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By email to: [Retailpriceregulation@ofgem.gov.uk](mailto:Retailpriceregulation@ofgem.gov.uk)

Dear Leonardo

**Price Cap - Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges<sup>1</sup>**

Centrica welcomes the opportunity to respond to Ofgem's consultation proposing licence modifications purporting to empower Ofgem to make mid-period adjustments to the level of the default tariff cap (DTC) outside of the established cycle of April and October changes notified in February and August respectively. This response is supported by the attached legal annex from Towerhouse LLP, setting out the substantial legal arguments.

As discussed further below, we have substantial concerns about Ofgem's proposal including:

- lack of clarity on the specific rationale for the changes proposed;
- failure to articulate clearly how Ofgem envisages this 'exceptional' provision would operate in practice, notably in relation to:
  - the consultation process it would expect to follow before making any 'out-of-cycle' changes<sup>2</sup>; and
  - the lead-times Ofgem envisages for any proposed changes in cap levels to become effective following decision<sup>3</sup>; and
- the vague and discretionary nature of Ofgem's proposed threshold tests for pursuing 'exceptional' out-of-cycle changes<sup>4</sup> and additional uncertainty to which they give rise.

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<sup>1</sup> [Price Cap – Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges | Ofgem](#)

<sup>2</sup> The draft modification refers to the existing SLC 28AD.16 which requires consultation but does not specify its form

<sup>3</sup> The draft modification merely refers to "a date specified by the Authority by way of a statement in Writing"

<sup>4</sup> Consultation document, paragraphs 15-18

Given the scant justification so far advanced we are not persuaded that the changes proposed are necessary or proportionate. Ofgem can already implement modifications to tariff cap conditions (if suitably justified) providing it follows the statutory procedure relating to consultation and standstill prior to implementation.<sup>5</sup> This makes a pre-emptive licence modification superfluous, unless Ofgem's intention is to circumvent such requirements. But in that case, any decisions would be challengeable because Ofgem cannot arrogate new powers to itself outside of the statutory framework.

The statutory framework is there to protect industry, the market and ultimately consumers from statutory bodies making decisions which have not been robustly tested by industry and are not supported by evidence; even a relatively minor adjustment to a price control can have catastrophic unintentional consequences if the decision-making body has not properly equipped itself with all of the relevant information.

*The rationale for Ofgem's proposal is not clear*

The consultation makes little attempt to make a positive case for the change it proposes beyond stating that, at present, Ofgem cannot make 'out-of-cycle' changes without a licence modification. While that statement may be uncontroversial, the inverse proposition is that Ofgem can (or could, in principle) already make 'out-of-cycle' changes in exceptional circumstances, if justified, via an appropriate licence modification.

Ofgem makes no real attempt to explain:

- why an out-of-cycle change might be necessary;
- why, if justified, it could not pursue such a change via licence modification at the time; or
- what practical difference Ofgem considers the pre-emptive change now proposed will make to its freedom of action.

Given this lack of compelling justification, we stand by our previous view that any proposed changes to the level or methodology of the cap once implemented must be treated by Ofgem as full licence modifications, requiring a full process of consultation on such proposed changes, rather than introduced through some internal mechanism.<sup>6</sup> This view is based on the following analysis, reproduced below for ease of reference.<sup>7</sup>

*65. Parliament has made specific provisions for modifications to tariff cap conditions. These are set out in section 1(2) of the Act. The requirements of that section are engaged for such modifications – including the need to have regard to the matters in section 1(6).*

*66. Ofgem is also required to conduct such consultation as is necessary in the circumstances and, in any event, a statutory consultation pursuant to section 4 of the Act.*

*67. This modification regime is specific to tariff cap licence conditions set under the Act. Unlike the Gas and Electricity Acts, there is no provision entitling Ofgem to include modification provisions with conditions themselves. There is thus no way of Ofgem to avoid consultation in accordance with the Act, whether by including provisions in the*

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<sup>5</sup> Sections 4 and 5 [Domestic Gas and Electricity \(Tariff Cap\) Act 2018 \(legislation.gov.uk\)](https://www.legislation.gov.uk/ukpga/2018/12/section/4) ('TCA 2018')

<sup>6</sup> Ofgem makes passing reference to "an appropriate consultation period" at paragraph 18 of the consultation document but is otherwise silent on the process it envisages.

<sup>7</sup> Centrica response 2 [Default tariff cap: overview document | Ofgem](#)

*licence conditions that enable modification or by 'sub-delegating' important parts of the licence to notices that Ofgem can issue. This matches the normal rules for sub-delegation.*

*68. Section 2(3) also explicitly sets out that Ofgem 'may' consult on the methodological aspects of any modifications subsequent to the introduction of tariff cap conditions. We take this explicit mention – which is not strictly necessary – to be a clear indication that there should be a presumption in favour of such a consultation.*

*69. Given the above, it follows that any proposed changes to the level or methodology of the cap once implemented must be treated by Ofgem as full licence modifications, requiring a full process of consultation on such proposed changes, rather than introduced through some internal mechanism.*

*Ofgem has not considered or clearly explained the effect of its proposal*

Ofgem states that a recalculation could represent an increase or decrease from the existing cap level<sup>8</sup> but does not spell out scenarios in which it considers such recalculations might be appropriate or what the consequences would be. Nevertheless, it is instructive to consider the potential consequences of both upward and downward out-of-cycle recalculations.

- *Upwards adjustments – a 'safety valve'?*

In its parallel consultation on potential adjustments to the wholesale cost allowance<sup>9</sup> Ofgem has recognised that, in current market conditions, the cap prevents suppliers from recovering wholesale costs associated with unexpected demand for which they have not been able to hedge in advance.

In principle, one potential application of an out-of-cycle adjustment might be to seek to introduce an emergency 'safety value' to lift the cap to a level which effectively removes this constraint on cost-recovery in the short term. However, 'recalculating' the cap so that suppliers purchasing wholesale energy on the spot market can recover exceptional commodity costs in extreme market conditions would effectively negate the price protection from which all customers on default tariffs currently benefit. It seems unlikely this is Ofgem's intention, but if it is Ofgem needs to say so explicitly so that stakeholders can properly understand the effect of the changes currently proposed.<sup>10</sup>

As currently designed, the price cap does not track changes in wholesale commodity costs in real time. This reflects a deliberate policy choice by Ofgem to use a lagged index of wholesale costs which suppliers can seek to match, and which shields customers from extreme market volatility by smoothing the impact of wholesale cost peaks and troughs over time.

So long as Ofgem retains the basic methodology of a lagged wholesale index the cap will not keep up with upward (or downward) movements in wholesale commodity costs, but the potential for mid-period adjustments will erode certainty for suppliers seeking to match the index. Ofgem acknowledges the risk and seeks to mitigate it by emphasising the rare and exceptional nature of any proposed use of mid-period adjustments.<sup>11</sup> It does not, however,

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<sup>8</sup> Consultation document, paragraph 7

<sup>9</sup> [Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem](#)

<sup>10</sup> TCA 2018 section 4(2)(b)

<sup>11</sup> Consultation documents, paragraph 14

advance any tangible consumer benefit to offset the additional costs and risks it (correctly) perceives.

In any event, there will be an inevitable lag between when Ofgem seeks to employ any 'safety valve' and when any increased cap translates into effective relief of the pricing constraint on suppliers. Even if Ofgem envisages that it can formally lift the price cap without advance notice (which is legally doubtful, as explained above) unless Ofgem makes other sweeping licence changes enabling suppliers to apply price increases without notice, suppliers would be unable to apply any increase in practice until they have been through the process of issuing price increase notifications to customers. This takes considerable time – reflected in the present window between Ofgem's announcement of cap levels for the next cap period and the start of that period.

Any substantive change to the methodology following consultation would be tantamount to a statutory modification, requiring a minimum of 56 days advance notice from the date of any confirmed decision in any event. Therefore, the idea that mid-term upwards revisions to the price cap could be introduced and have practical effect with extreme speed is illusory. Once this is recognised, the case for an out-of-cycle adjustment compared to a next period adjustment becomes hard to discern.

- *Downwards adjustments*

As with upwards adjustments, Ofgem provides no concrete examples of scenarios where it considers a mid-term downward adjustment in the level of the cap might be warranted. It is far from clear why a reduction in the spot price of wholesale commodity, for example, should trigger an immediate fall in the cap.<sup>12</sup>

Such a fall will not reduce the efficiently incurred costs of suppliers who have, prudently and responsibly, hedged in line with the 6-2-12 cap index, so would give rise to immediate economic losses. Ofgem is required to have regard, among other things, to the ability of suppliers to finance their licensed activities. It would be perverse for Ofgem to give weight to this need in relation to out-of-cycle upward adjustments only to deny it in relation to similar downward adjustments.

Assuming Ofgem could ever make a case for an out-of-cycle downward adjustment, suppliers would plainly require adequate advance notice to implement any change. This precludes any possibility of downward adjustments that are immediately effective, given that suppliers are at all times constrained by the cap.<sup>13</sup> As with upward adjustments, this calls into question the case for out-of-cycle adjustments rather than next period adjustments given timing differences (allowing for appropriate consultation and implementation lead-times) may be marginal.

*Ofgem's proposed threshold is vague, unclear and will not dispel uncertainty*

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<sup>12</sup> Under the current methodology, falls in wholesale cost will feed into lower subsequent prices via the 6-2-12 wholesale index.

<sup>13</sup> Ofgem notes at paragraph 20 of the consultation document: "SLC 28AD.1 states that suppliers must be compliant in relation to each relevant 28AD customer at all times within the cap period. This means that suppliers would be obliged to comply with the new cap level that is set for the remainder of the existing cap period if we made an in-period adjustment." (emphasis added). If Ofgem envisaged that suppliers could comply with a lower cap through retrospective customer rebates or credits, for example, that would further call into question the case for urgent action without notice.

Ofgem acknowledges that a pre-emptive licence change to enable out-of-cycle adjustments will increase uncertainty for suppliers and customers but insists that a high threshold for considering 'exceptional' circumstances will mitigate this risk. However, the (non-binding) guidance Ofgem offers is limited to a single paragraph suggesting that exceptional means 'rare' and having 'high impact without urgent action'.

While we agree in principle that any threshold for use of an 'exceptional' provision would have to be set high, we remain concerned that raising the prospect of out-of-cycle adjustments pre-emptively creates substantial unnecessary uncertainty which a loosely defined discretionary threshold cannot counteract.

## **Conclusion**

For the reasons set out above, we do not consider that Ofgem has made a sufficient case for the pre-emptive changes it proposes and therefore cannot proceed without further consultation (which would be required in any event before an out-of-cycle recalculation could be mandated).

Yours sincerely

Don Wilson  
**Market Design and Policy**