

17 January 2024

By email: Dan.Norton@ofgem.gov.uk; priceprotectionpolicy@ofgem.gov.uk

## Response to Ofgem's energy price cap wholesale costs review

Dear Dan

Thank you for the opportunity to respond to this consultation:

- We welcome the minded-to decision to make no downward ex-post adjustment and Ofgem's recognition that the proposed intervention was unwarranted.
- We are very concerned Ofgem is leaving the door open to future downward ex-post adjustments - we do not agree Ofgem has the power to do this.
- Ofgem's consultation purports to set out a summary of Ofgem's policy, but is in fact a complete reversal of Ofgem's decision in November 2018 not to make any provision for ex post adjustments to the cap.
- We urge Ofgem to engage fully with the concerns about its vires in this area and not paper over the conflicts between its proposals here and its 2018 decisions, or seek to change Ofgem's vires by stealth.
- We also urge Ofgem to be clearer in its decision on the dangers of clawback for customers, competition and investor confidence, which Ofgem begins to recognise in this consultation document.

While we support your decision, we have deep concerns with the reasoning in the consultation document. In particular, and for the sake of any "retrospective negative adjustment"/clawback that Ofgem might propose in the future, **it is essential that we put on record that we do not agree that Ofgem has the power to make downward ex-post adjustments to the price cap.** Taking such action, even in circumstances where (unlike in this case) there is evidence of a material and systematic over recovery of costs, would be *ultra vires*. You must bear this in mind should you consider a downward ex-post adjustment again.

Below we set out our concerns with the content of the consultation document as it relates to Ofgem's vires, the process and the proposed principles for downward ex-post adjustments. We also set out our initial thoughts on your proposed areas for review of the wholesale allowance, which we broadly support.

### ***Concerns with the reasoning in the consultation***

We strongly support Ofgem's minded-to decision to apply no clawback to the price cap in respect of wholesale costs incurred in the 12 months to end September 2023. Ofgem has reached this position because the evidence it has gathered shows no systemic market-wide over or under recovery of wholesale costs compared to the price cap allowances during this period. This assessment is broadly supported by the work that EUK members commissioned Frontier Economics to conduct, and while there has been no confidentiality ring to allow our own representatives to review the data, we have no reason to doubt Ofgem's analysis.

Notwithstanding our support for the decision, we have very deep concerns with the reasoning in the consultation. Specifically, Ofgem:

1. Implies it has the power to make ex-post downward adjustments to the price cap and that ex-post adjustments are a routine feature of the price cap, while claiming to make no judgement on its vires in this respect. For the reasons set out below **we do not agree that Ofgem has the power to make such adjustments.**
2. Fails to recognise that its assertion that there is potential for ex-post downward adjustments represents a **very significant departure from the original intent of the price cap and a complete reversal of Ofgem's own decisions** on updating the cap methodology. There has been no consultation or other process to reach this change of position.
3. **Seeks to legitimise ex-post downward adjustments through consulting on the principles for applying them, even though making such an adjustment would be *ultra vires*.** Ofgem's discussion of principles also fails to recognise how clawbacks would damage the market and introduce a new undiversifiable risk to retailers which will damage investment and competition in the market.

More detail on each of these points is set out below.

### ***Ex-post downward adjustments to the price cap are ultra vires***

Ofgem implies it considers it has the power to make ex-post adjustments to the price cap: *"We make after the fact (ex-post) adjustments to allowances if we identify that in previous cap periods there were material and systematic differences between allowances and efficient costs"*<sup>1</sup>

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<sup>1</sup> Ofgem, [Energy price cap wholesale costs review](#), 15 December 2023, page 4 (Executive Summary para 2).

While Ofgem claims not to take a position on its vires in this regard<sup>2</sup>, the content of the document as noted above, and the fact that Ofgem is consulting on principles for ex-post adjustments (see below) suggests that its working assumption is that ex-post adjustments are within its vires.

We do not agree with this assumption. Ex-post downward adjustments to the price cap would be inconsistent with Parliament's clear intention when introducing the *Domestic Gas and Electricity (Tariff Cap) Act 2018* and would exceed the powers given to Ofgem under statute and its public law duties. It is apparent from the text and purpose of the legislation that Parliament did not want the price cap to operate as a price target. The legislature intended for Ofgem to set a ceiling – a maximum figure under which suppliers would continue to compete on price to incentivise customers to switch. It did not intend for Ofgem to impose a single, uniform rate that would be charged across the entire market for the supply of energy to retail consumers.<sup>3</sup>

As Ofgem recognised in this consultation,<sup>4</sup> a price cap based on wholesale costs allowances that are deliberately set below Ofgem's wholesale costs estimates would remove the incentive for suppliers to ever price below the maximum allowed, even where they achieve cost savings relative to the cap which they would otherwise be able to pass onto consumers. In other words, ex-post downward adjustments would mean the end of price-based competition in the default tariff market, directly in contravention with Parliament's intention when introducing the cap.

### ***There has been no process to provide Ofgem with the power to make downward ex-post adjustments or clawbacks***

Ofgem says in the consultation that its policy is to make an adjustment to the price cap *"where we identify a systematic error which is unforeseen, clear, material and necessitated change"*.<sup>5</sup> Our primary concern is that Ofgem does not have the vires to make downward ex post adjustments or clawback. Accordingly, it is inappropriate and premature for Ofgem to seek to formulate principles or an approach for circumstances where it has no power to act. Setting out its position in the consultation (without even engaging with the vires issue) cannot provide a legal or appropriate basis for any such future action.

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<sup>2</sup> Ofgem, [Energy price cap wholesale costs review](#), 15 December 2023, para 3.58.

<sup>3</sup> The debates during the second reading of the bill in the House of Commons make this very clear. See, among other examples, HC Deb, 6 March 2018, vol 637, col 237 ("*[a] cap does not mean an end to competition... The cap is a maximum; it is not a requirement to charge prices at that level...*") and col 257 ("*...this is a cap, not a freeze. Companies will still be expected to compete below the cap to attract customers, just as they were before. Nobody will be prevented from reducing their bills by switching supplier or changing tariff, and energy companies will still be able to pass savings on to consumers when possible*").

<sup>4</sup> Ofgem, [Energy price cap wholesale costs review](#), 15 December 2023, para 3.26.

<sup>5</sup> Ofgem, [Energy price cap wholesale costs review](#), 15 December 2023, para 3.8.

Moreover, Ofgem refers to its 2018 decision on updating the cap as evidence that the clawback it had been contemplating is in alignment with its stated policy. This is entirely incorrect. Retrospective adjustments are directly contrary to the decision Ofgem made in 2018 following consultation on the approach to updating the price cap. In its 2018 decision document, Ofgem stated expressly that it had considered including a provision in the tariff cap licence conditions that would allow for ex-post adjustments to be made but ultimately decided not to do so:

*“We are not including a provision for the correction of under-recovery within the cap; equally we do not have a provision to correct for over-recovery... we consider that to do so would risk distorting competition and is therefore not appropriate or proportionate.*

*... For example, a negative retrospective adjustment (eg to correct for the cap being set too high in the previous period) could lead to a cap being set beneath an efficient level of costs. This would distort customers’ incentives to engage in the market, suppliers’ incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market”.*<sup>6</sup>

The reference to “*material systematic issues that require correction*” in the December 2018 Default Tariff Cap Decision document<sup>7</sup> which Ofgem refers to in this consultation document - and relies on as a statement of its policy on retrospective price cap adjustments - ignores the fact that in 2018 Ofgem clearly decided “*not [to] include[d] ... a mechanism to retrospectively correct for forecast error (which would risk distorting competition in the wider market)*”<sup>8</sup>. In mentioning “*material systematic issues that require correction*” it is clear that Ofgem was referring to the circumstances in which it would make corrections to update ex-ante allowances - not to make ex-post adjustments.

The consultation is patently not a simple “*summary of [Ofgem’s] policy*”,<sup>9</sup> but a complete reversal of it.

If Ofgem considers that it should have the power to make downward ex-post adjustments to the price cap, then that power must be introduced by way of legislation or amendment to the tariff cap conditions pursuant to Ofgem’s powers under the Act, following adequate consultation on such a change. For the avoidance of doubt, we do not consider this requirement was fulfilled by the two open letters in April and July 2023 which each made a passing reference to Ofgem’s intention to “*examin[e] areas where suppliers were allowed to recover costs from last year to understand whether a similar ‘benefit’ has been created in current market conditions which should be recovered for consumers*”.<sup>10</sup>

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<sup>6</sup> Ofgem, [Default Tariff Cap: Decision – Appendix 3 – Updating the cap methodology](#), 6 November 2018, paras 3.14–3.21.

<sup>7</sup> Ofgem, [Default Tariff Cap: Decision - overview](#), 6 November 2018, para 3.14.

<sup>8</sup> Ofgem, [Default Tariff Cap: Decision – Appendix 3 – Updating the cap methodology](#), 6 November 2018, para 1.8.

<sup>9</sup> Ofgem, [Energy price cap wholesale costs review](#), 15 December 2023, para 3.7.

<sup>10</sup> Ofgem, [Price cap - programme of work update](#), 18 April 2023; and Ofgem, [Open letter: changes in the energy supply market and Ofgem’s approach to regulation](#), 4 July 2023.

Furthermore, given that the 2018 decision document ruled out all ex-post adjustments, if Ofgem wishes to make ex-post upward adjustments a routine feature of the cap, it should set out its vires for doing so and consult properly, recognising this is a reversal of its 2018 position and formulate appropriate principles for applying such adjustments accordingly. The fact that Ofgem has already made upward retrospective adjustments during the energy crisis, does not excuse Ofgem from now taking these steps.

We note that through the Additional Debt Costs Review Consultation, Ofgem is now seeking to make an upward ex-post adjustment to the cap for debt costs without this foundational thinking. We are concerned that this will make ex-post adjustments a routine matter and lead to a cycle of ex-post adjustments for debt costs which Ofgem will find it difficult to escape.

***Ex-post adjustments cannot be legitimised through consulting on principles***

It is inappropriate for Ofgem to consult on principles for ex-post adjustments without engaging with the very serious concerns we and others have raised about its vires to make them. Ex-post adjustments cannot be legitimised through such a consultation and Ofgem also needs to recognise, as noted above, that the proposal to introduce downward ex-post adjustments as a routine feature of the cap is not just ultra vires but also a full reversal of its previous policy, changes to which it has not consulted on.

In addition to the legal concerns we raise, experience in recent years serve to underscore the validity of Ofgem's 2018 decision not to apply ex-post adjustments on the grounds of distorting the market. In particular, the risk of an adjustment to the price cap which requires suppliers to price below cost significantly reduces the incentive for suppliers to take on new customers on standard variable tariffs. This will damage the experience of customers (who may not always want to switch onto fixed term tariffs, especially when they are higher than the price cap as they have been over the last 2 years). It also completely changes the commercial decision-making, making it less attractive for suppliers to enter into trade sales which facilitate orderly market exit, and making it more expensive and difficult for suppliers to conduct SOLRs, as buyers may seek compensation for clawbacks. SOLRs were a vital tool in stabilising the market and looking after customers during the energy crisis, and we caution against Ofgem undermining market resilience in this way.

As well as discouraging suppliers from ever pricing standard variable tariffs below the price cap (which Octopus does routinely and which Ofgem recognises as a problem with downward ex post adjustments), the risk of a clawback on price cap revenues is not one that suppliers can mitigate against. Even if, as part of seeking new powers, Ofgem limited itself to making these downward ex-post adjustments in very extreme circumstances with a high evidence bar around over-recovery being material and systematic, the risk of clawback will remain a non-diversifiable risk which will drive up the cost of capital and make the sector less attractive to investors.

While Ofgem recognises that there may be different arguments for applying upward and downward ex-post adjustments to the cap, the serious damage clawbacks will do to the market and consumers as noted above do not appear in Ofgem's consultation. They are

relevant considerations which deserve very serious analysis should Ofgem ever seek to obtain the powers to make downward ex-post adjustments. For the avoidance of doubt, we do not agree that Ofgem currently has these powers.

### ***Our initial view on future reforms to the price cap***

We consider there are important improvements Ofgem can make to the cap in the medium term to reduce the regulatory burden that has become associated with the cap since Covid, and to address concerns that it is becoming a “lobbyists’ charter”.

We support Ofgem considering how the wholesale methodology will fare under market-wide half hourly settlement (MHHS), but are wary of Ofgem rushing to answer these complex, technical questions. MHHS will only be introduced in 2027 so as a market we have time to address this. More time will also enable policy design to be based on up to date information on consumer behaviours rather than forcing Ofgem to speculate about how consumer behaviour will change with more widespread HHS and smart tariffs - difficult at the best of times and exceedingly difficult in a fast moving energy transition. When it does begin addressing this question, we urge Ofgem to start with considering what customers the price cap is designed to protect, and what tariffs those customers are likely to be on (e.g. single rate, multi rate or dynamic time of use tariffs).

Instead of rushing into the complex area of MHHS, we urge Ofgem to prioritise the short term opportunity to significantly streamline the price cap. This could include: (i) considering what can be done to ensure that the cap only applies to default, not evergreen tariffs. This will allow more tariff innovation ahead of MHHS; and (ii) a simplified passthrough+ price cap, which has a wholesale allowance set quarterly (using the current methodology) and a number of other elements (e.g. passthrough costs and supplier cost and EBIT allowances) that are set less regularly - perhaps annually at most.

In terms of a review of the quarterly cap - we ask Ofgem to carefully consider the case for making significant changes to the current wholesale methodology ahead of 2027 as any big change will by definition only be in place for less than 2 years before the MHHS changes. We understand there may be concerns with the impact of the quarterly wholesale updates on consumer prices and we would like to see more evidence that this is having a significant effect on customers before Ofgem launches work to review the current approach.

We also support the technical changes Ofgem is making to Annex 2 - “wholesale cost allowance methodology” to improve transparency.

Yours sincerely

**Rachel Fletcher**

Director for Regulation and Economics, Octopus Energy Group



## Consultation questions

### **1. Do you agree with our minded-to position to make no adjustment to the price cap for wholesale costs incurred between October 2022 and September 2023?**

We strongly support Ofgem's minded-to decision to apply no adjustment to the price cap. While we support the decision, we have deep concerns with the reasoning in the consultation document, as set out in detail in the cover letter.

### **2. Are the three topic areas identified for medium-term review the right priorities? If not, what alternative topics should be considered?**

As set out in the cover letter, before rushing to assess how the price cap will work with MHHS we think Ofgem could take steps to simplify and streamline the price cap, building off the work that is already happening with the review of the operating cost allowances. We urge Ofgem to prioritise this work before addressing the technical question of how the wholesale allowances will work in a world of MHHS.

We ask Ofgem to carefully consider the case for making significant changes to the current wholesale methodology ahead of 2027 as any big change will by definition only be in place for less than 2 years before the MHHS changes need to be put through. We understand there may be concerns with the impact of the quarterly wholesale updates on consumer prices and we would like to see more evidence that this is having a significant effect on customers before Ofgem launches work to review the current approach.

### **3. What is the relative order of priority between the three broad areas identified for review?**

In terms of the areas discussed in the consultation document, we suggest prioritising:

1. We support the technical changes Ofgem is making to Annex 2 - these will improve transparency and make forecasting easier.
2. Driving cap simplification in 2023 - starting with (i) completing the opex allowances reviews; (i) considering what can be done to ensure that the cap only applies to default, not evergreen tariffs; and exploring (iii) a simplified passthrough+ price cap, which has a wholesale allowance set quarterly (using the current methodology) and a number of other elements (e.g. passthrough costs and supplier cost and EBIT allowances) that are set less regularly - perhaps annually at most.
3. Explore how the wholesale methodology will need to change to prepare for MHHS in 2027.

4. Prioritise the review of the quarterly cap only if there is evidence significant change is needed ahead of 2027.

4. **Within each topic, are there any specific areas of focus you consider should be in scope?**

Please see the cover letter and response to questions 2 and 3.

5. **Do you have any initial views to share on the topics identified, or more broadly?**

Please see the cover letter and response to questions 2 and 3.