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By email only

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Dear Dan,

OVO response to Ofgem's consultation on the wholesale costs review

Thank you for the opportunity to respond to this consultation. OVO supports Ofgem's minded-to position to make no adjustment to the price cap for wholesale costs incurred between October 2022 and September 2023.

We have raised our concerns with the process that Ofgem have followed throughout the wholesale costs review and we believe there are important lessons and principles that should be learned for future reviews.

1. Suppliers are responsible for their risk management and commercial strategies and should both bear the risk and retain the benefits of their commercial decisions. It is highly inappropriate for the regulator to seek to apply an ex-post recovery in these circumstances through a lens of "perfect hindsight".
2. Regulatory uncertainty caused by the risk of such action undermines investor confidence and reduces the attractiveness of the sector - suppliers must be able to make, and retain, sufficient returns to attract investment. In the context of Ofgem's minimum capital requirements, and government desire for energy retailers to support households in the transition to net zero through investing in innovative solutions and propositions, this uncertainty is particularly damaging.
3. The potential for ex-post adjustments that seek to "claw back" the benefits of commercial decision making also risk actively damaging consumer outcomes. Not only in risking investment in innovation as noted above, but also reducing supplier confidence to price below the cap and pass savings to customers, thus stifling competition and switching.

Therefore, while we support the proposal for a wider review of the wholesale allowance, it must be clear at the outset that the fundamental aim of the review should be to provide

greater certainty regarding the risks which suppliers are expected to manage which will therefore not be subject to ex-post adjustment, and to ensure that there are sufficient allowances within the cap for recovery of the associated costs of that risk management.

We would urge Ofgem to review its Price Cap Programme of Work¹ before embarking on the next stage of the wholesale allowance review, there are a number of areas within the price cap which do not allow for full recovery of costs for which suppliers have no, or limited, ability to control, such as CfD costs, gas transportation costs, and ECO costs which have not received appropriate attention. We would also refer Ofgem to our responses to the recent consultations on levelisation and the bad debt allowance where we address the materiality of the historical misallocation of debt costs - given the severely distortive impact of this methodological flaw this should be prioritised above the next phase of the review of wholesale allowances.

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

¹ <https://www.ofgem.gov.uk/publications/price-cap-programme-work-update>

Q1. 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?

- OVO agrees with Ofgem's assessment that, with evidence showing a large variance in supplier wholesale costs, it is hard to isolate a systemic issue that should result in ex-post adjustments. We do however believe that the optionality that the Price Cap gives customers means that it is inevitable that during periods of high volatility in wholesale prices there will be a large variance in how different suppliers manage this optionality. This variance will be more pronounced when there is such a dramatic increase in the cost of risk management products but no increased allowances to allow suppliers to deal with this exceptional increase in the expected costs of managing customer optionality. Given the lack of regulatory certainty, it could be reasonable for some suppliers to expect an ex-post true up of this whereas others may have operated assuming there would be no ex-post adjustment.
- There is a clear mechanism by which suppliers should match the indexation of wholesale prices that set the price cap but there has always been ambiguity around which of the allowances are exposed to ex-post adjustments and therefore it is unreasonable to expect all suppliers to manage the exposure to wholesale allowances in a similar way. OVO have sought clarity on this point in the past and we would like to reiterate that having clarity on which elements are, and which are not, exposed to ex-post adjustments is essential to allow suppliers to effectively risk manage their exposures.
- The evidence from this review suggests that the limitations on supplier pricing strategies associated with the Price Cap, and therefore holding of short optionality positions in a volatile market has created a tariff where the average supplier has under-recovered their wholesale costs by £71 per dual fuel customer. Suppliers had to make difficult commercial decisions to deal with this uncertainty and it does not seem fair or reasonable that it could potentially be the case that a supplier who made sensible, responsible commercial decisions made an unrecoverable loss because another supplier who took large risks achieved wholesale costs below the allowances in the cap.

Q2. Are the three topic areas identified for medium-term review the right priorities? If not, what alternative topics should be considered?

i. Wholesale allowance methodologies • Updating the additional wholesale allowances using up to date data. Considering any other methodological changes which could improve the functioning of the allowances.

- The past is not always a good predictor of the future. Therefore, we believe that allowances should be set based on a forward-looking assessment of potential outcomes for the relevant price cap period rather than a roll forward of historic costs incurred. This requires a consideration of wholesale market volatility, which is the key driver of the level of risk and the value of customer optionality, as well as outright wholesale price levels.

- Suppliers need clarity on which Price Cap allowances in the cap will be subject to retrospective review, and which allowances will not be reviewed and so therefore must be actively risk managed by Suppliers. We are still unclear whether Ofgem will retrospectively allow recovery of high balancing costs caused by extreme weather conditions, or if they will seek to claw back excess allowances in the event of low outturn balancing costs. The uncertainty on the approach Ofgem will take has created a barrier to effective risk management of domestic energy costs by the sector, resulting in these risks sitting with end consumers.
- Historic outturn costs for any supplier are subject to the hedging strategies implemented. While the price cap mechanism implies a broad hedging approach, there are many potential variations in the actual hedge strategy adopted. If wholesale cost allowances are to be adjusted retrospectively, Ofgem should clarify the hedge strategy that they expect suppliers to adopt, against which the assessment of reasonable costs can then be assessed.
- We believe that there are two potential approaches that Ofgem should take to setting Price Cap allowances. Different approaches could be adopted for different cost items, depending on the ability of Suppliers to risk manage that specific cost item.
 - **Supplier Risk Management** - Where Ofgem views that a cost element can and should be risk managed by Suppliers, an allowance should be set that recognises the potential range of cost outturns and the cost of sourcing risk management products (i.e. insurance products, weather derivatives, options etc). This allowance should not be set at the mean or median cost outturn, but should be set to recognise the range of cost outcomes and enable suppliers to procure effective risk management products. For these risks Ofgem **should be clear that no post event reconciliation of allowances** against actual outturn costs will be carried out.
 - **Outturn cost passthrough** - Where Ofgem views that a cost element cannot or should not be risk managed by Suppliers, any allowance should **always** be subject to post event reconciliation against actual outturn costs. In order to enable Suppliers to manage costs, the methodology for calculating actual outturn costs should be defined so that Suppliers can replicate any assumed hedging strategies. The exact level of allowance included in the cap becomes less important as Suppliers have certainty that a post event reconciliation will happen. This means that allowances can be set at a reasonable estimate with no risk of under or over recovery.
- Currently, the approach is somewhere in between. There is no clarity over the conditions that would trigger a post event reconciliation, or details of how any reconciliation calculations and assessment would be carried out. This means that Suppliers cannot determine the risk minimising strategy and are left with uncertainty as to whether Ofgem will implement post event reconciliations and what methodology would be used.

- As a lot of the variation in cost expectation is based on changing levels of expected cost of customer optionality we would urge Ofgem to reassess the removal of the Market Stabilisation Charge as part of any wholesale review. The MSC limits the risk for Suppliers associated with customers exercising their option to switch from an SVT tariff to a fixed price tariff, and with its removal Suppliers will either have to accept more risk or spend money on mitigating the risk by procuring option contracts from the market. When the MSC is removed, we would expect to see an increase in wholesale allowances to enable Suppliers to manage the increased risk.

ii. Review of the policy to move to quarterly cap updates • How have customers experienced and understood the move to quarterly updates? How did the change affect liquidity? Does the approach to recovering backwardation costs, including the recovery period, remain appropriate?

- The introduction of quarterly price caps has delivered both benefits and issues for Suppliers.
- One of the main benefits is the reduction in time between when commodity hedges are bought and delivery. This reduces the likely differential in price between indexation and balancing trades. If price caps return to seasonal indexation this will increase the average length of time over which a commodity hedge is held. If MSC was to remain post-March 2024 this would not be as much of an issue but with the removal of the MSC we would expect a move back to seasonal price caps to be an increased risk and therefore would recommend an increase in allowances to represent the increases in expected hedging costs. If the MSC was to remain then we would not expect to see expected hedging costs increase with a move to seasonal caps.
- Problems with quarterly price cap updates have been mainly concentrated within the operational overhead in delivering 4 price cap tariffs per year. It is particularly operationally difficult to deliver the January price cap update over the Christmas period. The increase in customer contact and workload associated with each price change comes at a significant cost to all suppliers.
- The introduction of quarterly caps did make it more difficult for suppliers to match the wholesale indexation with commodity purchases due to a lack of liquidity in the reference products, and therefore led to increased costs from holding larger basis risk. Wholesale costs were potentially slightly inflated by the fact suppliers were sometimes needing to pay a premium in order to transact less liquid products.
- Quarterly caps make it more difficult (almost impossible) for suppliers to procure suitable backwardation hedging products to manage the backwardation deadband exposure. This was easier when the backwardation exposure was seasonal as seasonal products are more liquid and therefore it is easier to unwind any hedges against seasonal spreads in line with the indexation roll in.

- Delayed backwardation recovery comes at a cost of capital to suppliers. If backwardation recovery was extended to seasonal timescales then the increased cost of capital should be represented in an increased allowance within the cap.

We do see material operational and customer benefits in moving back to seasonal Price Caps. However, it would increase risk associated with customer optionality and so should be accompanied by other changes, such as the reintroduction of the MSC and/or an increase in wholesale risk allowances, to ensure Suppliers can effectively risk manage this.

iii. Wholesale methodology under market-wide half hourly settlement (MHHS) • Do the wholesale allowances need to be changed considering the move to MHHS? If so, how?

- The shaping allowance in the SVT price cap is currently based on an average demand shape of a domestic user, as calculated by the Elexon NHH demand profiles. This means that consumers on a price cap tariff who use most of their energy during high priced carbon intensive periods are being cross subsidised by consumers who use energy in a clean way at periods of lower demand and carbon intensity.
- In a MHHS market, if the industry is to take advantage of the huge investment that has been made on Smart Meters, OVO believes it is essential that consumers who use their energy in cheaper off-peak periods are offered lower priced tariffs than if they were settled on an industry profile. Conversely customers who use expensive peak energy should not have access to these cheaper tariffs as their costs will be higher than average.
- If the shaping allowance for the price cap is set based on industry average of shaping costs we believe this will lead to customers with high consumption in high priced peak periods being incentivised to stay on the price cap tariff as these customers won't be paying for their energy consumption at a price that matches the high price periods in which they consume.
- A likely outcome of basing price cap shaping costs on industry average in a MHHS market would be that all users who used energy during high priced peak periods stayed on the price cap (due to them realising a benefit of reduced shaping costs in their bills) but all of the low shaping cost customers move to fixed tariffs (that represented their lower wholesale costs). This would mean that most of the price cap customers would be having their energy provided at a loss to their supplier.
- This mechanism of undercharging users of higher carbon, higher priced energy during peak periods will have the effect of reducing their incentive to change their behaviour to lower carbon usage patterns by essentially receiving a subsidy to maintain their consumption habits. We do not believe this can be an acceptable outcome of any price cap mechanism and would be contrary to Ofgem's statutory net zero duty under the Energy Act.
- OVO's initial recommendation to address this concern would be to implement a shaping allowance in the cap that is based on a shaping profile of a customer with high usage in peak periods. This will remove the incentive for customers to maintain

uneconomical and unecological energy consumption but still provide a price cap that offers meaningful protection to consumers.

- Alternatively, Ofgem could look to address any perverse incentives to not improve customer usage behaviour by implementing different price caps for different usage profiles. However, this would introduce significant additional complexity to the price cap regulations and their implementation which we believe makes this approach unattractive.

Q3. What is the relative order of priority between the three broad areas identified for review?

OVO's preference of order would be

1. Reviewing Wholesale Allowance Methodologies
2. Quarterly Cap Review
3. Wholesale Methodology Under MHHS

We have listed MHHS as our third option as, while we believe this to be very important, we believe Ofgem needs to address the wider issue of what retail price regulation will look like in the future before reviewing how it interacts with MHHS. We would not envisage the price cap to be in its current form by the time MHHS has been delivered, and so would support an urgent wider review of retail price regulation.

Q4. Within each topic, are there any specific areas of focus you consider should be in scope?

See response to Q2. Ofgem needs to provide increased clarity on what risks suppliers should be managing ex-ante to allow suppliers to fully understand their risk exposures.

Q5. Do you have any initial views to share on the topics identified, or more broadly?

See response to Q2.