Energy UK

The voice of the energy industry

EUK Response: Consultation on Medium-term Changes to the Price Cap Methodology

4 March 2022

Introduction

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

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

This is a high-level industry view in response to Ofgem's Consultation on Medium-term Changes to the Price Cap Methodology. Energy UK's members may hold different views on particular aspects of the consultation. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes the opportunity to feed in its views on Ofgem's latest considerations for price cap methodology reform in response to volatile markets ahead of the October 2022 price cap period. Energy UK does not put forward a preferred option for price cap reform in this response, however we are greatly encouraged with Ofgem's openness and willingness to engage with industry throughout this process to date. We would encourage Ofgem to ensure that it continues to do so to ensure the challenges and risk balances can continue to explored in full. As outlined in Ofgem's consultation, we recognise that there is no perfect solution that could address all methodological issues exacerbated by the current crisis which can definitively balance the underlying risk between suppliers and consumers.

With regards to backwardation, however, we do not believe that Ofgem has fully appreciated the significant and material impact that its proposed ex-post allowance approach would have on suppliers' financeability over the winter period. If there is a risk of costs relating to backwardation in the price cap reform option ultimately selected, we believe that Ofgem must also take action through an **ex-ante methodology**, set **based on actual costs** incurred during the hedging window, to address the material risks that are apparent in the market.

Price Cap Reform

At this stage in the policy development process, Energy UK's members hold differing views on the optimal approach with regards to medium-term price cap reform, and so this response will not put forward a view on the merits of the three proposals that Ofgem is consulting upon. However, we do highlight some challenges that have been raised by our members to ensure that they are appropriately considered and addressed by Ofgem as it progresses towards a decision.

We welcome Ofgem's ongoing openness to engage with industry throughout this process, whether through bilaterals or through targeted workshops, and in particular to explore the transition, implementation and operational challenges for the price cap contract option. We would urge Ofgem to continue its open engagement as it further develops its thinking in response to feedback to ensure that all the potential options are explored fully ahead of its final decision.

Backwardation

Backwardation, as set out in the consultation, is presented as a single cost with a single risk. However, based on the valuable discussions we have had in the workshops organised by Ofgem as part of this consultation process, our understanding of backwardation has evolved. We believe there are actually three varieties of backwardation being discussed and it is important to treat each in turn.

'Backwardation A' – the core seasonal spread risk

Costs associated with volumes purchased within the price cap observation window - this is the cost summarised in Ofgem's consultation and represents the most significant risk that Ofgem must address appropriately. The price cap methodology is currently calculated on the basis of 12-month hedges but the price cap is reset every 6 months. For winter price cap periods, the forward prices in the later 6 months are lower than in the first 6 (the actual price cap period) and it brings the price cap level below the cost of purchasing energy for suppliers. When the market is in backwardation, the corresponding "over-recovery" during summer periods is not sufficient to offset the significant losses in winter.

Energy UK has significant concerns that the consequences for supplier financeability of Ofgem's proposed ex-post approach to the recovery of these core backwardation costs have not been appropriately considered within the consultation, and does not support the market in either reducing costs for consumers or efficiently maintaining prudent risk management. The expected costs of backwardation over the winter period at current levels is highly material, representing a significant cashflow issue for suppliers throughout the winter period if recovery cannot be expected until summer 2023 and winter 2023 price cap periods. It is not acceptable or manageable to recover on an ex-post basis. Without action, customers risk incurring material costs of supplier exits, and the funding of the working capital to manage the cashflow of this unprecedented cost through the winter. This should also be taken into account when selecting which option to take for price cap reform in the medium term.

In addition, Ofgem's proposed approach of calculating a backwardation allowance based on an average of suppliers' input is not appropriate. We recognise that Ofgem consider a market average approach appropriate in its calculation of incurred costs for the winter 2021 price cap period, because intervention had not been signaled in advance. However, Ofgem has recognised the extreme backwardation costs for the winter 2022 cap period and confirmed its intention to intervene to support supplier stability. As such, it is no longer appropriate to adopt the same approach going forward as to do so would only increase uncertainty for suppliers when attempting to devise effective risk management strategies. In this case, the "market average" approach ignores the effect that the intervention suppliers know will occur on the risk management strategies that Ofgem states it expects a prudent supplier to implement.

To bring this to life, consider the following hypothetical scenario:

- Supplier A elects to hedge 100% of the Win-22 vs Sum-23 spread risk at current market levels, locking in achieved margins that are £100 per dual fuel customer lower than in previous years
- The Win-22 vs Sum-23 spread falls resulting in the unhedged impact falling to £25 dual fuel customer
- The majority of the sector has not hedged this exposure, and so Ofgem calculates that the average cost of backwardation across the sector of £30 per customer, and uses this to set the backwardation allowance
- Supplier A has incurred losses of £100 per customer due to its high hedge strategy but only received an adjustment of £30 per customer

- The majority of the sector who didn't hedge this exposure receive a windfall benefit of £5 per customer

Instead, Ofgem should base its backwardation allowance on actual costs and with an ex-ante methodology. The costs associated with backwardation (and any benefits associated with the market subsequently being in contango) can be calculated in advance of any cap period. These are known, quantifiable costs (or benefits), and should therefore be passed through to customers. To avoid imparting a seasonal structure to prices and address the risk associated with backwardation on a systemic basis, , for any given price cap period (e.g. P9) Ofgem should add 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 add the other half to the next price cap period (i.e. P10). As Ofgem acknowledges in the consultation, this aligns with Ofgem's overall ex-ante approach to setting the price cap on known costs.

'Backwardation B' – backwardation costs associated with volume risk.

If there is more or less default tariff demand than prudently forecasted, the cost of correcting for this can be significant, both in terms of the cost of purchasing that volume and the backwardation costs associated with purchasing that volume. In this respect, backwardation risk is a component of the larger volume risk issue.

Given the difficulties in managing volume risk, adjustments should be made to the price cap within period to mitigate when it becomes a significant issue in exceptional circumstances. Failing that, an ex-post allowance should be provided for based on the weighted average of costs borne by suppliers. To the extent there is a backwardation element to the cost incurred, this should be factored into any ex-post allowance.

'Backwardation C' – deviating from the implied hedging strategy used to calculate the level of the price cap in order to benefit from contango.

Suppliers can deviate from the strategy set out in the cap and make a gain compared to the cap if their chosen strategy was less costly than the price cap hedging strategy. Backwardation in this circumstance would be an input into a wider decision on trying to achieve lower hedging costs. Any deviation from the price cap methodology can bring gains but it also exposes suppliers to enormous costs if their 'bet on the future' does not pan out. As a prudent regulator, Ofgem should be monitoring this activity and intervening as appropriate. If suppliers do choose to take risks by diverging from what the cap methodology assumes, any gains or losses associated with this would not be a "windfall"; they would simply be a consequence of the risk-reward calculus. It is important to note that a supplier cannot know with 100% certainty that their approach, if different to the price cap, will be more or less costly; this is only known after the event. However, we note that if Ofgem takes an ex-ante approach to the backwardation allowance then suppliers would have an incentive to remain close to the ex-ante figure.

Notice Period

Ofgem must ensure that it considers in full any wider impacts or unintended consequences on suppliers' operations or costs and include appropriate solutions within its final decision. For example, whether the existing prescriptive nature of Disadvantageous Unilateral Variations requirements (SLC 23) remain appropriate with a shortened price cap level notice period. We expect that Energy UK's members will provide full details of these operational and systems impacts within their individual response.

Long-term Price Cap Reform

As highlighted in response to Ofgem's initial Call for Input, we remain concerned that there is no clear lead on longer-term price cap reform, and where the role of Government and Ofgem sit in relation to one another when it comes to reforming the price cap to make it fit for purpose in the future. If the optimal long-term fix for the price cap methodology sits outside of Ofgem's current powers under the Tariff Cap Act, then there is a clear need for the Government to lead on overall price cap reform. However, to date, there has been no indication the Government (via BEIS) is seeking to take on that role. We would, again, welcome a clearer understanding from Ofgem on any engagement it has had with Government on this issue.

We fully recognise that the immediate risk of the current volatile market must be addressed, and we welcome Ofgem's openness to engage with industry to find solutions. However, the importance of exploring longer-term solutions that both address the current issues, as well as adapts the cap for the future retail market, is only strengthened by the necessity to make changes to the cap methodology ahead of each new cap period. In light of the Government's stated intention to extend the possible lifetime of the price cap past its current sunset deadline of the end of 2023, we believe it is only appropriate and responsible for Ofgem, Government and industry to begin seeking answers to this key question.

Part of this work will need to consider how price cap protection can work in a market with market-wide half-hourly settlement and the future innovations that it is expected to proliferate, such as Time of Use tariff offerings. In addition, it will need to consider the impact of Faster Switching, and the impacts on suppliers' risks in light of the current market volatility and if that is repeated in the future. It will likely also need to revisit the underlying rationale for price protection in the domestic energy market, and make sure that any future iteration remains appropriately targeted at consumers who are deemed at need of that protection. There needs to be greater transparency and a recognition that price caps produce costs for customers, and that price caps themselves need to be efficient in the way that they are designed and implemented. Energy UK and our members are keen to work with Ofgem and Government to explore the requirements of a price cap in the longer-term.

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