

EUK Response to Ofgem's Default Tariff Cap Reform Consultations

17 December 2021

Introduction

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering over 80% of both the UK's power generation and energy supply for the 28 million UK homes as well as businesses. The energy industry invests £13bn annually, delivers £31bn in gross value added on top of the £95bn in economic activity through its supply chain and interaction with other sectors, and supports 738,000 jobs in every corner of the country.

This is a high-level industry view in response to Ofgem's consultations on the potential impact of increased wholesale volatility on the default tariff cap, and the process for updating the methodology and setting maximum charges; Energy UK's members may hold different views on particular aspects of the consultation. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes Ofgem's review in light of the market volatility due to unpredictable wholesale price rises, and the impacts that the current price cap methodology has had on supplier financeability market stability. We believe that the primary objective of this review should be to ensure that the price cap appropriately reflects efficient supplier costs, and that abnormal costs being incurred due to the current unprecedented wholesale price rises can be recovered before further irreparable damage is done to market stability and competition. Our response below summarises the key concerns raised to us by some of our supplier members.¹

With regards to Ofgem's proposals to allow it to update the cap outside of the current 6-monthly periods in extreme circumstances, Energy UK is not in a position at this stage to agree or disagree with Ofgem's proposal until it has engaged further with industry on the details to address unanswered questions and potential barriers.

Potential Impact of Increased Wholesale Volatility on the Default Tariff Cap

Ofgem must announce the level of cap for the April 2022 cap period no later than 7 February. Ahead of that deadline, Ofgem should seek to publish its final decision on changes as soon as possible to allow suppliers to mitigate the risks of uncertainty in a volatile market as best as possible. Given the short timeframe available to Ofgem to develop, consult and decide upon any intervention, we recognise that its options to adjust the price cap methodology are limited. However, we are concerned that Ofgem's

¹ Octopus Energy does not agree that there should be an adjustment to the price cap methodology to account for the recent period of high wholesale prices, nor does Octopus Energy agree that other costs categories should be adjusted in April. Octopus Energy's full position can be found in its responses to the consultations.

approach so far has been to look at the short-term and medium-term options for reform completely separately, despite there being important links between the two workstreams. That being said, we welcome Ofgem's consideration of increased costs to suppliers and this review to establish its significance, and its recovery.

Overall, it is essential that Ofgem ensures suppliers are able to fully recover efficiently-incurred costs for supplying default/SVT customers through the cap and that it does not ignore significant cost categories that are not currently considered under the methodology.

Ofgem's Approach to Suppliers' Hedging

Firstly, we are concerned with the Ofgem minded position to conduct a negative true-up of the CfD allowance. Well run suppliers with robust risk management processes will have hedged the risk of wholesale price exposure embedded within the CfD levy, and therefore have not benefited from reduced CfD costs. Reducing the wholesale allowance will financially penalise these suppliers, and contradict Ofgem's own recent messaging and action on supplier financial resilience. We believe that this would be a concerning message for the industry in a very volatile environment, and would have significant implications for rational risk management going forward. Longer term, Ofgem could engage with industry to explore price cap reform to adjust the CfD allowance in every price cap, removing the need for suppliers to hedge against the risk.

Secondly, we are not convinced by Ofgem's argument that the steepness of backwardation could be netted off by a similar steepness of contango in the medium to long term. We would, therefore, encourage Ofgem to carefully consider any additional data being provided by suppliers in response to this consultation and ensure that, if required, there is a sufficient backwardation allowance in the April 2022 price cap, with an ongoing wholesale price adjustment implemented from Winter 2022.

Additionally, we would like to understand the rationale behind Ofgem using inconsistent approaches to calculating wholesale costs. For example, Ofgem has indicated that it will re-assess cost recovery of the wholesale risk adjustment over time, whilst only assessing CfD recovery over the October 2021 cap period. We do not think such an approach is appropriate and strongly believe that Ofgem must assess all elements in the same manner, where reasonably possible, to ensure uniformity of calculation, as well as appropriate scrutiny from industry.

Finally, Energy UK agrees that, in principle, suppliers should be taking on some of the risk of the current market conditions and that Ofgem needs to differentiate between losses suffered as a result of normal market processes, and losses caused by the crisis conditions which were unpredictable and unhedgeable, allowing for the recovery of the latter. However, we are concerned with the approach taken by Ofgem in its consultation in assuming that some hedging positions were inherently more efficient or inefficient than others in hindsight when there was not a clearly correct strategy to take at the time. It is incorrect for Ofgem to determine that there was a singular correct approach for suppliers to take. As a result, it is not suitable for Ofgem to suggest applying a lower quartile benchmark approach to any allowance. Energy UK believes that using a weighted average benchmark would be the most reasonable, and in line with Ofgem's reassessment of wholesale costs in price cap period one.

Increased Industry & Mutualisation Costs

We are also concerned that there are some aspects of the price cap methodology which do not allow for the recovery of costs over which suppliers have no control. Ofgem should ensure that the price cap adequately accounts for real levels of industry costs, with which allowances in the cap have not kept pace as a result of only being increased by CPIH, and consider how the methodology can best be altered to allow suppliers to recover these efficiently-incurred costs. We have included an illustrative estimation on cost/allowance gaps in Annex A as raised to us by members, but would welcome the opportunity to facilitate engagement between Ofgem and industry to explore these concerns in greater detail.

In addition, the price cap methodology should take account and allow recovery of the significant mutualisation costs facing the market. With a shortfall of just over £218m across both RO schemes, there is a material misalignment between the costs of the RO mutualisation faced by suppliers and the assumptions in the price cap methodology based on 2017 data.

It is not sufficient to seek recovery of these increased and mutualised costs through the headroom alone, especially as the headroom allowance has been used by Ofgem repeatedly to account for increased costs from new regulatory requirements since the price cap's implementation. This information is publicly available so no further RFIs are needed for Ofgem to understand the true costs to suppliers, and account for it effectively within the cap.

The Process for Updating the Default Tariff Cap Methodology and Setting Maximum Charges

In principle, Energy UK could see the benefit in Ofgem having the power to react quicker to extreme circumstances to ensure that the cap remained reflective of efficiently-incurred costs. However, Energy UK is not in a position at this stage to agree or disagree with Ofgem's proposal to make within-period changes to the cap because important questions are unanswered in the consultation, need to be further discussed with industry and answered via a further consultation. These questions include ensuring Ofgem is clear on the circumstances in which it envisages any mid-period change would be made, and the legal basis of the proposals given the need for 28-day consultation and 56-day implementation time for any modification under the Tariff Cap Act 2018.

Some of our members recognise that there may be benefits in building in some greater flexibility in the price cap in the short-term, in advance of Ofgem's work on medium-term price cap reform; for example, to help manage situations where wholesale market dynamics cause actual costs to diverge from the price cap, as seen this winter.

However, there are also risks that the ability to use such a power could also increase uncertainty in the market and make it harder, not easier, for companies to hedge appropriately. We would, therefore, strongly encourage Ofgem to engage further with industry as soon as possible so that the questions and barriers outlined can be explored in detail, and for the benefits and risks can be assessed through a further consultation process that establishes a clear, timely and data-driven threshold that would need to be met for Ofgem to act. As part of a further consultation process, Ofgem should engage with industry to develop and set out clearly the thresholds and associated trigger points to minimise any uncertainty and its resulting impacts on the market.

As part of this, Ofgem will need to clearly set out the decision-making framework and timeframes in which the process would take place if utilised, as greater clarity is needed on how Ofgem will minimise the impacts on suppliers' ability to recover efficiently-incurred costs if the cap level is hastily changed, and to what extent it will consult and seek evidence from industry during the process.

For further information or to discuss our response in more detail please contact Steve Kirkwood on 0207 747 2931 or Steve.Kirkwood@Energy-UK.org.uk.

Annex A – Estimate of Rising Industry Costs

December 2021

	2017/18	2018/19	2019/20	2020/21	2021/22
SPAA*	£3,824,000	£4,075,000	£4,109,894	£5,942,105	£1,682,000
MRA*	£10,643,026	£14,987,366	£14,211,363	£14,869,747	£6,791,900
DCUSA	£4,043,000	£4,311,684	£5,125,057	£6,225,202	£2,501,521
REC*	£0	£0	£4,367,000	£9,514,000	£21,942,000
Elxon**	£41,500,000	£43,600,000	£53,200,000	£52,600,000	£83,653,035
Xoserve***	£16,551,000	£19,307,000	£35,313,000	£44,230,000	£41,354,000
Total	£76,561,026	£86,281,050	£116,326,314	£133,381,054	£157,924,456
Total + CPIH	£76,561,026	£77,403,198	£77,945,020	£78,412,690	£78,647,928
Estimated variance to cap allowance		£8,877,852.25	£38,381,294.17	£54,968,363.37	£79,276,528

Cost currently apportioned to suppliers

**Added MHHS related budget addition for 2021/22 value of £14,553,035

***Cost apportioned to shippers