism of explaining cost changes to customers is already very confusing for many.

***Question 7: What other operational impacts could a quarterly update or price cap contract have? Please provide data on the costs and benefits***

As outlined in Octopus's response to Question 1, establishing the direct wholesale cost element of monthly updated price cap contracts is technically challenging and requires the creation of an arbitrage-free forward curve. This is not an insurmountable challenge, however we would advise Ofgem to calculate a set of historical counterfactual price cap contracts for the past 12 months using only products available from ICIS (or a similarly robust third party). When Octopus conducted this analysis it found that it was necessary to interpolate for some price cap cohorts, for which there is currently no methodology defined within the consultation document.

From a purely operational perspective moving to a quarterly cap will reduce the cycle time for existing processes, with a likely seasonal lean in terms of customer contacts. Suppliers should be able to manage this without having to drastically change processes, but would likely need to recruit further permanent resource to handle the workloads.

For the 12 monthly price cap contract option, suppliers will need to rethink the build of tariff structures in their tech solutions and shift the compliance and assurance work to be more agile. Whilst these could be seen as blockers for some suppliers, they are not insurmountable challenges and could in fact smooth the tariff pricing work out to the benefit of suppliers. A bigger concern for the contracts option is the communication work that would need to take place during the transition window. Suppliers will need to invest in training and marketing over the summer of 2022, for this to be successful. Customers trust Ofgem and we would highlight that Ofgem would too need to add campaign time into the calendar to

successfully deliver this option.

***Question 8: Are there any challenges in transitioning to quarterly updates or the strengthened status quo? If so, please provide details.***

In all options, there is the possibility of some transitional complexities caused by the shortening of the notification period, however suppliers should be well placed to handle this. Beyond this we do not see any particular challenges in the transition to the quarterly or the strengthened status quo methodologies, assuming Ofgem properly factors in the cost of hedging according to the status quo methodology from 1 February until further notice.

***Question 9: What would the impact be if suppliers tried to buy the energy requirements for all their customers on price cap contracts in August (for 12 month contracts) or August and February (for 6 month contracts) of each year? Do stakeholders agree there would be liquidity challenges in the wholesale markets? How damaging would this be? Are there any ways to avoid this issue?***

Octopus agrees that hedging all customers on price cap contracts in a single month (August or February) would be untenable due to liquidity constraints in the market. The markets are unlikely to be able to clear this much volume in such a short period of time. It is possible that market makers could wear the liquidity risk on behalf of suppliers, but there would be a premium associated with this that would need to be passed onto customers; raising the level of the price cap.

The simplest way to avoid liquidity issues is to increase the frequency of the 12 month price cap updates (for example quarterly, or monthly), allowing hedging for the customer base to be spread across the year.

***Question 10: If we were to implement the price cap contract, how should we implement it - with an immediate start and single cohort on a price cap, or with a staggered start and six or twelve different cohorts?***

For the reasons mentioned in our response to Question 9, an immediate start is unlikely to be viable due to liquidity constraints. The best way to implement price cap contracts would be via a staggered start, along the lines in the Ofgem document. We understand that this might mean that initially one customer cohort would have a price cap contract of 15 months from October 2022, with other cohorts migrating to 12 month contracts from January onwards, and all cohorts on 12 month contracts by December 2023.

We note that even with this staggered approach there are likely to be challenges with hedging during the transition to the price cap contract, and these need further consideration. If it is decided to implement this new methodology, we ask Ofgem to give careful consideration over when the first cohort moves onto a 12 month contract and the implications for hedging. The more this can occur ahead of April 2023 the better as this will allow us to offset the initial hedges with those we are already holding under the current



methodology. Similarly, if some cohorts are initially on 15 month or longer contracts, this will expose suppliers to further volume risk if prices fall and they are left holding 15 month hedges, compared to the current 6 month hedged approach.

### ***A variant on the 12 month contract***

Octopus acknowledges that there will likely be a number of issues of perceived fairness for customers who find themselves on a considerably more expensive price cap contract compared with other customers. One way to mitigate this could be to implement price cap contracts with fewer cohorts.

A 12 month price cap contract with four cohorts rather than 12 (starting January, April, July, October) would mean the price cap is based on wholesale prices only in 4 months of the year. This would reduce the chance of having to use a wholesale price spike in the calculation of the cap, lowering the risk of big price variations across cohorts. For example, with this approach the high prices we saw in December 2021 would not make their way into the price cap cost stack -the November forward curve would be the reference price for the January contract

Additionally, by setting a 12 month price cap contract quarterly in January, April, July, October, the price cap periods will align with a set of liquid futures contracts. As discussed above in our response to Question 1, aligning the price cap period with liquid future contract delivery periods makes price setting easier and removes the need to construct a monthly forward curve.

We note that this variant would expose retailers to a greater rising price volume risk than the 12 month price cap contract approach in the consultation document as there would be a greater lag in the cap reflecting wholesale price movements. Further consideration is needed over whether this is sufficiently robust for highly volatile periods, such as at present. However, this approach is likely to have the advantage of being easier to implement and still removing backwardation risks. As explained above it has the benefit of being less likely to expose customers to short term price volatility and the risk of big variations across the cap faced by different cohorts. We would like to engage with Ofgem to explore this variant further.

### ***Question 11: What is a fair and practical way to allocate consumers to different cohorts?***

As noted above, Octopus believes that a staggered implementation is preferable to an immediate roll out. The only way to allocate customers is through an identifier which is not open to interpretation, can't be gamed by customers and can be objectively verified. The date the customer lapsed onto SVT seems to be as good as alternatives (such as surname initial).

As far as possible Ofgem should avoid implementation at a time when there will be an immediate large difference in the price faced by cohorts. As explained above, alternatives such as setting a different 12 month price cap across 4 cohorts rather than 12 should be considered further.

***Question 12: Should we consider any of these variations further? If so, which one(s) and on what basis? (Please provide evidence)***

We do not think that any of the variations in the consultation document represent an improvement on the 12 month price contract approach. In question 10 above we have proposed a further variant (setting a different 12 month contract across 4 cohorts) which we consider might reduce the variation between the price cap for different cohorts and make it easier for retailers to hedge for these cohorts. In particular whether to stick to traditional calendar quarters or map the cohorts so that messaging does not occur during the weeks of Christmas (particularly in relation to Q14 notice period considerations).

## **Chapter 5 – Reducing the notice period to a minimum of 28 days**

***Question 13: Do you have any evidence or data that supports or challenges our assessment of the benefits of this? What are the practical considerations for price changes over winter and Christmas?***

***Question 14: Do you have evidence or data to support a move to a shorter implementation window – such as 14 days? What are the potential risks to consumers of a shorter notice period? And what are the operational considerations?***

We strongly support Ofgem's proposal to move to a shorter notice period of 28 days. This will significantly reduce the volume forecasting risk and volatility exposure retailers face. We are confident we could provide the necessary outbound communication and activate relevant operational resources in a timely fashion with this shorter period - even over the winter and Christmas periods.

We think a further shortening (for example to 14 days) is unlikely to provide significantly greater benefits in terms of risk reduction and could start to become difficult operationally - especially if the price cap was being updated monthly.

## **Chapter 6 – A new mechanism for managing backwardation costs**

We would strongly favour a price cap approach which does not create a backwardation (or contango) problem. The challenges around correcting for this as indicated by the questions below underline the case for a price cap contract approach.

If Ofgem does not introduce a price cap contract approach then a backwardation adjustment will be needed. We favour an ex ante, formulaic approach to calculating the impact of backwardation using the same data that sets the price cap.

***Question 15: Given the changes in the wholesale market since summer 2021, how should these be reflected in the deadband calculation?***

We agree that methods should apply equally to backwardation and contango situations to flatten both losses and profits due to the methodology.

Due to the significant increase in volatility since summer 2021, we don't believe that taking a 3 year mean and standard deviation is appropriate. The cap period 9 risk is currently many multiples greater than those observed in prior years and taking a smoothed historical approach would push material losses onto suppliers that would be partially unrecoverable for several years and partially completely unrecoverable.

***Question 16: Do you have any views on the challenge of collecting backwardation costs from suppliers via RFI?***

We do not support an ex post approach based on RFI data. We don't believe that it's appropriate for suppliers to attempt to mitigate themselves for the following reasons: - Octopus projects the absolute loss in the October 2022 to March 2023 price cap window across all suppliers to be in the region of £8 billion - it's unlikely that there is sufficient liquidity in optionality markets to cover this.

We believe that this should be straightforward for Ofgem to calculate and administer and that the existing price cap calculation spreadsheet contains all the necessary information.

***Question 17: Are there additional costs or benefits of taking an ex-post approach in this instance? If so, please provide details or evidence of these.***

There is a very strong case for an ex ante approach. In times of high market volatility an ex post approach would result in suppliers wearing huge swings in P&L and cashflow volatility. An ex post approach will also expose retailers to the risk of not being able to fully recover the cost if customers move en masse off to fixed products. Indeed in times of high volatility, the ex post uplift could trigger such a move.