

Non-Confidential, can be published

10th October 2025

Response to consultation on Contracts for Difference (CfD) Wholesale Allowance in the price cap

By email: priceprotectionpolicy@ofgem.gov.uk

Dear Daniel,

Thank you for the opportunity to respond to this consultation discussing the methodology of the CfD allowance in the price cap, and the potential need for a reconciliation mechanism.

To summarise our headline positions:

- We do not support the inclusion of a direct reconciliation mechanism for price risk, as price risk is within the power of an efficient supplier to hedge effectively.
- However, the interaction of price and volume risks is increasingly material, as high volumes of CfD generation bear down on wholesale market prices.
- We do therefore support further consideration by Ofgem on how to manage these changes for suppliers and customers - one approach may be reconciliation relating to volume risk, for which hedging is limited and expensive. If this is not explored, Ofgem will need to consider how suppliers can support the cost of managing these increasingly material risks.
- Ofgem should consider adopting a rolling average CfD allowance. Depending on design, this could also act as a form of partial reconciliation without eliminating the need to hedge.

This cover letter serves as answers to your specific questions and should be treated as such.

Please find further discussion below.

Differentiating price and volume risk is increasingly difficult

We maintain that direct price risk reconciliation is not advisable as it applies at P50 (i.e., median) volumes. Shielding suppliers entirely from price-related risks would discourage efficient hedging practices and is therefore not in the best interests of consumers.

However, CfD recovery risk more generally is now approaching levels where it could be considered material and systematic under the current allowance methodology. This risk will only continue to grow due to the rapid deployment of new renewables and accompanying grid infrastructure, which has the dual effect of increasing volumes whilst increasing wholesale price cannibalisation.

This correlation between price and volume effects is an already substantial and increasingly material risk. Namely, windy weather will increasingly depress wholesale prices, which then increases the level of CfD top-ups. This combination of factors means that not only is the total CfD levy set to rise substantially, but also the volatility of the outturn value and suppliers' exposure to it.

We would welcome further exploration of how to account for this increasingly material volume risk - including through a reconciliation mechanism

Whilst suppliers can explore specific solutions to the mitigation of volume risk, such as weather-related insurance, these products are typically expensive, eroding suppliers' already tight margins, and subsequently drive up costs for customers. If reconciliation is not pursued, Ofgem should therefore review whether further allowances or headroom should be factored into the cap to help suppliers to manage the cost of funding volume risk hedging solutions.

We recommend Ofgem consider adopting a rolling average methodology

Our preferred approach to the CfD allowance methodology would be to apply a rolling weighted average across a consistent time window.

Ofgem's current CfD methodology devises an annualised weighted average CfD levy based on best-available data available for the current financial year (starting in April). This results in a time-varying mixture of predicted and reconciled values being factored into cap allowance. This creates a transient risk profile that shifts throughout the financial year, making hedging unnecessarily complex.

Depending on design, the adoption of a rolling average could also provide a limited form of implicit reconciliation. For instance, consistently applying two reconciled and two predicted quarters of CfD levy data, as might be expected in the January price cap period currently. This would have the added benefit of maintaining the need to hedge and employ innovative risk management, whilst providing partial downside and upside protection on both sides of the equation.

We recommend strengthening and aligning the market price across the cap

We recommend that the CfD allowance uses an averaged reference price methodology aligning with that of the wholesale allowance. Doing so would help to mitigate price risk uncertainty associated with before-period adjustments and create a robust market price against which to progressively hedge.

Octopus Energy broadly believes that the current format of the price cap is in need of radical simplification in order to maintain transparency and predictability, and to avoid potential lobbying and rent-seeking behaviour in setting the methodology. One of the ways Ofgem could seek to do this is to align methodologies wherever possible between various elements of the price cap.

Improving transparency in LCCC's methodology

At a minimum, Ofgem should engage with LCCC (or DESNZ as shareholders), to ensure the accuracy of the CfD cost forecasting that goes into the cap, and promote transparency in its methodology where appropriate in a competitive market framework.

Using the discussed example of combined price/volume effects, LCCC's model currently materially underestimates capture price discount rates, outputting a 5-6% capture price discount rate per quarter. LCCC acknowledges¹ this value is "*smaller than the actual discounts we observe*", which in reality is currently closer to 6-10%.

This uncertainty over the cost-reflectivity of the forward-looking CfD allowance forces even efficient suppliers to adopt conservative hedging strategies, which can raise costs unnecessarily and reduce market efficiency.

Octopus' hedging strategy

Octopus Energy follows a strict and sophisticated hedging policy, and does not speculate on market movements, not assuming or relying on market movement in either direction. We actively hedge CfD risks for both fixed customers and those on Standard Variable Tariffs.

- Octopus Energy efficiently and directly hedges against price risk, but only to the extent that price risk can be mitigated at P50 outturn volumes.
- Volume risk, and the growing coincidence of price/volume effects, is more difficult and expensive to hedge. This requires costly, imperfect, or otherwise novel hedging solutions.

For customers on standard variable tariffs, Octopus executes a rolling hedge that follows the price-cap methodology as set by Ofgem which operates on a three-month cycle. Any

¹ <https://www.lowcarboncontracts.uk/resources/faqs/supplier-cfd-rab-faqs/>

strategy to manage CfD risk for default tariff customers would be reviewed in line with changes to the price cap methodology.

For customers on a fixed price contract, Octopus makes forward commitments for power and gas delivery for the duration of the term offered to the customer, allowing for some expected attrition. Daily adjustments are made to correct the wholesale position for variances in demand and renewable generation versus forecast.

We would be happy to discuss our response further.

Yours sincerely,

Sam Whitworth
Energy Market Regulation Adviser