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

Dear Neil

Consultation on Medium Term Changes to the Price Cap Methodology: non-confidential version

Our response¹ to this consultation is made up of:

- This letter
- Appendix 1, which contains further detail on the key points in our response
- Appendix 2, which contains answers to the consultation questions

Our position at a high level: we do not believe that technical changes to the cap are likely to reconcile conflicting objectives including: the ability for consumers to benefit from falling wholesale prices by switching; the promotion of responsible business models and strategies pursued by suppliers, which includes prudent hedging; protection from the risks posed by rising wholesale prices; recovery of efficiently incurred costs; market stability and investment in customer service and innovation. A more fundamental review of the purpose and nature of price regulation is needed to consider the appropriate balance between these competing objectives.

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.

However, urgent changes to the price cap design are needed in order to ensure that the energy supply market functions in an orderly way and operates in the best interests of consumers, by providing suppliers with legal and regulatory certainty to manage their risks and recover their costs in the short to medium term. The best way of doing so is implementing the 12-month price cap contract with fully effective Market Stabilisation Charge (MSC) using the

¹ Our response must be read in full; no part should be substituted for another.

staggered approach. This option comes closest to eliminating volume risk and basis risk because it aligns the cap index with spot wholesale prices, and the cap index fully aligns with the delivery period. By contrast, the quarterly updates option and the price cap contract without the MSC leave significant volume risk unaddressed. As such, Ofgem's quarterly update will be incapable of attaining the desired policy objective in this case.

Urgent action is needed because existing remedies are ineffective and the situation is worsening following the Russian invasion of Ukraine. The risk of prices spiking incentivises suppliers to hedge to protect against rising prices. However, the current calibration of the MSC may provide a counterincentive to companies to run a shorter hedge in the hope prices will fall, which could introduce massive risk into the market. Suppliers are also facing extreme and unresolved backwardation costs for next winter.

Further detail

We believe that all interested stakeholders are agreed that the objective of medium-term price cap reforms is to as far as possible eliminate:

- Volume risk arising from the eight-month lag between spot wholesale prices and the 6-2-12 index that is used to set the existing cap. This volume risk manifests as unexpected and unhedged SVT demand from consumers exercising the free option to stay on the cap when it is relatively cheap, and leaving when it is relatively expensive.
- Basis risk (i.e. backwardation costs) arising from the mismatch between the 6-2-12 index that is used to set cap prices and the 6-2-6 index that can actually be bought and delivered via the wholesale market.

These risks – which are caused by the existing cap design – are very challenging for suppliers to manage. Neither risk can be fully mitigated under the current cap. The consequences of these risks are real and material; an extra £61 has been added to the cap from 1 April 2022 to recover losses incurred from these risks materialising in cap period 7. As of 2 March 2022, we estimate that a typical supplier with the British Gas customer base hedging in line with the cap would incur a cost of ₤ in backwardation costs for winter 2022 that would not be recovered under the cap. This cost is even higher at ₤ under the quarterly cap option. Ofgem should urgently provide certainty to suppliers that it will structurally eliminate the basis risk, to avoid unnecessary costs.

Ofgem's preferred cap reform option of quarterly updates would be a step in the right direction to addressing the volume risk issue because it reduces the lag between spot wholesale prices and the cap index from eight months to five. But the quarterly updates option does not align the cap index with spot wholesale prices, so significant volume risk will remain.

In contrast, the 12-month price cap contract will much more closely align with spot hedges wholesale prices, and therefore come closest to eliminating the volume risk in the rising prices scenario. The 12-month price cap contract would need to be combined with a fully effective – i.e. set with a 0% threshold for wholesale price falls and 100% hedge recovery – to properly mitigate the volume risk in a falling prices scenario.

We do not believe that Ofgem's objections to the 12-month price cap contract option are substantiated by any meaningful or credible evidence; they are therefore little more than assertion. Consumers may be as likely to perceive quarterly updates to be unfair, for example because it looks like a good deal in one quarter and a bad deal the next. The answer to concerns of unfairness with the 12-month price cap contract option and quarterly updates option is the same; consumers would be able to switch away with no exit fee.

The quarterly update option alone will not address the basis risk. The 12-month price cap contract with a fully effective MSC will address the basis risk. If Ofgem implements either the enhanced status quo option, it must entirely eliminate basis risk for any given price cap period (e.g. P9) by adding half the difference between the 6-2-12 and 6-2-6 indices for that price cap period to that price cap period (i.e. P9), and adding the other half to the next price cap period (i.e. P10). This method could be adapted for the quarterly updates option as described in Appendix 2.

Looking beyond the near-term

We strongly welcome the fact that Ofgem has stated that it expects suppliers to continue to hedge for the 6-2-12 index unless and until they state otherwise. We have taken this statement as Ofgem's firm position and we are relying on it to inform our hedging decisions. It is in these circumstances not open to Ofgem to resile from or reverse its stated position or assurance without engaging concerns about impermissible retrospection. However, we reiterate that suppliers are facing extreme and unresolved backwardation costs for next winter, which needs to be addressed urgently.

In addition to ensuring that suppliers can recover their efficient costs in full if transitioning from one cap design to another this October, we expect Ofgem to do the same for any future - more fundamental - cap reform.

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

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:

- 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 look forward to engaging with Ofgem and BEIS on the design of the longer-term framework for retail market regulation in due course.

Yours sincerely

Tim Dewhurst
Director of Regulation and Policy

Appendix 1

The broader context: this consultation as part of the “package” of retail reforms

1. At the time of writing, the broader context to this consultation is that - despite all the supplier failures and Ofgem announcements - consumers still face unacceptable risks from:
 - Undercapitalised and underhedged suppliers using customer credit balances to fund day-to-day operations and acquire more and more customers on loss-making tariffs. Effectively the risk is undercapitalised and underhedged suppliers betting customers' money on wholesale prices being stable or falling to grow their customer base. Put another way, too much risk of supplier failure sits with consumers, and not enough with shareholders. This inappropriate allocation of risk away from shareholders and towards consumers equates to moral hazard.
 - Unmanageable volume risk and basis risk described above.
2. Whilst we recognise that Ofgem has outlined steps that it intends to take to mitigate these risks, it has thus far only taken two decisions that have had a substantial positive impact, and one of those decisions is retrospective only. Those positive decisions are:
 - To temporarily pause new supplier entry; and
 - To recover through the cap in periods 8 and 9 efficient unexpected SVT demand costs, backwardation costs and balancing costs that were incurred but not recovered in cap period 7.
3. Ofgem has attempted to mitigate the unmanageable volume risk issue for summer 2022 by introducing a Market Stabilisation Charge (MSC) and by prohibiting new customer only tariffs² (its “16 February 2022 Decision”). Although the conceptual design of the MSC is appropriate, the mechanism has been calibrated in such a way that it is ineffective. In addition, the prohibition on new customer only tariffs is counterproductive to the aim of mitigating unmanageable volume risk. More specifically:
 - The MSC only kicks-in once wholesale prices fall by over 30%, and even then only 75% of the value of the hedged volumes may be recovered. This calibration may (just) avoid the bankruptcy of another large supplier, but it will not avoid the risk of very substantial losses for well-hedged suppliers in the event that wholesale prices fall. The risk of prices spiking incentivises suppliers to hedge to protect against rising prices. However, the current calibration of the MSC may provide a counterincentive to companies to run a shorter hedge in the hope prices will fall, which could introduce massive risk into the market. Ofgem's calibration of the MSC already looks unwise in the context of the Russian invasion of Ukraine. Any efficient costs that suppliers incur but cannot recover because of the mis-calibrated MSC will need to be recovered through the cap.
 - The prohibition on new customer only tariffs is especially damaging, as it risks incentivising suppliers not to hedge to protect against rising prices because some suppliers have a lower cannibalisation risk than others (e.g. if they have relatively few customers on capped tariffs). It only takes one supplier to start the “race to the bottom” that led to the supplier failures last year and the £3.5bn costs to consumers.
4. On the financial resilience side, although Ofgem's stated direction of travel for regulatory reform is positive, no directly enforceable measures have yet been put in place that will have

² [Decision on short-term interventions to address risks to consumers from market volatility | Ofgem](#)

a tangible impact on commercial decision making. As set out more fully in our response to Ofgem's Action Plan, it is imperative that Ofgem introduces as soon as it is able:

- Robust requirements to protect customer credit balances;
- Capital and liquidity adequacy requirements; and
- Fit and proper person requirements, that (importantly) include personal liability.

5. Taken as a whole, therefore, Ofgem's "package" of retail measures remains insufficient. In this context, it is all the more important that Ofgem chooses the medium-term price cap reform that best protects consumers, specifically by as far as possible eliminating the unmanageable volume risk and basis risk that the current 6-2-12 index creates.

Eliminating unmanageable volume risk: the price cap contract with an effective MSC

6. The 12-month price cap contract with a fully effective and permanent MSC comes closest to eliminating unmanageable volume risk without introducing exit fees to default tariffs. Significant unmanageable volume risk will remain under the enhanced status quo and quarterly update options. The extra costs of unmanageable volume risk from cap period 7 that are currently being passed to consumers has led to a cap increase of £41 per customer. If Ofgem chooses either the enhanced status quo or quarterly update options, it is likely to have to add further allowances to the cap to recover future losses arising from unmanageable volume risk.
7. As well as better mitigating volume risk, we see substantial additional benefits of the 12-month price cap contract option compared to the enhanced status quo and quarterly updates options:
 - It will better enable comparisons with non-default fixed term tariffs, giving consumers more confidence that they are making an accurate choice.
 - The end of the fixed term will create a natural point of engagement, and splitting default customers into 12 roughly equal cohorts – see next paragraph – will create natural groups for suppliers to be able to target with attractive offers.
8. On the approach to implementing the 12-month price cap contract option, we strongly agree with Ofgem's proposed staggered approach. There is insufficient wholesale market liquidity to implement the approach where all the energy for customers on default tariffs is bought in one go for a 12-month contract starting on 1 October every year. Even if there was sufficient liquidity, the "big-bang" approach to implementing the 12-month price cap contract option would still be riskier and entail higher costs than the staggered option because:
 - The volume risk in a falling market would be much higher; and
 - Customer contact would focus around the renewal of all default tariffs at the same point rather than spread over the year between the 12 cohorts. Large peaks and troughs in consumer contact are more expensive to manage because of inconsistency in demand for customer-facing staff.
9. Whilst Ofgem explains why it does not consider exit fees on default tariffs to be in the interests of consumers – i.e. because it may put poorer consumers off engaging – it does not say why it has not included a permanent and fully effective MSC as an option. We assume that Ofgem's reasoning is an extension of its reasoning from the 16 February 2022 Decision, which is that it wants consumers to "benefit" from the fall in wholesale prices by switching. This focus on switching, even if it means imposing losses on suppliers individually

and as a whole, indicates that Ofgem has not learned the lessons from the supplier failures of 2021. One of the key lessons from the supplier failures of 2021 is

10. It is very important for Ofgem to recognise that any purported benefits to consumers that arise from the eight-month lag between spot wholesale prices and the 6-2-12 index are artificial and do not come from genuine innovation or efficiency on the part of suppliers offering the lower spot wholesale prices. They are instead based on asymmetric moral hazard, given falling commodity markets are capital intensive for suppliers who hedge and therefore encourage suppliers to carry unhedged positions. A fully effective (i.e. a threshold of 0% and 100% hedge recovery) and permanent MSC will remove this artificial competition and drive suppliers to compete on genuine efficiency and innovation.
11. It is very important for Ofgem to recognise that any purported benefits to consumers that arise from the eight-month lag between spot wholesale prices and the 6-2-12 index are artificial and do not come from genuine innovation or efficiency on the part of suppliers offering the lower spot wholesale prices. A fully effective (i.e. a threshold of 0% and 100% hedge recovery) and permanent MSC will remove this artificial competition and drive suppliers to compete on genuine efficiency and innovation.
12. Ofgem rightly recognises that in absence of an effective MSC or exit fees, the price cap contract option leaves significant volume risk for suppliers in a falling prices scenario. The volume risk of the price cap contract without an MSC or exit fees is one main reason that Ofgem currently favours the quarterly update option.
13. The main reason that Ofgem gives for favouring quarterly updates over the price cap contract is that it is concerned that consumers may perceive the latter when implemented under the staggered approach to be unfair. We do not believe that this comparison – or these concerns – are well-founded. Consumers may be as likely to perceive quarterly updates to be unfair, for example because it looks like a good deal in one quarter and a bad deal the next. The answer to any concerns of unfairness with the 12-month price cap contract option and quarterly updates option is the same; consumers would be able to switch away with no exit fee. There being no exit fee draws out the important distinction between perceptions of unfairness, and actual unfairness, the latter of which has or may have economic implications.
14. We agree that it is important to understand and where necessary manage consumer perception. However, it is not clear how perceptions of fairness would relate to the requirements within Section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act), which dictate what Ofgem must consider when setting the cap. In any event, any concerns that Ofgem has around consumer perceptions of fairness would need to be based on robust consumer research rather than speculation. In doing so, Ofgem would need to be careful to explain to consumers the trade-offs between the options, for example that the price cap contract with an effective MSC would likely be the lowest cost option for consumers in aggregate, and consumers would be able to switch with no exit fee.
15. Any perception of unfairness under the 12-month price cap contract option with different customer cohorts having different default prices – albeit with no exit fee – could be further mitigated by having a six-month contract instead. Under the six-month contract, it may be possible to equalise prices between seasons via a set adjustment rather than introduce basis risk with a 12-month price that does not match the 6-month back-to-back hedge.

Eliminating unmanageable basis risk

16. If Ofgem implements the 12-month price cap option, there would be no need for another mechanism to mitigate basis risk. However, if the quarterly updates or the “enhanced status quo” options are chosen, another mechanism to address basis risk will be needed.
17. Under the quarterly updates and “enhanced status quo” options, we support the approach for addressing basis risk that we describe on page 2 above. Our proposed approach has several advantages over or the same as Ofgem’s proposal and has no relative disadvantages:
 - i. Our proposal removes basis risk entirely, whereas Ofgem’s proposal only reduces it. Underlying Ofgem’s proposal is an unjustified claim that there is an “efficient” way to manage basis risk, when there is not. If a supplier hedges against backwardation, it sacrifices contango benefits, and the hedging costs money. All things being equal, Ofgem’s proposal will lead to higher costs because of the extra capital required to hedge. Under Ofgem’s proposal, there will be some winners and losers because of arbitrary movements of the curve rather than genuine efficiency.
 - ii. Our proposal will give certainty to suppliers in advance of winter 2022 that basis risk will be mitigated, and therefore the approach that they should take to manage it. Ofgem’s ex post proposal will not provide that certainty to suppliers. Certainty is urgently needed in part because of the magnitude of the costs involved: ⌘ for a typical supplier of the size of British Gas as of 2 March 2022. The uncertainty adds to risk, impacts investor confidence and will feed through into the cost of capital.
 - iii. Our proposal can meet Ofgem’s objectives of avoiding seasonality in pricing and thereby smooth costs for consumers. Under our proposal, the costs of backwardation which are usually incurred in winter are spread across the summer periods as well as the winter periods.
 - iv. Ofgem’s proposed deadband is an extension of the assumption – which may be wrong – that the costs of backwardation will be balanced out by the benefits of contango over the course of the cap. The method purports to be scientific but in fact it is an arbitrary way of reducing seasonal differences in the cap; the past may not be a good guide to the future, as we have recently seen. Also, if the deadband captures periods of unusually high backwardation in the calculation of the standard deviation, the threshold to cost recovery may become even higher, exacerbating the risk that suppliers do not recover their efficient costs. If Ofgem intends to use a deadband to avoid seasonal differences between the cap, it should explicitly and transparently select an arbitrary level – e.g. £10 – and keep it constant to reduce uncertainty.
 - v. There can be no “windfall” to suppliers under our proposal; there is currently no allowance in the cap for hedging backwardation risk, so any benefits from hedging backwardation risk would not be a windfall gain. Looking at it another way, if the recent trend had been unusually high contango benefits rather than unusually high backwardation costs, we doubt that Ofgem would be proposing to increase the cap to compensate suppliers who had hedged against backwardation risk and incurred “windfall losses”.

Appendix 2: responses to consultation questions

Question 1: Are there any other costs and risks to consumers and suppliers that we should consider?

1. Transaction costs will increase for any option which assumes suppliers purchase quarterly products. Quarterly products have very limited liquidity and very wide bid offer spreads. Any such price cap would require a higher transaction cost allowance: we estimate that the transaction costs for quarterly products might be three to four times the level of seasonal products, which could lead to an increase in costs and ultimately bills of ₤ or more per dual fuel customer per year.
2. If suppliers are unable to purchase quarterly products, then they would instead need to purchase seasonal products and reshape closer to the time of delivery. This would then add additional shaping costs, which would need to be reflected in the cap. As noted in response to question 9, these costs could be ₤ of annual wholesale costs, which would be a similar order of magnitude to the transaction costs described above.

Question 2: To what extent would a price cap contract without exit fees leave suppliers carrying volume risk in a falling prices scenario? How significant would this risk be? How might it be mitigated?

3. The risk is very material. Ofgem's analysis of historical costs in figure 4.1 (which we understand informs the figures in table 4.2) is likely to understate the issue as:
 - i. It is based on a relatively short sample of data (since 2015) which may not include rarely occurring extreme falls in price; and
 - ii. Historical data may not be a good proxy for potential future price changes given the high volatility experienced recently.
4. To illustrate the magnitude of this issue, consider a scenario in which wholesale energy costs have been steady for some time (say at £1,000 for a year of energy), so all 12 price cap cohorts are on the same 12-month price cap tariff. Costs might then, in an extreme but plausible scenario, fall by 50% within a month.³ If a supplier was on average holding ₤ months of energy (since some customers will have just started the contract, and others will be about to finish – and allowing for the way in which suppliers are assumed to start building the hedge two months before the contract starts) then they would lose ₤ per switching customer. If half of their customers switched, the average cost per customer⁴ would be ₤.
5. Under a price cap contract with the “big bang” approach to implementation rather than staggering, the risks are even greater, as it is possible that a fall in prices could happen just after all customers have moved onto a new contract. In this case, the supplier would be holding a full year's worth of energy, and the average cost per customer who switches would be ₤. If half of the customers switched, this would represent an average of ₤ per customer previously on the cap.

³ For example, the monthly average day ahead baseload power contract prices have increased by 110% between August 2021 and September 2021. (<https://www.ofgem.gov.uk/energy-data-and-research/data-portal/wholesale-market-indicators>) A fall in prices as material as this increase is equal to -52% ($1/(1+110\%)-1$).

⁴ Per customer previously on the price cap. If these costs had to be recovered from the 50% of customers remaining on the price cap after the switch, then the increase for these customers would be £312.50 each.

6. However, the costs that suppliers may be exposed to under falling prices have the potential to be extremely high under any of Ofgem's suggested price cap options. For example, under quarterly updates (which Ofgem indicates is the best option for falling prices), a supplier would on average be holding four months of energy at any one time. In the scenario described above, the supplier might be exposed to an average loss of \pounds per switching customer, or (if half of the customers switched) \pounds per customer that was previously on the cap.
7. As shown above, none of the options as outlined in the consultation eliminate the issue. Without some form of upward adjustment to the cap to cover the losses, any capped default tariff without an exit fee provides consumers with an option to exit the tariff, which will result (on average, over the long term) in suppliers incurring costs which cannot be recovered.
8. These are plausible scenarios (especially given the extreme volatility observed recently), and the market needs to be able to cope with such eventualities without the widespread failure of suppliers or severe losses that would result.
9. As we described in our response to Ofgem's November consultation on the potential impact of increased wholesale volatility, there are a number of ways in which the volume risk under the falling prices scenario could be addressed:
 - i. The use of an additional allowance to recompense suppliers for the costs *ex-post*, like Ofgem recently did with an uplift to the wholesale risk allowance to account for unexpected SVT demand costs during cap period seven. However, the use of an additional allowance has downsides, particularly compared to removing the risks entirely. An additional allowance is relatively expensive, the weighted average means that some suppliers do not recover their efficient costs, and customer churn means that suppliers may not recover their costs unless Ofgem includes an uplift. Importantly, an additional allowance imposes the costs on customers on the cap, rather than the "switchy" customers who drive the costs. Imposing the costs on customers on the cap rather than "switchy" customers who drive the costs is unfair from a cost reflectivity perspective.
 - ii. An ex-ante allowance akin to a risk premium. For example, Ofgem could determine the cost of an option strategy which removes the volume risk, and allow for this in the cap. However, given the illiquidity of the options market, it is unlikely that a strategy could be mandated which entirely eliminates the risk, and we expect that it would be relatively expensive compared to removing the risks entirely.
 - iii. Meaningful exit fees. Although we believe that Ofgem has overstated the case against exit fees and that it has not considered the option in sufficient detail, we do not advocate for their introduction on default tariffs because of the likely adverse customer response.
 - iv. A fully effective Market Stabilisation Charge (MSC), which is calibrated to ensure that suppliers can recover all of their costs in the event that consumers leave the price cap contract early – i.e. current 30% threshold reduced to 0%, and 75% cost recovery increased to 100%. The fully effective MSC will be the lowest cost and most effective solution. We also consider that it will promote sustainable competition rather than dampen it. Please see Appendix 1 for further views on the impact of the MSC on competition.
10. While Ofgem states that price cap contracts are associated with a "*very small* [volume] risk" under rising prices, this assumes that suppliers have the confidence to fully hedge the

customers on the contract. Without an MSC covering the full extent of losses (or meaningful exit fees), suppliers will have to continue to factor in the possibility of losing customers from the price cap contract. Managing this risk would result in suppliers not fully hedging for the customers taking up the price cap contract at a certain date, on the assumption that some of them may leave it. This may in turn lead to volume risk associated with rising prices if these customers then do not leave the contract as expected.

11. If Ofgem implements the 12-month price cap option but does not (a) implement the MSC with 0% wholesale price fall threshold and 100% cost recovery, and (b) does not build in an appropriate risk premium to allow suppliers to manage the volume risk, then it is likely that Ofgem will have to add an additional ex post allowance to the cap compensate suppliers for losses associated with the volume risk that Ofgem chose not to mitigate with the fully effective MSC.

Question 3: Quarterly updates are a balance between the reduced volume risks and the increased backwardation risks. Please provide evidence and data on the relative costs and benefits of this.

12. We disagree that there is a need to strike a “balance” between volume risks and basis risks; they can be both mitigated to the largest extent by introducing the 12-month price cap contract with a fully effective MSC.
13. Quarterly updates result in significant volume risk (as described above for falling prices) and *increase* backwardation risk above current levels.
14. It is not always the case that quarterly updates would lead to much lower volume risk than a 12-month price cap contract under falling prices. Consider a scenario where prices have been at £1,000 (for a year of wholesale energy) for some time, increase to £1,500 for September to November, and then fall back to £1,000 in December:
 - i. Under a quarterly price cap, suppliers will have bought energy for delivery in Q1 for *all* of their default tariff customers at the high prices. Their entire portfolio will therefore face the incentive of switching to a lower price FTC from the start of Q1.
 - ii. Under a 12-month price cap contract, suppliers will have bought energy at the high prices for only one quarter of their default tariff customers (those for which contracts started in October, November, and December). The remaining three quarters will have had their energy purchased before the price rise, and so will not face an incentive to switch. The overall costs of switching are therefore likely to be lower.
15. This scenario demonstrates how the volume risk exhibited by each option is extremely dependent on the overall *pattern* of prices that is observed. Without further analysis it is not possible for us to state which option is likely to exhibit the greatest volume risk under the sorts of conditions that might be expected in the coming years.
16. On balance, we believe that a 12-month price cap contract is the option that will best protect consumers - providing it is implemented using the staggered approach, and with the MSC calibrated at 0% for wholesale price fall and 100% for hedge cost recovery. The 12-month price cap option will best protect consumers because:
 - i. It eliminates basis risk and therefore backwardation costs;
 - ii. It significantly reduces volume risks under rising prices (assuming the MSC gives suppliers the confidence to fully hedge); and
 - iii. The MSC eliminates volume risks under falling prices.

17. Aside from these benefits, the 12-month price cap contract has the following benefits:

- i. It will better enable comparisons with non-default fixed term tariffs, giving consumers more confidence that they are making an accurate choice;
- ii. The end of the fixed term will create a natural point of engagement, and splitting default customers into 12 roughly equal cohorts will create natural groups for suppliers to be able to target with attractive offers;
- iii. It will incur lower shaping costs (see our response to question 1); and
- iv. It will not suffer from issues regarding the liquidity of quarterly products (see our response to question 9).

18. We do not believe that Ofgem's objections to the 12-month price cap contract option are well-founded. Consumers may be as likely to perceive quarterly updates to be unfair, for example because it looks like a good deal in one quarter and a bad deal the next. The answer to concerns of unfairness with the 12-month price cap contract option and quarterly updates option is the same; consumers would be able to switch away with no exit fee.

19. Any perception of unfairness under the 12-month price cap contract option with different customer cohorts having different default prices – albeit with no exit fee – could be further mitigated by having a six-month contract instead. Under the six-month contract, it may be possible to equalise prices between seasons via a set adjustment rather than introduce basis risk with a 12-month price that does not match the 6-month back-to-back hedge.

20. For further views on Ofgem's concerns about perception of unfairness of the 12-month price cap contract option, please see Appendix 1.

Question 4: Please provide further evidence on the impact of quarterly updates and price cap contracts on households and their finances, and how these could be mitigated.

21. It is difficult to say how consumers on the cap will respond to these options because they have not been implemented before for default tariffs. However, inferences can be made from experiences of the use of price cap contracts in other contexts. For example, consumers who are on a 12-month fixed contract are generally likely than not to engage and re-fix at the end of the fixed term, unless there are good reasons otherwise (for example the default is the cheapest deal available). Feedback from consumers on fixed term fixed price products suggests that they value the price stability, and that they are not too often called upon to bear the costs of engagement with price change notifications and switching.

22. Ofgem granted British Gas a derogation to make its default offering for some customers fixed term fixed price rather than evergreen. Ofgem granted the derogation in part because British Gas submitted evidence that a fixed term default promotes engagement compared to the evergreen default. We give Ofgem permission to review the evidence we submitted as part of its considerations. If Ofgem cannot find it, please let us know and we will re-send.

23. The quarterly updates option will obviously expose consumers to more price changes than the enhanced status quo option. Overall, we suspect that – all else being equal – consumers on default tariffs would prefer the lower engagement costs but potentially more powerful prompt of one price change per year compared to four. There is a risk that with four changes per year, consumers become desensitised to the prompt.

24. Perhaps most importantly, all else will not be equal. The evidence indicates that the 12-month price cap contract option with fully effective MSC will lead to consumers on default

tariffs paying the lowest costs in aggregate, because it best mitigates the unmanageable volume risk and unmanageable basis risk of the current 6-2-12 index.

25. If Ofgem implements any option other than a 12-month price cap contract or a 6-month price cap contract with a 6-month hedge with a fully effective MSC, then it is likely that Ofgem will have to add an additional ex post allowance to the cap compensate suppliers for losses associated with the volume risk that Ofgem chose not to mitigate ex ante. Importantly, an additional allowance imposes the costs on customers on the cap, rather than the “switchy” customers who drive the costs. Imposing the costs on customers on the cap rather than “switchy” customers who drive the costs is unfair from a cost reflectivity perspective.

Question 5: Do you think it is unfair that consumers would sometimes have higher or lower prices depending on the wholesale cost at the time their cohort starts the price cap contract? Do you think over the longer run this would even out?

26. The main reason that Ofgem gives for favouring quarterly updates over the price cap contract is that it is concerned that consumers may perceive the latter when implemented under the staggered approach to be unfair. We do not believe that this comparison – or these concerns – are well-founded. Consumers may be as likely to perceive quarterly updates to be unfair, for example because it looks like a good deal in one quarter and a bad deal the next. The answer to any concerns of unfairness with the 12-month price cap contract option and quarterly updates option is the same; consumers would be able to switch away with no exit fee. There being no exit fee draws out the important distinction between perceptions of unfairness, and actual unfairness, the latter of which has or may have economic implications.
27. We agree that it is important to understand and where necessary manage consumer perception. However, it is not clear how perceptions of fairness would relate to the requirements within Section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act), which dictate what Ofgem must consider when setting the cap.
28. In any event, any concerns that Ofgem has around consumer perceptions of fairness would need to be based on robust consumer research rather than speculation. In doing so, Ofgem would need to be careful to explain to consumers the trade-offs between the options, for example that the price cap contract with an effective MSC would likely be the lowest cost option for consumers in aggregate, and consumers would be able to switch with no exit fee.
29. If Ofgem undertakes consumer research, it would be useful to understand consumers’ perceptions of fairness in other markets where prices vary depending on when a customer takes a particular product. For example, available mortgage rates both default and non-default will vary according to the prevailing Bank of England interest rate. As another example, mobile phone contracts are likely to vary according to the mobile phone handsets available at the time, which change over time.
30. Any perception of unfairness under the 12-month price cap contract option with different customer cohorts having different default prices – albeit with no exit fee – could be further mitigated by having a six-month contract instead. Under the six-month contract, it may be possible to equalise prices between seasons via a set adjustment rather than introduce basis risk with a 12-month price that does not match the 6-month back-to-back hedge.
31. It is not possible to say whether the relative cost of 12-month price cap contracts would “even out” over the long run, because we do not know how long the cap would last using that design, and we do not know what will happen to wholesale prices.

Question 6: What opportunity and impact could each proposal have on consumer engagement? And where there may be negative impacts, please provide options to address these. (Please provide evidence.)

32. As well as better mitigating volume risk, we see substantial additional benefits of the 12-month price cap contract option compared to the enhanced status quo and quarterly updates options:

- It will better enable comparisons with non-default fixed term tariffs, giving consumers more confidence that they are making an accurate choice.
- The end of the fixed term will create a natural point of engagement, and splitting default customers into 12 roughly equal cohorts will create natural groups for suppliers to be able to target with attractive offers.

33. For further views please see our answer to question 4.

Question 7: What other operational impacts could a quarterly update or price cap contract have? Please provide data on the costs and benefits.

34. There will be some complexity and costs involved in transitioning from the current cap to the 12-month price cap contract with an effective MSC, for example in creating the new tariffs on our system. However, we believe that these costs will be vastly outweighed by the benefits of mitigating the volume risk and basis risk more effectively than the enhanced status quo and quarterly update options. Please see our answers to questions 4 and 6 for further views on the superiority of the 12-month price cap option with effective MSC compared to the enhanced status quo and quarterly updates.

35. Following derogation from Ofgem, we have previously changed some customers' default tariff from evergreen to fixed term; the costs of doing so were clearly not prohibitive, given we voluntarily chose to do something that was not required by regulation. A key difference between our "end evergreen" initiative and the 12-month price cap contract is that we had the SVT variable cap running in parallel with the fixed term default, which meant that our running costs were higher than they would be with the 12-month price cap contract applying to all default customers.

36. Under the price cap contract, Ofgem will need to set allowances for non-wholesale costs (such as network, policy, and smart metering costs) out further than the 8-month forecasts required for the current price cap. Our initial view is that overall setting allowances for non-wholesale costs should be relatively straightforward to do, since these costs are incorporated into fixed term tariffs as part of business-as-usual in both the domestic and non-domestic retail markets today – albeit not on the basis of a price cap.

37. We have done some initial thinking on how the allowances might be set for the non-wholesale costs and would welcome a meeting with Ofgem to discuss them.

Question 8: Are there any challenges in transitioning to quarterly updates or the strengthened status quo? If so, please provide details.

38. We strongly welcome the fact that Ofgem has stated that it expects suppliers to continue to hedge for the 6-2-12 index unless and until they state otherwise. We have taken this statement as Ofgem's firm position and we are relying on it to inform our hedging decisions. It is in these circumstances not open to Ofgem to resile from or reverse its stated position or assurance without engaging concerns about impermissible retrospection. However, we

reiterate that suppliers are facing extreme and unresolved backwardation costs for next winter, which needs to be addressed urgently.

Question 9: What would the impact be if suppliers tried to buy the energy requirements for all their customers on price cap contracts in August (for 12-month contracts) or August and February (for 6-month contracts) of each year? Do stakeholders agree there would be liquidity challenges in the wholesale markets? How damaging would this be? Are there any ways to avoid this issue?

39. On the approach to implementing the 12-month price cap contract option, we strongly agree with Ofgem's proposed staggered approach. There is insufficient wholesale market liquidity to implement the approach where all the energy for customers on default tariffs is bought in one go for a 12-month contract starting on 1 October every year. Therefore, the staggered approach is needed. By contrast, quarterly updates would lead to liquidity issues which could be more difficult to overcome.

Liquidity issues associated with an immediate transition

40. An immediate transition to price cap contracts would not be feasible due to insufficient wholesale market liquidity.

41. Purchasing our customers' forecast demand over the 1-month pricing window would use $\frac{1}{3}$ of the average UK gas market liquidity, $\frac{1}{3}$ of the average UK power baseload and $\frac{1}{3}$ of the average UK power peakload market liquidity (for the Winter ahead contract, ignoring any shaping requirements). Scaling these numbers to all residential suppliers, this would equate to $\frac{1}{3}$ of the gas and power baseload liquidity and almost $\frac{1}{3}$ of the power peakload liquidity. The equivalent numbers for the current cap index are $\sim \frac{1}{3}$ gas/ $\frac{1}{3}$ power baseload/ $\frac{1}{3}$ power peak (for all residential suppliers).

42. These comparisons are based on average market liquidity. On days where liquidity is lower, these could be 3-4 times higher.

43. If the wholesale allowance was based on a similar methodology as current (using ICIS Heren close prices), in order to minimise risk suppliers would have to buy gas/electricity around the window when ICIS assesses the market price, increasing the liquidity requirements during that window.

44. Having to buy this amount of volume would likely:

- i. Significantly increase wholesale market prices, resulting in a higher price for customers (all other things being equal); and
- ii. Lead to increased volatility (and risk of exploitation of market power), thereby exposing suppliers to significant market risk, which would need to be reflected in the default cap wholesale allowance.

45. Spreading the customer base out over the year through a staggered start would solve this issue.

Liquidity issues associated with the quarterly option

46. The quarterly option would also create significant wholesale market liquidity challenges.

47. Quarterly products have very limited liquidity, in particular Q+2 (quarter beyond the front quarter, which would be used in the first month of pricing) or the first quarter of a season (Q4 and Q2), and very wide bid/offer spreads. (c.3-4 times higher than for seasons, which if implemented should be reflected in a higher allowance for transaction costs).
48. For example, we would have required \propto of the average UK gas market liquidity to purchase the forecast demand for our customers in Q4-21 between Jun to Aug-21, which scales up to over \propto for all suppliers. Similarly, we would have required \propto of the power baseload volumes traded during that time, which scales up (for all suppliers) to almost \propto times the total traded volumes.
49. As a result of this poor liquidity, ICIS Heren assessments (currently used for the allowance calculation) are often derived rather than observed market prices, and therefore cannot be traded.
50. Poor liquidity in quarterly products might be manageable by buying other products, such as seasons instead of quarters but that creates significant spread risk which should be covered by an appropriate allowance:
51. For example, for Q4-22, assuming a demand of 1,500MW (Power baseload), we would need to:
- i. Buy 250MW of Winter 22 contract during Jun-22 (instead of Q4-22 which would be Q+2 at that point and trades very rarely)
 - ii. Buy 500MW of Q4-22 contract during Jul-22
 - iii. Buy 500MW of Q4-22 contract during Aug-22
 - iv. Buy 500MW of Q4-22 and sell 250MW of Winter-22 during Sep-22
 - v. We would therefore be exposed to the spread between Q4-22 and Q1-23 between Jun-22 and Sep-22
52. Based on historical analysis, we estimate this risk to be an additional c. \propto of the annual dual fuel allowance.

Question 10: If we were to implement the price cap contract, how should we implement it - with an immediate start and single cohort on a price cap, or with a staggered start and six or twelve different cohorts?

53. If Ofgem implements the price cap contract (as we suggest in response to question 3) then it is essential that it does so using the staggered approach rather than the “big bang” approach.
54. As described in response to question 9, the “big bang” approach to transitioning to the price cap contract would lead to severe liquidity issues.
55. Even if there was sufficient liquidity, the “big-bang” approach to implementing the 12-month price cap contract option would still be riskier and entail higher costs than the staggered option because:
- i. The volume risk in a falling market would be much higher; and
 - ii. Customer contact would focus around the renewal of all default tariffs at the same point rather than spread over the year between the 12 cohorts. Large peaks and troughs in consumer contact are more expensive to manage because of inconsistency in demand for customer-facing staff.

56. For example, a supplier would have to choose between:

- i. Sizing its call centre operation to the volume of contact occurring throughout most of the year (in which case it would be overwhelmed when the contracts renew); or
- ii. Sizing its call centre operation to the peak contact (leading to surplus capacity outside this period, a cost which the price cap would not cover); or
- iii. Attempting to hire, train, and offboard temporary staff on a yearly basis, which would likely degrade quality of service and lead to extra costs.

57. As described in response to question 2, a “big bang” transition substantially increases the volume risk in a falling market. Under certain circumstances (a price fall occurring shortly after the start of the contract), all of a suppliers’ customers may face an incentive to switch to a fixed-term tariff, and the supplier would be holding 12 months of energy for them. The staggered transition avoids this possibility, since on average a supplier will hold six months of energy for its portfolio at all times, and with different cohorts on different tariffs, not all of them may face the incentive to switch at the same time.

Question 11: What is a fair and practical way to allocate consumers to different cohorts?

58. We agree with Ofgem’s proposal under the staggered approach to allocate consumers into different cohorts according to the month that they most recently moved onto the cap. The point of cap entry seems to be the most objective and least arbitrary way of allocating consumers into different cohorts.

59. It is very important in alleviating volume risk that consumers are not able to choose to go onto a different 12-month price cap contract. Restricting access to closed and not yet open price cap contracts should not be a major issue since there will be no exit fee on the price cap contract and consumers will be free to switch to non-default tariffs.

Question 12: Should we consider any of these variations further? If so, which one(s) and on what basis? (Please provide evidence)

Variations of strengthened status quo

60. **Strengthened status quo with six-month hedge:** this would not address volume risk and would lead to significant differences in prices between seasons.

Variations of quarterly updates

61. **Quarterly update with 4-month cap, updated every four months:** this would leave significant volume risk unaddressed. It would also not be achievable, as it is not aligned with tradable products.

62. **Quarterly update with forward prices based on six months rather than 12:** this would leave significant volume risk unaddressed. It would also lead to significant differences in prices between seasons.

63. **Quarterly update with six-month observation window:** as noted by Ofgem, this negates the benefits of moving to quarterly updates. The longer observation window increases volume risk (since prices in the market have longer to diverge from the prices used to set the cap). It also offers no improvement in basis risk over the basic quarterly update option.

Variations of price cap contract

64. **Exit fees:** although we believe that Ofgem has overstated the case against exit fees and that it has not considered the option in sufficient detail, we do not advocate for their introduction on default tariffs because of the likely adverse customer response.
65. **Forward prices based on six rather than 12 months for six-month contracts:** any perception of unfairness under the 12-month price cap contract option with different customer cohorts having different default prices – albeit with no exit fee – could be further mitigated by having a six-month contract instead. Under the six-month contract, it may be possible to equalise prices between seasons via a set adjustment rather than introduce basis risk with a 12-month price that does not match the back-to-back hedge.
66. **6-month price cap contract with 12-month prices.** We do not support this option because of the basis risk it creates. With no effective MSC, it would also have significant volume risk in the event of falling prices.

Other variations not included in the consultation document

67. **Half-yearly cap with 6-1-6 hedging, but “offset” so each cap period includes three months of summer and three months of winter.** This proposal would significantly reduce basis risk and has the attraction of doing so without either introducing seasonal pricing or requiring a separate adjustment mechanism. However, it would still be subject to a similar volume risk to the current cap and would therefore require a sufficient MSC to eliminate this risk. We would be happy to explore the option further with Ofgem, although note it is not without issues:
- One of the two price cap changes per year would take place around Christmas, which may present issues for customer communication.
 - The price cap periods would not align to the widely available seasonal products (and, as described in response to question 9, quarterly products have poor liquidity). It would therefore be necessary to purchase seasonal products and reshape closer to the time of delivery. This would introduce significant spread risk which should be covered by an appropriate allowance.

Question 13: Do you have any evidence or data that supports or challenges our assessment of the benefits this? What are the practical considerations for price changes over winter and Christmas?

68. It would be much easier to implement a shorter price cap notice period where there are fewer customers to notify. It would therefore be much more straightforward to have a shorter price cap notice period for the price cap contract option - using the staggered approach to implementation – than for either the status quo or quarterly updates.
69. For the latest price cap change it took our IT department ⌘ to extract all of the data from SAP during which time the various stakeholders involved have checked through hundreds of customer data proofs. ⌘
70. It takes significant time to process and produce ⌘ customer data records. Our current print centre partner needs around ⌘ to complete the paper production element of the activity, providing we can provide them with enough data to keep all of the production machinery fed.
71. We generally aim to deploy the comms over a ⌘ period to lessen the impact of inbound calls to the call centre during the price cap activity. If we were to reduce this ⌘ period under

the status quo or quarterly updates options, the customer experience and call centre resource would be severely impacted.

72. We need to give our customers reasonable notice before implementing a price increase. For example, if we need \times to print and start deploying the notices and then we give customers \times notice, this already takes 28 days before considering the \times needed for data extraction. However, if Ofgem found a different means of notifying customers of their new prices acceptable – for example putting the updated prices on our website – then this could significantly reduce notification timescales.

73. The challenge of communicating and updating the prices on smart and traditional PPMs is an industry-wide one that needs to be considered for all options. We have not had time to do this within the consultation timeframe but will seek to do so. The challenge may include availability and therefore sequencing of tariff slots, as well as getting the new prices activated on the meter and billed from the correct point in time.

Question 14: Do you have evidence or data to support a move to a shorter implementation window – such as 14 days? What are the potential risks to consumers of a shorter notice period? And what are the operational considerations?

74. Please see answer to question 13.

Question 15: Given the changes in the wholesale market since summer 2021, how should these be reflected in the deadband calculation?

75. As described in the cover letter, Appendix 1 and in response to question 3 above, the option which best protects consumers the 12-month price cap contract with fully effective Market Stabilisation Charge (MSC) using the staggered approach. If Ofgem instead adopts a price cap approach which does not eliminate basis risk, our response to Q17 describes our overall proposal for the treatment of backwardation. As we have presented before, this is an ex-ante adjustment, without a deadband, which is applied with a partial lag in order to remove any systematic seasonal effect. This approach allows suppliers to recover their efficient costs in a simple, transparent fashion, that does not add additional risks. This approach could be adopted to work with a quarterly price cap (we note that Ofgem does not appear to have explicitly considered the implication of moving to a different hedging strategy on its backwardation calculation).

76. Ofgem's proposed deadband is an extension of the assumption – which may be wrong – that the costs of backwardation will be balanced out by the benefits of contango over the course of the cap. The method purports to be scientific but in fact it is an arbitrary way of reducing seasonal differences in the cap; the past may not be a good guide to the future, as we have recently seen. Also, if the deadband captures periods of unusually high backwardation in the calculation of the standard deviation, the threshold to cost recovery may become even higher, exacerbating the risk that suppliers do not recover their efficient costs. If Ofgem intends to use a deadband to avoid seasonal differences between the cap, it should explicitly and transparently select an arbitrary level – e.g. £10 – and keep it constant to reduce uncertainty.

77. The concept of the deadband is flawed. We explain below how:

- i. If a price cap were introduced that required a backwardation adjustment, there is no reasonable justification for a deadband; and
- ii. In any event, the deadband methodology proposed by Ofgem is flawed.

If a backwardation adjustment is included, there should be no deadband

78. Under the ex-ante approach we describe in response to Q17, the costs of backwardation can be identified ahead of time at the point the cap is set – much like wholesale energy costs themselves. There is no more reason to expose suppliers to a proportion of basis risk than to expose them to a proportion of price risk in the wholesale market (by including a “deadband” for wholesale costs that allows suppliers to obtain some profit from falling prices and make losses from rising prices).
79. By lagging half of the costs of backwardation by six months (in the case of a half-yearly cap – an equivalent adjustment could be made for a quarterly cap) our proposal ensures that there is no systematic seasonal impact, even without a deadband.
80. While there is no clear rationale for a deadband, there are strong arguments for its exclusion.
- i. It is associated with a cost. Any deadband leaves at least a proportion of the basis risk with suppliers, resulting in increased costs to manage this risk. The cap must allow these costs to be passed through to customers (resulting in higher bills), otherwise it will not allow efficient suppliers to recover their costs.
 - ii. Suppliers are able to price below the price cap, but not above it. This leads to an asymmetry: If the price cap were set at a level that was reflective of suppliers’ efficient costs (which has not hitherto been the case) then sustained periods of contango benefits may be reflected by suppliers in a price below the cap. The reverse is not true – therefore even if the benefits of contango were to net off the costs of backwardation over time, the asymmetric nature of the price cap may cause suppliers to under-recover their costs.
 - iii. In its decision on the potential impacts of increased wholesale volatility in the cap, Ofgem argued that the long-term mean backwardation costs it calculated (£0.04) could be absorbed by the uncertainty allowances. However:
 - i. Ofgem has not provided any evidence that the uncertainty allowances in the cap are sufficient to cover even this figure. They are not: as we described in our response to Ofgem’s consultation on this decision, we have under-recovered our wholesale costs in each year of the past three years by \times on average, or \times . The uncertainty allowances in the cap are therefore already insufficient.
 - ii. The presence of a deadband means that backwardation costs could significantly exceed this level and not be recoverable. For example, if market conditions were such that suppliers incurred a backwardation cost in the winter of £16 followed by a contango benefit of only £6, then they would face a net backwardation cost of approximately £5 per customer per year – over 100 times the mean backwardation cost. The volatile market conditions which we are currently experiencing make such an under-recovery much more likely.

There are flaws in Ofgem’s calculation of the deadband

81. Additionally, there are serious flaws in how Ofgem has calculated and plans to implement the deadband.

82. As noted above, the deadband is currently centred around a backwardation cost of £0.04, exposing suppliers to a systematic cost which will not be covered by the allowances in the price cap. In order to avoid under recovery of efficient costs, any deadband should be centred around zero.
83. Related to this, there is no justification for a “rolling” deadband which is adjusted every period:
- i. If the deadband does not change, then there will have been no point in updating it in the first place.
 - ii. However, if the deadband *does* change, then this suggests that suppliers are being exposed to a materially different basis risk than they were in the past. The stated purpose of the deadband is to account for the “normal” basis spread that suppliers would be exposed to⁵ (and, by implication, Ofgem believes are built into the allowances within the cap). If the deadband changed as a result of an update, this would be evidence that the level of basis risk is no longer “normal” – and therefore unsuitable as a benchmark.
 - iii. In particular, the extremely high costs of backwardation currently being experienced are the result of exceptional market conditions which were not foreseen by Ofgem when the price cap was first implemented. They should therefore not be included in any deadband calculation
84. A further issue with the rolling deadband when combined with actual costs is that any changes made to the cap structure (and therefore basis risk) will affect the variations in backwardation costs and contango benefits. For example, if a quarterly structure is adopted, then we would expect the costs of backwardation and benefits of contango may become more pronounced. If the deadband were to be updated based on these figures, it would expand, and fail in its purpose to protect suppliers from all risks which were not “normal” under the current price cap.
85. Any deadband should therefore be fixed and not updated on a rolling basis. This would also reduce suppliers’ risk when faced with an uncertain deadband.
86. The proposed methodology is inconsistent in that it uses one set of data to calculate the deadband (historical modelled cost) but then compares suppliers’ actual costs to this deadband. To the extent that suppliers have historically adopted a hedging strategy that has smoothed out the costs and benefits of backwardation and contango, actual costs will have a lower standard deviation than modelled costs. If Ofgem does continue as proposed to calculated backwardation costs based on suppliers’ actual costs, then the deadband should be calculated on these costs too.
87. There is also no justification why a deadband of one standard deviation is correct. If Ofgem is to set a deadband, then it needs to provide an objective explanation for how it should be set. For example, if the deadband is intended to represent the variation in costs which are covered by the uncertainty allowances, then Ofgem needs to demonstrate why a deadband of one standard deviation does this.
88. For further views on addressing basis risk, Ofgem’s proposed ex post approach and the deadband, please see Appendix 1.

⁵ The deadband was introduced in Ofgem’s Decision on the potential impact of increased wholesale volatility of the default tariff cap, which states the deadband “...reflects our estimation of what ‘normal’ basis spreads suppliers would have experienced during cap period seven.”

Question 16: Do you have any views on the challenge of collecting backwardation costs from suppliers via RFI?

89. Centrica would be able to provide these costs. However, all suppliers in the market would need to be able to provide numbers on an accurate and timely basis to avoid bias in the calculation.

Question 17: Are there additional costs or benefits of taking an ex-post approach in this instance? If so, please provide details or evidence of these.

90. If Ofgem implements a price cap option that involves basis risk (i.e. not the 12-month price cap contract) then we would support the adjustment we have outlined in prior consultation responses. This is an ex-ante approach which should entirely eliminate basis risk for any given price cap period (e.g. P9) by adding half the difference between the 6-2-12 and 6-2-6 indices for that price cap period to that price cap period (i.e. P9), and adding the other half to the next price cap period (i.e. P10). The “rolling average” nature of the correction ensures that it does not lead to prices which vary systematically by season.⁶

91. If Ofgem moves to a quarterly price cap structure, then this method could be adapted: The adjustment in quarter 4 would equal a quarter of the modelled difference between the 3-1-12 and 3-1-3 indices for that cap period, plus a quarter of the differences in the preceding three quarters.

92. Ofgem’s preference for an ex-post adjustment over an ex-ante adjustment appears to be based on the following:

- i. An ex-post adjustment would “*incentivise good risk and cost management*” while an ex-ante adjustment “*does not necessarily incentivise good risk management*”.
- ii. An ex-post adjustment would “normally smooth a falling price rather than add to a rising price” while an ex-ante adjustment would “normally add an extra cost at a time of already rising prices”.
- iii. An ex-post adjustment would “not build in unnecessary costs for consumers” while an ex-ante adjustment “could result in windfall gains if the costs are less than the modelled costs”.

93. As we describe below and in Appendix 1, none of these arguments would hold in practice.

Impact on risk management

94. We disagree that an ex-post adjustment will promote good risk and cost management, compared to an ex-ante adjustment. The reverse is likely to be true: an ex-post adjustment would lead to suppliers bearing *additional* risks.

95. If a supplier’s hedge is out of the money but its competitors hedges are in the money, it would face a double impact of higher backwardation costs and a lower allowance. Such a situation would not reflect poor risk management, as any hedging strategy, however efficient, will risk being out of the money for certain market conditions. The ex-post allowance therefore adds an additional element of complexity to suppliers’ hedging

⁶ An alternative way of making an ex-ante correction without imposing seasonality would be to make a seasonal adjustment: For example, the summer correction could be uplifted by a set amount, and the winter correction reduced by the same absolute amount.

strategies, forcing them to try and second-guess the average hedging strategy of other suppliers in order to minimise their exposure to this risk.

96. If Ofgem were to use the ex-post approach, to avoid this additional uncertainty it would need to define what the “efficient” hedging strategy is, so suppliers can match it.
97. An ex-post adjustment also introduces an additional volume risk: as the price cap is adjusted for the costs of backwardation (or benefits of contango) with a significant delay, this increases the likelihood that suppliers will under- or over-recover these costs, due to changes in the number of customers on the default tariff cap. There is therefore an advantage to applying the backwardation adjustment as soon as possible to when the costs are incurred.
98. By contrast, our proposal will give certainty to suppliers in advance of winter 2022 that basis risk will be mitigated, and therefore the approach that they should take to manage it. Ofgem’s ex post proposal will not provide that certainty to suppliers. Certainty is urgently needed in part because of the magnitude of the costs involved: ⚡ for a typical supplier of the size of British Gas as of 2 March 2022. The uncertainty adds to risk, impacts investor confidence, and will feed through into the cost of capital.
99. We understand that Ofgem is concerned that, by encouraging suppliers to align to the cap (and not hedge for basis risk), an ex-ante backwardation adjustment may disincentivise forms of risk management which would have lower costs overall. This is not the case: there is no hedging strategy which, over the long run, would be expected to “beat the market” and result in lower costs than not hedging. While Ofgem found that many suppliers were able to do this in the previous cap period, this is unsurprising as the costs of backwardation were unexpectedly high. Over the long term, it would not be possible to achieve such savings.

Impact on smoothing prices

100. It is not the case that an ex-post adjustment would tend to smooth prices more than an ex-ante adjustment.
101. Ofgem’s logic for supposing that the ex-post approach will smooth prices more than the ex-ante adjustment appears to be that a period of backwardation is likely to coincide with falling prices, and so an ex-post adjustment would increase the price cap at the point at which prices are falling (rather than before this, when they are higher). This logic is incorrect for three reasons.
102. First, it conflates the timing of the adjustment with its method of calculation (ex-post or ex-ante). An ex-post adjustment has to be applied with a lag, by its nature. However, an ex-ante adjustment could equally be applied with a lag (indeed, our preferred approach, described above, lags half of the costs/benefits by six months). A desire for a smoother profile of prices is therefore not an argument for adopting an ex-post adjustment over an ex-ante adjustment.
103. Second, it is not necessarily the case that periods of backwardation are followed by falling prices. The current market demonstrates this clearly: despite the market being in backwardation, the winter 2022/23 wholesale allowance is expected to be above the summer 2022 allowance (which was itself above the winter 2021/22 allowance). In the current circumstances, an ex-post adjustment would push extra costs on to the cap into the periods when prices will be highest. By contrast, an ex-ante adjustment would have front-loaded the adjustment to a period when prices were comparatively lower.

104. Third, even if a lag in the backwardation adjustment beyond the one we propose leads to smoothed prices, it also risks suppliers being unable to recover these costs if customers leave the default tariff in the meantime.

Impact on costs for consumers

105. We disagree with the implication that an ex-ante backwardation adjustment could lead to windfall profits for suppliers.
106. Ofgem's concern appears to stem from the belief that there is a hedging strategy available which would lead to costs which are, on average, lower than those without any additional hedging for basis risk. As described above, this is not the case.
107. A supplier which has hedged backwardation risk might benefit in some periods but would lose out in others – there would be no windfall gain. Looking at it another way, if the recent trend had been unusually high contango benefits rather than unusually high backwardation costs, we doubt that Ofgem would be proposing to increase the cap to compensate suppliers who had hedged against backwardation risk and incurred “windfall losses”.
108. Under the ex-ante approach we have previously described, a risk-averse supplier seeking to avoid deviations from the cap would align its purchases of wholesale energy to the strategy implied by the cap. The ex-ante adjustment would mean that it would make no losses or gains as a result of backwardation or contango.