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Sent by email to: Neil.Kenward@ofgem.gov.uk; pricecapchanges@ofgem.gov.uk

Dear Neil

Adapting the Price Cap Methodology for Resilience in Volatile Markets: Call for Input¹

Centrica is pleased to respond to Ofgem's Call for Input on adapting the price cap methodology for resilience in wholesale markets. The Call for Input seeks to address a specific yet highly consequential defect to the current price cap methodology. The defect that Ofgem seeks to address is that there is a lag between the 6-2-12 index used to set the cap and spot wholesale prices, which tend to set non-default tariff prices. The consequence of the defect is that even prudent well-managed suppliers cannot recover their efficient costs when the wholesale market experiences a certain level of volatility.

Whilst it is right that Ofgem addresses the specific defects with the 6-2-12 index, a much wider and fundamental overhaul of retail price regulation is required.

We encourage BEIS and Ofgem to engage with all relevant stakeholders to define the characteristics of the energy market they want to see, and then design price regulation to deliver those objectives. We do not believe that the starting point for the wider review should be the existing cap, which has been shown to be fundamentally flawed. But we would like to reiterate that we do support price regulation which has well thought through objectives and is both principles based and designed well enough to achieve those objectives.

We suggest that the overarching policy objective for the retail market should be the protection of current and future consumers, where protection includes the reduction of greenhouse gas emissions. Underneath that overarching objective, we would suggest the following characteristics of the market that will best protect current and future consumers:

¹ [Adapting the price cap methodology for resilience in volatile markets | Ofgem](#)

- A resilient market, where suppliers are well-capitalised and able to withstand the kinds of wholesale price shocks that occurred at the end of 2021.
- A competitive market in which suppliers with sustainable business models compete vigorously and responsibly, and can recover their efficient costs.
- A market – underpinned by a stable and predictable regulatory and policy framework - that gives suppliers the confidence to invest in technology, customer service and other innovations that will be crucial to meet customer needs and deliver net zero at lowest cost.

We have started our own thinking on these questions and look forward to engaging with Ofgem, BEIS and others. However, this response necessarily focusses on the problems with the 6-2-12 methodology that Ofgem is explicitly seeking comments on.

Up to a point, we agree with Ofgem’s description of the problem as expressed in the second paragraph of page 2 of the Call for Input. However, there are two issues with Ofgem’s description of the problem, one of which is an error and one which is an omission:

1. **The error.** The phrase “*hard for suppliers to hedge appropriately for*” implies that it is possible - albeit difficult - for suppliers to manage unexpected SVT demand risks under the current price cap methodology. Such an implication is wrong. It is not possible under the current price cap methodology for suppliers to hedge in such a way that adequately protects against rising prices and falling prices at the same time. Ofgem appears to imply that rising prices is a risk and then falling prices is a risk, when in fact they are both risks at any given time. It is essential for Ofgem to recognise that even when wholesale prices rise, even to unprecedented levels, they may always rise further, and indeed they may fall and then rise again.²
2. **The omission.** Ofgem’s description of how efficient wholesale costs not covered by the price cap focusses solely on unexpected SVT demand and ignores costs arising from the curve being in backwardation. Ofgem rightly recognises³ that the *design of the price cap itself* causes unrecoverable costs because there is a lag between forward wholesale prices and their recovery through the price cap. However, it also needs to recognise that the *design of the price cap itself* – i.e. the 6-2-12 index - cannot be matched and thereby creates unrecoverable costs arising from the curve being in backwardation.

In our response to Ofgem’s consultation on the potential impact of increased wholesale volatility on the default tariff cap⁴ (“November 2021 wholesale consultation”), we showed that Centrica incurred the following efficient costs that were not accounted for by the current cap methodology, annualised for a dual fuel customer at current Typical Domestic Consumption Value (TDCV):

- ⌘ for unexpected SVT demand in cap period 7; and
- ⌘ for backwardation across cap periods 6 and 7

² Ofgem must fully equip itself with all of the facts/considerations relevant to any particular problem statement, ensuring it fully understands the exact nature of the problem under consideration, to do otherwise would render a decision vulnerable on appeal due to mistake of fact. We would be very happy to discuss with Ofgem how we are mutually exposed to the risks of rising and falling prices at any given time if that would be helpful.

³ Call for Input, page

⁴ [Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem](#)

The wholesale gas and electricity markets have continued to experience extreme volatility, such that estimates of future costs that are not accounted for by the cap quickly become outdated.

In our response to Ofgem's November 2021 wholesale consultation, we estimated that the shortfall in the cap for backwardation costs alone in cap periods 8 and 9 would be around £ per dual fuel customer at current TDCV. The £ estimate was based on a snapshot taken as of 29 November 2021. As of 17 December, the market was showing that for winter 2022 there would be a loss to efficient suppliers arising from backwardation of around £ per dual fuel customer, which was a move of £ per dual fuel customer in 14 days. The impact of the backwardation problem is likely to be particularly severe for suppliers who took on customers from failed suppliers via the Supplier of Last Resort (SOLR) process.

The materiality of losses faced by prudent well-managed suppliers shows that the situation is very serious, and that "do nothing" is not an option⁵. In respect of cap changes from period 8 onwards, our starting point in responding to this Call for Input is what we said in response to Ofgem's November 2021 wholesale consultation:

- To address risks and costs arising from unexpected SVT demand, the options – which are not mutually exclusive – include: (a) another Adjustment Allowance, with float and true-up; (b) an uplift to the wholesale risk allowance akin to a risk premium; and (c) the Market Stabilisation Charge that is currently subject to Ofgem statutory consultation⁶. Whichever option - or combination of options – Ofgem decides upon, it is clear that it needs to ensure that suppliers can recover their efficiently incurred costs and manage their risks that arise in cap period 8 and beyond. It also needs to ensure that the incentive on suppliers to prudently hedge for anticipated demand is maintained.
- To address the risk⁷ associated with backwardation issue on a systematic basis, Ofgem should take an average of the difference between the 6-2-6 and 6-2-12 index for the forthcoming and previous cap period, as we showed in the spreadsheet we submitted on 17 December 2021. For example, £.

The above solutions we put forward in response to Ofgem's November 2021 wholesale consultation do not envisage a departure from the current 6-2-12 wholesale cost index in the cap. Ofgem's Call for Input is about whether there should be such a departure, and in doing so considers six alternatives to the 6-2-12 index, with three of those shortlisted as preferred options⁸. In the Appendix below we set out our preliminary comments on each of the three shortlisted options, and also on the three options that Ofgem considers "do not effectively tackle the issue, or could expose consumers to excessive prices or volatility". We provide these comments without prejudice to any views we may express in response to any subsequent policy consultation, statutory consultation and decision that Ofgem may publish.

⁵ Doing nothing would not be compatible with S1.6 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the **Act**); Ofgem must ensure that suppliers are able to finance their efficiently incurred costs in order to comply with their primary duty to protect existing and future consumers; the two are symbiotic and are not mutually exclusive considerations. Given the clear case for change due to the current unprecedented volatility, doing nothing would be irrational.

⁶ [Statutory consultation on potential short-term interventions to address risks to consumers from market volatility | Ofgem](#)

⁷ As opposed to continually addressing the actual cost, which would be expensive

⁸ Ofgem must give significant consideration to all available options which could be made rapidly within the existing legislative framework, including those previously proposed by us in the bulleted paragraphs above. A failure to properly consider such alternative solutions would constitute a process failing and render any decision made without proper consideration of all alternative solutions vulnerable to appeal.

Whilst we expect to see our alternative options given due consideration in the forthcoming policy consultation, of the options in the Call for Input, Option 3 looks to have the most potential to address the problem that the current price cap design means that prudent and well-managed suppliers cannot recover their efficient costs arising from unexpected SVT demand and backwardation. However, the details would need to be right to be genuinely effective and work in the interests of customers. Key details include the operation of the exit fee, how the assumed hedge in the cap works, and how long the fixed term fixed price period is.

In addition to the specific comments on the options provided in the Appendix, we have two key concerns with Ofgem's Call for Input *that applies to all options* in the document:

- i. Ofgem does not mention how it intends to approach any transition from the 6-2-12 methodology (which starts pricing in from 1 February 2022 for 1 October 2022) to one or more of the options discussed in the Call for Input and this response. The transition issue was the subject of British Gas' successful judicial review challenge of Ofgem's original price cap decision⁹.
- ii. In line with the omission to consider costs arising from the curve being in backwardation in Ofgem's problem statement described above, Ofgem's assessment appears to focus wholly on how the different options might address costs and risks arising from unexpected SVT demand. Ofgem's assessment appears to ignore the extent to which the options might address the backwardation issue, which as we have shown causes a systematic and material departure between efficient costs and what is allowed for in the cap.

We expect Ofgem to address these concerns by considering the transition and backwardation issues in the subsequent consultations and decisions on addressing the defects with the 6-2-12 index.

We hope that our comments are useful. We look forward to continuing our constructive engagement with Ofgem as its thinking develops.

Yours sincerely

Tim Dewhurst
Director of Regulation and Policy

⁹ R (British Gas Trading Limited) v. Gas and Electricity Markets Authority [2019] EWHC 3048 (Admin)

Appendix – preliminary comments on the options in the Call for Input

Option 1: “Enhanced status quo”

Our understanding of Option 1:

- Option 1 is an evolution of Ofgem’s proposals set out in its consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges, published on 19 November 2021¹⁰ (“November 2021 process consultation”). In this November 2021 process consultation, Ofgem proposed to give itself the power to amend the price cap methodology - in extreme circumstances - without following the requirements in the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act) to consult for 28 days before modifying the cap methodology and allowing a 56-day standstill period before any such modification coming into force.
- The only difference between Option 1 and its proposals from the November 2021 process consultation is that under option 1 the “circuit breaker” would be automatically triggered if pre-defined circumstances were met, rather than being at Ofgem’s discretion. Centrica’s response to the November 2021 process consultation also applies here.

Our preliminary comments on Option 1:

- Ofgem does not say: (a) what such pre-defined circumstances would be; (b) what if any change to the price cap they would trigger; or (c) in what timescales any such price cap change would come into force. It would therefore not be possible to anticipate how a change could impact customers and suppliers who will have a range of approaches to risk management. These circumstances, changes and timescales would need to be carefully thought through and clearly defined.
- We reiterate our views expressed in our response to the November 2021 process consultation that the Act only permits Ofgem to make licence modifications, within and outside the relevant 6-month review period, provided the statutory modification process is followed i.e. 28-day consultation period and a 56-day standstill period.
- The requirement to consult is essential to help ensure that Ofgem has the necessary information to take decisions, which is all the more important in the context of the computation of a price cap where technical errors may have significant adverse consequences for suppliers and consumers.
- We are open to a discussion about a change to the standstill period that is enshrined within the Act. However, as the standstill period is a legislative requirement, it cannot be a change that Ofgem makes unilaterally. If there was a change to the standstill period, Ofgem would need to consider how it interacted with current Supply Licence Conditions (SLCs), including adverse unilateral variation requirements set out in SLC 31I.

Option 2: Quarterly updates

Our understanding of Option 2:

- Under the current 6-2-12 wholesale index, for any cap period starting 1 October of any given year, the six-month observation period starts on 1 February, and the forward view period runs from 1 October in the given year to 30 September the following year. The cap then resets mechanically every six months.

¹⁰ [Price Cap – Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges | Ofgem](#)

- Under Option 2, for any cap period starting 1 October of any given year, a three-month observation period would start on 1 May, and the forward view period would run from 1 October in the given year to 30 September the following year. The cap would then reset mechanically every three months.
- In the Call for Input, Ofgem refers to the 1 February – 1 October period in the current cap as an eight-month “lag” between wholesale price movements and their recovery. Under Option 2, Ofgem describes this lag being reduced to five months (i.e. 1 May to 1 October).

Our preliminary comments on Option 2:

- We agree with Ofgem’s observation that Option 2 “only partially addresses the volume risk” since there is still an “extended period where suppliers are exposed to unexpected/unhedged demand”.
- With respect to costs arising from the curve being in backwardation – which Ofgem’s assessment does not take into account– Option 2 changes the basis risk and potentially makes it more complicated because under Option 2 the forward view period encompasses four price cap periods rather than two, and on average changes twice a season rather than once.
- Price cap changes impose costs on consumers and suppliers arising from the time spent preparing for and reacting to the changes; under Option 2 there would on average be twice as many changes than now. If Ofgem were to take Option 2 any further, it would need to fully understand these costs and carefully weigh them against any benefits.

Option 3: Fixed Term Default Tariff

Our understanding of Option 3:

- Under Option 3, each customer’s default tariff would be a fixed term fixed price tariff with an exit fee. The term of the fixed price would be six months. There would be a new six-month cap set every month, which would be priced on the basis of the previous month’s six-month forward hedges set 8 days before the start of the month. Any given customer would only be able to access one six-month default tariff: the one that is “live” in the month they become newly subject to the default, or when they roll off their previous six-month term.
- The exit fee “could be set at the economic cost determined at the point the customer leaves, i.e. diminishing over the contract period”.

Our preliminary comments on Option 3:

- Of the options in the Call for Input, Option 3 looks to have the most potential to address the problem that the current price cap design means that prudent and well-managed suppliers cannot recover their efficient costs arising from unexpected SVT demand and backwardation.
 - **Unexpected SVT demand.** In Option 3 there would be a new six-month cap set every month, which would be priced on the basis of the previous month’s six-month forward hedges. Although not exactly the same, this is much closer to a back-to-back hedge that is used in the non-default fixed tariff market than the current methodology which has a significant lag to the non-default fixed tariff market. Therefore, in Option 3 the unexpected SVT demand risk is much reduced. But the unexpected SVT demand risk is only reduced to the extent that it is close to a genuine back-to-back hedge, the exit fee is genuinely effective,

and any given customer can only access one default tariff (i.e. they cannot exercise a “free option” to choose a different default tariff).

- **Backwardation.** Under Ofgem’s six-month back-to-back proposal there would be less basis spread risk because the cap index cap be more closely matched by suppliers, but as Ofgem recognises it will introduce differences in pricing between seasons. Under the current cap index, basis risk mainly arises from the mismatch between the cap index and the delivery period.
- Whilst Option 3 appears to have the most potential to address the unexpected SVT demand and backwardation issues, the details would need to be right to be genuinely effective and work in the interests of customers. Key details include the operation of the exit fee and how long the fixed term fixed price period is.
- **The operation of the exit fee**
 - **How should it be calculated?** Under Ofgem’s proposal the exit fee could “be set at the economic cost determined at the point the customer leaves, ie diminishing over the contract period”. Fairness will be key to enforceability and any exit fee must fairly and reasonably reflect the cost to the supplier of breaking a hedge when the customer leaves to take a cheaper fixed term contract with another supplier. However, customers may not understand a variable exit fee and there is a question about its applicability if wholesale prices rise during the contract period. Contract terms must be transparent and capable of being understood by the average consumer and so it is essential that any sliding fee is capable of being understood. Another option may be a binary exit fee – e.g. in a certain wholesale price scenario the exit fee is a fixed sum (fairly reflective of costs) otherwise there is no exit fee.
 - **Who would set the exit fee?** It is not clear under Option 3 whether Ofgem or suppliers would set the exit fee and if it would be mandatory. Our preliminary view is that Option 3 would be more effective – in terms of addressing unexpected SVT demand and ensuring customer understanding – if Ofgem set the exit fee and it was mandatory.
 - **When would it apply?** Under Ofgem’s proposal, there would be “a window when each contract renews where a consumer would be able to switch away or select a different tariff” when the exit fee would not apply. There is a question about how long this window is and what prices would apply during this time. There is also an unanswered question about whether the exit fee would apply with customers moving home onto deemed contracts, customers rolling off non-default fixed tariffs and customers moving via the Supplier of Last Resort (SOLR) process. Whilst the presence of exit fees could be drawn to the attention of customers newly acquired or rolled onto new fixed term default tariffs, there remains the significant question of how exit fees could successfully be applied to the increasingly large number of customers already on the existing cap. As highlighted above, any transition from the 6-2-12 methodology should be fully addressed in the policy consultation.
- **Duration of fixed term fixed price period.** Under Ofgem’s proposal, the fixed term would be six months. However, Ofgem has said that Option 3 “could also be configured based on 12-month contracts and/or with the price cap level set using 12-month forward prices, which would deliver more price smoothing for consumers and remove the seasonal impact”. If the details were right, we believe that a 12-month fixed term fixed price period would be preferable to six months because customers are more familiar them, they will be more comparable with non-default fixed tariffs available in the market and they remove potential issues related to seasonal pricing. 12-month contracts would also be easier and therefore less costly to manage from a supplier perspective. However - to reiterate - any solution would need to properly address the SVT demand and backwardation issues, which are key issues with the current cap.

Comments on the three options that Ofgem considers “do not effectively tackle the issue, or could expose consumers to excessive prices or volatility”.

Option 4: Monthly direct pass-through

Our understanding of Option 4:

- The wholesale element of the price cap would be reset every month. For any given month the level would be specified advance with reference to how much monthly hedges for that cost month during the previous month. For example, the wholesale allowance that applies for the month of May would be set towards the end of April using prices for May that were available during April.
- Ofgem suggests that it would “calculate and publish the price level in time for suppliers to post the prices on their website and update their systems, say, 8 days before the start of the month.”

Our preliminary comments on Option 4:

- We agree with Ofgem that this option would “expose consumers to significant price volatility, with bills low in summer months, but potentially much higher when demand and (usually) energy prices peak in the winter.” There are policy and fairness questions about how much it is appropriate to expose consumers to volatility, and answers to those questions may change over time. For example, there are currently no cost-effective alternatives for many consumers to using gas to heat their homes; it would therefore seem inappropriate and unfair for these gas users to be exposed to significant price volatility - and potentially very high prices during winter - for something they need and have no alternative to use.
- Ofgem suggests that publishing updated prices on their website would be sufficient as a notification for consumers of the price change. Ofgem would need to consider how the notice provision under Option 4 interacted with adverse unilateral variation requirements set out in SLC 311.

Option 5: Relative Price Cap across the market

Our understanding of Option 5:

- The price cap would be reset every month with reference to the average price of a selection of non-capped tariffs available in the market from the previous month. Ofgem would allow default tariffs to be priced at a premium to the selection of non-capped tariffs.

Our preliminary comments on Option 5:

- Ofgem does not say which tariffs would be chosen as the reference, how the average would be determined or how the premium would be calculated. These are very complex questions.
- Ofgem expresses concern that “there is scope for suppliers to manipulate a relative price cap, either changing their tariffs to boost the price cap level or, potentially, setting aggressively low tariff levels to bring the cap down and force out other suppliers.” We agree that these are serious risks that would need to be considered.
- Option 5 appears to be similar to the “market basket” option that Ofgem considered and dismissed as part of its 2018 consultation process on the implementation of the Tariff

Cap Act. We recall that Ofgem rejected the “market basket” for good reasons at the time.

- If Option 5 operated with the default as an evergreen tariff, then it may need to be changed every month as the reference changed every month. Monthly changes would cause cost to suppliers and consumers. Ofgem would need to consider how monthly changes would interact with adverse unilateral variation requirements set out in SLC 311. Option 5 would be more compatible with the default as a fixed term fixed price tariff, with the differential to the relevant market basket only being applicable at the time the default was set.

Option 6: Relative price cap within suppliers

Our understanding of Option 6:

- Under Option 6 Ofgem would specify a maximum difference that any given supplier could charge between its cheapest and most expensive tariff.

Our preliminary comments on Option 6:

- Ofgem’s view expressed in the Call for Input is that because Option 6 allows different suppliers to have default tariffs set at different (absolute) levels, Option 6 would not be “in line with the price cap legislation”. Another relevant consideration is that the relative price cap impinges upon non-default tariffs, as well as default tariffs, whereas Tariff Cap Act is restricted to default tariffs.
- Ofgem does not say whether the default tariff in Option 6 would be evergreen or a fixed price fixed term tariff. If the default tariff in Option 6 was evergreen, the read across to non-default tariffs would greatly and unduly impinge on suppliers’ commercial freedom and competitive position. It would make more sense for the default tariff in Option 6 to be a fixed term fixed price tariff, with the differential taking into account the relative cost of shorter versus longer hedges to allow variety in product offerings.

Final comments

Of the options in the Call for Input, Option 3 looks to have the most potential to address the problem that the current price cap design means that prudent and well-managed suppliers cannot recover their efficient costs arising from unexpected SVT demand and backwardation. However, the details would need to be right to be genuinely effective and work in the interests of customers. Key details include the operation of the exit fee, how the assumed hedge in the cap works, and how long the fixed term fixed price period is.

In its Call for Input, Ofgem asks “which adaptations to the price cap are preferred and why, *including any additional options not set out in this paper?*” (emphasis added).

We encourage Ofgem to proactively seek input from academics on reform options. For example, as part of the review into energy costs Dieter Helm recommended that Ofgem sets a maximum supply margin, with risks associated with exogenous costs being reduced through explicit error correction mechanisms¹¹.

There is no discussion about to what extent the options are compatible with market-wide half-hourly settlement (MHHS), which is due to be implemented by 2025. Whilst we recognise that

¹¹ [Cost of Energy Review.pdf \(publishing.service.gov.uk\)](#)

the cap under the Act cannot be extended beyond the end of 2023, BEIS has signalled its intention to legislate to extend the retail price cap beyond that date. Therefore, Ofgem's assessment of the options should consider the possibility that they may be in place at the point when MHHS is introduced.