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Neil Kenward
Director for Strategy and Decarbonisation
Retail Price Regulation
Ofgem
10 South Colonnade
London E14 4PU

Email: Alisonrussell@Utilita.co.uk

Dear Neil,

Call for input: Adapting the price cap methodology for resilience in volatile markets

The Call for Input (CFI) requests views on how the price cap methodology can be adapted to increase resilience in volatile markets. Adaptation alone will not meet the need – broader reform is necessary.

Failures in the price capping regime have been instrumental in undermining the financial resilience of suppliers. In particular:

1. **The regime is too complex** – there are 3 price caps rather than 1, and nominally it covers only Standard Variable Tariffs (SVTs) and not fixed price contracts. However, it is now clear that many consumers that chose fixed price deals will switch back to SVTs if the SVT price is lower. This demonstrates that it is not a safe assumption to presume differential levels of engagement between SVT and fixed price customers, and more importantly in this context errors of judgement on this point have resulted in badly managed hedge positions.
2. **Wholesale cost management** – there are a number of failings in the current indexation method:
 - a. the reference period is too short (and hence doesn't smooth wholesale price shocks). Given that price risk is inherently asymmetric, this will result in consumers paying more than necessary (as is the current situation);
 - b. the reference period includes energy prices outside the cap period (leading to structural issues like backwardation). We understand that the reason for this was to avoid seasonal retail price variance, however seasonal variation is less significant than the wholesale price movement that we have seen. If there is a desire to maintain seasonal smoothing, an adjustment to eliminate the effects of backwardation must be applied; and

- c. the cap period duration is too long and consequently wholesale costs do not adjust quickly enough. This has resulted in the retail market effectively shutting down, and all the while wholesale prices are significantly above the cap allowance it will not be economically rational for suppliers to take on new customers.
3. **Insufficient supplier allowance** – due to a fundamentally flawed methodology, Ofgem calculated an unrealistic and overly optimistic assessment of supplier costs, and an under recognition of the risks absorbed by suppliers, these have resulted in negative margins (as demonstrated by Ofgem’s own analysis and the annual reports of all major suppliers). The issue of cost allowance is further complicated by the Ofgem decision to attempt to implement a cross-subsidy between payment methods.

Consequently, Ofgem has failed under its duty under the Domestic Gas and Electricity (Tariff Cap) Act 2018, to have regard to (and to balance) the critical matters under Section 1(6)¹.

The current high wholesale price regime has also highlighted another policy error that has historically been associated with supplier failure, the Renewables Obligation (the RO). The payment terms for the RO are annual, 6 months after the end of the year. As the RO has grown (from the original 3% to the current 49.2%), along with the buyout price (from £30 in 2002/03 to £50.80/MWh in 2021/22), this has resulted in significant non-payment risk. This risk has materialised on several occasions, and resulted in a call for a change to the payment terms. Change is essential, not the least because the resultant liability is socialised amongst the remaining suppliers and the price cap doesn’t allow for this cost.

However, it does not make sense to continue to subsidise renewable construction when wholesale market prices make that subsidy unnecessary. Current wholesale prices are well in excess of the combined income from the ROC payment and wholesale price forecasts assumed by renewable project developers and investors. The RO is now closed to new renewable generation projects, which must use the CFD scheme. CFD income for generators is currently negative because of the high wholesale prices and new CFDs are likely to be struck either with a delayed start date or with a strike price below the current forward price for the near future.

This unnecessary extra cost, currently totalling around £100 for the two schemes, is being passed on to consumers. Removing ROC payments, or introducing a suitable taper mechanism, will address: (i) the financial resilience of suppliers; (ii) price cap complications; and (iii) the level of consumer bills.

The CFI does not address the above issues and at the same time it restates critical errors frequently put forward by Ofgem to support Ofgem’s preferred approach to the price cap. Utilita has been very clear and consistent in highlighting these errors since the inception of the price capping regime with the prepay price cap in 2017.

¹ S1(6) The Authority must exercise its functions under this section with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to the following matters—

- (a) the need to create incentives for holders of supply licences to improve their efficiency;
- (b) the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- (c) the need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- (d) the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

The CFI restates the claim by Ofgem that price capping has generated £1bn in efficiency savings for consumers. We believe this claim is not correct and has not been properly evidenced by Ofgem. We contend that the assessed £1bn was derived from incorrect calculations, and that the efficiency savings claimed in fact relate to a failure to allow suppliers to recover their efficient costs, forcing suppliers to supply customers at below cost prices. We dispute that such sums are real savings. Furthermore, the savings claimed take no account of the very high, enduring losses imposed on suppliers and the consequential damage to their balance sheets.

We have also reflected on the costs of the current crises in the industry as they are known to date, in particular, the costs of supplier failures including: SoLR Levy costs, Special Administration costs and the mutualisation costs faced by the remaining suppliers. Based on publicly available information, we estimate these 'failure costs' are currently running at over three times the price cap savings claimed by Ofgem. We also believe that the full costs of the crises – both to consumers and suppliers – are not yet clear.

To focus on the impact of the price cap, we have assessed one option in respect of the wholesale cost component of the cap – where limited, but fundamental changes would make a real difference. We believe this could have been a realistically likely outcome had suppliers' hedging practices not been constrained by Ofgem to impractical levels, and had suppliers not been placed in a position where they could not recover their efficient costs.

We used a prudent hedging policy that we have constructed to demonstrate how an alternative approach results in a better outcome for the consumer. In order to better reflect the constraints imposed by the cap, we did not use our own previous policy, instead, we modelled hedging over a 24-month period (which was the duration we used to use) but sought to fit within the confines of the cap, such that the full hedge is in place two months before each price cap period. We consider this approach to be straightforward and in alignment with the type of approach a prudent operator would be likely to use if they were allowed to do so.

If deployed instead of the current cap constrained approach, our resulting scenario indicates that over the last few years, customers on average would have paid less than £10 more per annum. However, they would now be paying £600 less for the wholesale cost component of the price cap for the Winter 22 and Summer 23 cap periods.

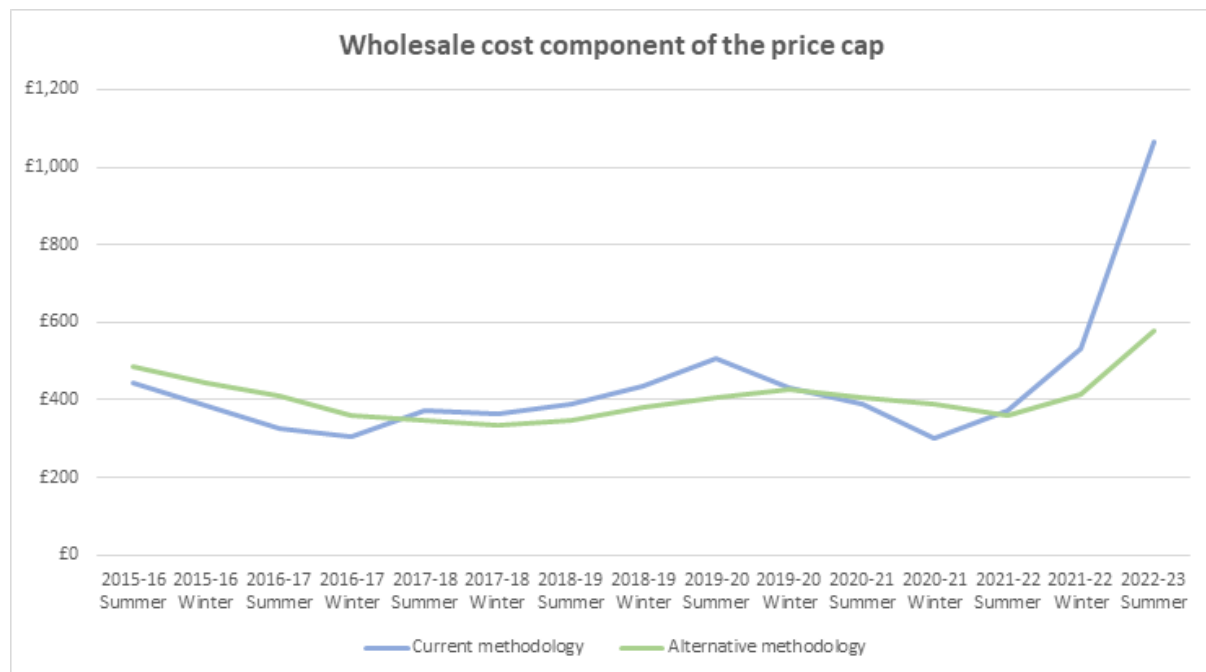
This change alone would not have avoided the current problems, though it would have provided significant amelioration. However, if Ofgem had implemented a more sustainable design for the cap, with both a less volatile price reference and a higher margin that reflected the cost of risk management, the position would have been different. Customers would benefit from steadier prices and would be protected from extraordinary events and in return suppliers would be suitably remunerated for the risk management service they provide (and which has been compromised by the existence of the price cap in its current form).

The chart below shows the outcome of our assessment. While this is only one scenario, and applied only to the wholesale cost component, it shows that by:

- taking a two-year period for prices (rather than six months)
- reflecting in-period prices (rather than in- and out-of-period prices as now), and
- applying a constant co-efficient to normalise the allowance for winter and summer (avoiding the risk of excessive backwardation or contango distortion)

the levels of variability could be massively reduced.

The resulting projected wholesale cost component of around £580 for Summer 2022 is approximately half our expectation of around £1,064 based on the current methodology. This is a substantial difference.



While we are glad that Ofgem is considering correcting some of the errors of the price capping regime, we are disappointed that the solutions suggested do not address its fundamental flaws and instead seem designed to rescue suppliers with business models incompatible with price capping.

While volume risk in the form of weather, and the correlated wholesale price risk, are inadequately provided for in the price cap, the volume risk inherent in the roll-off of fixed term contracts finishing and customers remaining on a price capped tariff is not an unmanageable risk. As the price cap has been set below the level of efficient costs, it is obvious that at times, it will be the case that the price capped variable tariffs will be cheaper than fixed term contracts, and the decision to offer fixed term contracts without adequate wholesale market risk management² in such circumstances is a consciously risky one. Suppliers choosing this business model must also be responsible for carrying out – and bearing the costs of – the necessary risk management activities to support that business model. They must not be permitted to rely on a regulatory ‘bail-out’ to manage the costs of such failure.

The proposals in the CFI are therefore, specifically designed to bailout those companies that have either failed to foresee this risk (i.e., ‘badly run’) or decided to take this risk without appropriate wholesale market risk management. In neither case should Ofgem seek to create new regulation to remedy the problems of badly run or intentionally high-risk companies. It would be discriminatory to compensate some suppliers for losses due to failed – elective - risk-taking simply because the suppliers in question are large, while failing to compensate efficient suppliers that have been forced to sell energy at below cost to prepayment customers since 2017.

² For example, with call options on the volume at risk.

The best way to tackle all the flaws of the price cap, including providing increased resilience in volatile markets, without requiring any legislative changes is to simplify the price capping regime such that there is one cap for all payment methods, set at the level of the 'pay on receipt of bill' or 'credit' price cap. Such an approach prevents excessive prices being charged to customers (this cannot be denied as the methodology is already in place), allows recovery of efficient costs for suppliers, obviates the requirement for future interventions, and allows competition to exist below the level of the cap (as intended by Parliament).

Unpredictable interventions to adjust the cap mid-period only increase risk for suppliers; a rational supplier may find an unexpected reduction in the level of the price cap will cause unmerited losses and price cap increases that may occur in inevitably poorly defined circumstances only complicate the task of risk management: suppliers will act rationally to adapt risk management practices to the prospect of mid-period adjustments with the possible result of efficient suppliers exiting the market if an expected emergency change does not occur.

More frequent updates to the cap do not address the fundamental issue. The requirement is to update the reference period – i.e. the period over which wholesale prices are observed. Increased frequency of update will not address the many fundamental flaws of the price cap. It will also increase operating costs for suppliers forced to double the number of price change events and expose customers to greater wholesale price volatility. Ofgem could implement quarterly updates based on a longer period of price observation as we have suggested above (that would partly overlap for different price cap periods), but the best solution Ofgem could implement within the existing legislation is a simplified cap described above and the longer wholesale price reference period to reduce volatility. While more frequent price changes may reduce price 'shocks' we do not believe that quarterly or more frequent price changes are in the interests of customers.

A fixed term cap with an exit fee will discourage competition and protect the businesses of inefficient suppliers that would otherwise lose customers to efficient suppliers. A change of this nature will have profound wide-ranging effects on the market and significantly stifle competition; if Ofgem believes the current conditions are not sufficiently competitive to relieve energy supply of price capping, a change of this sort will ensure such conditions can never exist.

Utilita considers that none of the three preferred options suggested by Ofgem will address the effects of high wholesale market volatility in an effective way, instead either increasing risks for suppliers, increasing price volatility for customers or deadening competition.

Instead, Ofgem should simplify the price capping regime within the confines of existing legislation, allowing efficient suppliers to recover their costs, competition to operate and protecting customers from excessive and volatile retail prices.

In terms of the three questions asked by Ofgem in the CFI:

Question 1: what is your view on the nature and scale of the volume risk facing suppliers, and the case for changing the current price cap methodology?

Utilita considers that there is – as we have stated repeatedly – an incontrovertible case for changing the price cap methodology. The basis for the change is that the price cap as it stands is wrong, discriminatory, and unfair as it does not allow suppliers to recover their efficient costs; compete for customers within the cap or to finance their regulated activities.

However, this does not mean that the cap methodology should be changed simply to bail out those suppliers who have elected to follow risky business models, which are incompatible with the price cap and depend on abusive or unsustainable acquisition pricing strategies and using consumer credit balances to generate growth.

The changes made to the cap should be those required to address the fundamental errors within the cap to ensure that it can operate to the benefit of both present and future consumers. This is clearly not the case at present, which is demonstrated by the claimed 'savings' and 'failure costs' generated by the current methodology.

Question 2: what is the best way to tackle this issue whilst protecting consumers interests?

As set out above, Ofgem should move to a single cap, based on the 'pay on receipt of bill' current cap. In addition, we have proposed additional measures – such as increasing the scale and scope of the Warm Home Discount core group – in our submissions to the other documents in the suite of consultations issued alongside this CFI. Please refer to those submissions.

Question 3: which adaptations to the price cap are preferred and why, including any additional options not set out in this paper? (Please provide an outline description of how any alternatives would work)

As set out above, we consider that rather than seeking to tweak the price cap to rescue suppliers who have sought risky business models incompatible with price capping, Ofgem should address the clear, longstanding errors in the cap to the benefit of present and future consumers. This will include allowing suppliers to recover efficient costs of supply, compete within the cap and finance regulated activities.

At one stroke, this will improve resilience in the industry, create scope for investors into the industry and provide real choice and options for customers, returning to a position where Suppliers can offer sustainable prices below the cap. If Ofgem is no longer seeking to choose winners and allowing the market to function, market forces will drive genuine efficiency savings.

This is not to say that Ofgem does not also need to use the powers it (already) has to enforce supplier conduct and financial responsibility on suppliers – this is a second essential area of activity for Ofgem, but it will be simplified in the context of a single, fair cap.

In addition to the points above, we have provided an illustration of how we consider improvements could be made to the wholesale cost methodology, but allowing suppliers scope to exercise carefully honed trading and hedging skills to the benefit of customers. As the impending extraordinary increase in retail prices demonstrates, the design of the price cap does not deal with energy risk management well, either for the customer or the supplier: customers are exposed to volatile retail price changes, while suppliers are insufficiently remunerated for the risk management service they provide.

Changes to the price cap regime that both adequately compensate suppliers for risk management, as we have outlined in the response to the *Reviewing the potential impact of increased wholesale volatility on the default tariff cap: November 2021 policy consultation*, and protect customers from

volatile wholesale markets is in the interests of both parties. Ofgem must recognise that it is not in the interests of the customer in the long run to force artificially low gross profit on suppliers while exposing customers to volatile retail price changes and indeed celebrating and taking credit for reductions in the price cap when they occur; customers' interests are best served by allowing energy suppliers, whose function it is to manage energy risk for the customer, to shield customers from extraordinary wholesale market events and be compensated for the service.

We hope this submission has been helpful, and I would be happy to arrange a discussion with your team to explore the issues raised in more detail.

Yours sincerely

By email

Alison Russell
Director of Policy & Regulatory Affairs