



Consultation on Medium Term Changes to the Price Cap Methodology

The energy crisis has exposed inherent and structural shortcomings in the price cap design which were previously masked by a benign wholesale market and have now placed suppliers under extreme financial pressure and are increasing costs to customers. This consultation on medium term changes to the Price Cap, and future work to review the cap in the interests of both the consumer and suppliers, are critical to the ongoing integrity of the retail market and ensuring customers get value for money in the regulatory protections Ofgem provides.

Executive summary

There are significant trade-offs associated with every option Ofgem proposes. We do not believe any of Ofgem's proposed options in their current form adequately address the existential risks that suppliers face. Flaws in price cap design could be overcome by the additional mechanisms Ofgem implements to manage volume and basis risk, however neither of these effectively deals with their respective risk in their current form.

The market stabilisation charge (MSC) is particularly flawed, the volume risk it exposes suppliers to is unacceptable. Therefore, we recommend Ofgem focusses on removing volume risk through price cap design. This will make basis risk worse, therefore Ofgem must focus on improving the proposed adjustment for basis risk.

E.ON does not support any of Ofgem's proposals in their current form, however, given the ineffectiveness of the MSC, we can support the price cap reform that minimises volume risk (the quarterly cap, 3:12), strictly on the condition that improvements to the basis risk adjustment are made as follows:

- a) Backwardation adjustment being collected ex-ante
- b) Backwardation adjustment based on actual modelled costs not supplier average
- c) Backwardation adjustment recovered from all customers not just SVT

For the avoidance of doubt, if these conditions are not met we do not support the quarterly (3:12) cap given the basis risk it introduces and cashflow impacts of the proposed basis risk adjustment.

What's the objective of price cap reform?

Ofgem's focus is rightly on the two most significant risks that have increased because of the extreme wholesale market volatility and its interaction with the price cap:

- a) Basis risk (caused by current backwardation in the wholesale market).
- b) Volume risk (caused by differences between the price cap and acquisition prices).

Ofgem's own data shows around 22m customers on price cap tariffs in early February, with this number of customers Ofgem's own analysis on backwardation implies a cost of over £3bn across the industry next winter under the current price cap design. Ofgem proposes to allow suppliers to



recover a proportion of this cost over the 12-month period after it is incurred. We are extremely concerned that the retail sector cannot manage the cashflow impact of this potential cost and this could lead to suppliers becoming insolvent or otherwise exiting the market.

Ofgem's data also shows that, in February 2021, around 15m customers were on price cap tariffs. This suggests 7m customers have joined price cap tariffs over the last 12 months which indicates the minimum number of customers who are likely to leave capped tariffs if/when the wholesale market falls (noting that this number increases daily as customers continue to roll on to capped tariffs whilst the cap is lower than fixed term contract prices). Ofgem's market stabilisation charge covers 75% of a supplier's losses once the wholesale market falls more than 30% below the implied price cap wholesale element. For 7m customers, this implies losses of up to £2bn across the industry before MSC starts even partially compensating suppliers. We note that this volume risk increases as more customers default onto SVT tariffs (as they are doing) and, if the wholesale market rises (as it has done, significantly, since Ofgem completed its analysis on MSC) the absolute cost for suppliers also rises as the 30% fall references a much higher number. Again, we are extremely concerned that the retail sector cannot manage the impact of this risk if it materialises which could lead to suppliers becoming insolvent or otherwise exiting the market.

Price cap reform can't solve both risks at the same time

We agree with Ofgem that it would be preferable to engineer these risks out of the price cap entirely, but we do not believe that is possible, particularly whilst meeting Ofgem's further objectives for the price cap.

Of Ofgem's lead options, the quarterly cap (3:12) is the most effective at addressing volume risk but is the worst option for basis risk.

Ofgem's 12-month price cap contract option effectively removes basis risk but is the worst option for volume risk in a falling price scenario.

Whilst enhanced status quo and the 6 month price cap contract may improve risks marginally, this is a fraction of what is needed.

The way forward must be based on the most effective way to manage the risks outside of the cap

As highlighted above, the MSC is ineffective given the level of risk it exposes suppliers to before it takes effect. The proposed adjustment for basis risk is flawed but can be improved to better address the basis risk suppliers face.

Therefore we believe the most sensible way forward to address both volume and basis risk in the short term is to move to a quarterly cap as Ofgem proposes (noting this reduces volume risk, it doesn't eliminate it) whilst at the same time improving the basis risk adjustment. For the avoidance of doubt, our position in support of the quarterly cap is entirely conditional on making the improvements to the basis risk adjustment highlighted below, without these improvements the basis risk introduced by the quarterly cap is unacceptable.

Basis risk

Recovery of basis risk must be ex ante

The ex-post nature of the proposed backwardation adjustment expects suppliers to absorb the financial cost of backwardation up front until the adjustment is made; as highlighted above, these costs could reach into the £bns across the sector next winter so the cashflow implications for



suppliers are significant. Considering that backwardation costs can be calculated in advance without any risk of windfall benefit given that the price cap hedging observation window finishes before the calculation would be made, these costs should be included in an ex-ante adjustment.

Calculation of basis risk must be based on actual modelled costs, not a supplier weighted average

Given that basis risk is a function of the wholesale element of the price cap methodology and the underlying energy that a supplier must physically purchase, it is relatively simple to calculate the basis risk resulting from the cap. Using a supplier weighted average is not necessary and is inappropriate. Suppliers may make different decisions when hedging risks imposed by the price cap. Some may benefit, some may lose; but this is completely separate to the underlying basis risk the price cap introduces. Using a supplier weighed average basis risk adjustment encourages high risk hedging strategies which could result in supplier failure.

Recovery of basis risk must be from all customers, not just SVT

We recognise that recovering basis risk from customers via an adjustment has an impact on bills. Making the adjustment ex ante doesn't change this impact but does bring it forward. We'd also highlight that the cost of backwardation is one that is driven by all customers on capped tariffs during the observation window. If wholesale prices fell and some customers switched to FTCs it is not right that remaining SVT customers pick up their cost. Likewise, adding the cost of backwardation to only SVT customers increases the differential to FTCs so makes the volume risk, and likelihood of customers switching away from SVT, worse. To mitigate this, the basis risk adjustment should be recovered from all customers, not just SVT, for example via network charges or a similar mechanism on the basis that all customers benefit from the free option to take up the capped product, whether they exercise that option or not.

This would reduce the backwardation adjustment cost per customer significantly and ensure all customers pay a fair share for the protection that the price cap has afforded during this period of volatility. We note that Ofgem was proposing a within-period adjustment of network charges when looking at options to mitigate the impact of the SoLR levy on customers, a similar adjustment could be made to allow for ex ante recovery of any winter 22 basis risk from October.

The long-term future of the cap

Our suggestion above, to implement a quarterly cap alongside improvements to the basis risk adjustment, should be viewed as a short-term solution to prevent a situation where suppliers face unmanageable risks in the coming months which could lead to some suppliers becoming insolvent or otherwise exiting the market. The pace of change and short timescales has meant that suppliers will not have been able to evaluate these proposals in the level of detail needed. The long-term design of the price cap needs a fundamental review with more measured timescales. The price cap was introduced to address a perception that disengaged customers could become a source of excessive profit to suppliers. The cap was not intended to ensure that energy is affordable to all customers; this objective can only be addressed by a fundamental review of energy policy, reform of the wholesale market and change in social policy. The design of the price cap creates huge risks such as volume risk and basis risk. Some of these risks arise due to the free option engaged customers have to join or leave the capped SVT at any time without penalty. The proposed design changes do not eliminate these risks, and we do not believe these risks can all be engineered out of the price cap methodology at the same time. Discussions on the long-term future of the cap should focus on the best way to protect customers, especially those who are vulnerable, and weigh up the cost to customers driven by each cap feature versus the benefit it provides to customers.

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

As outlined in the executive summary above, there are significant trade-offs associated with every option Ofgem proposes. Suppliers are facing significant risks due to a combination of market volatility and the current price cap methodology which are not sufficiently addressed by the proposed changes or the basis/volume risk mechanisms in their current form.

Going forward, there needs to be an open discussion about the objectives of the cap and the costs it imposes on customers. The current cap provides a free option to all customers in the market (whether they use it or not) which drives a lot of these costs, there needs to be a debate about whether a more targeted cap or a fundamentally different approach to the cap provides better value for money for the customers it's designed to protect.

Chapter 4 – Changes to the price cap methodology

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?

The asymmetric nature of risk borne by suppliers and ineffectiveness of the MSC (see above) means that price cap contracts with no exit fee leave suppliers significantly exposed to volume risk:

- If wholesale costs rise and SVT becomes the cheapest product available, then churn decreases as customers continue to default to SVT – suppliers then have to top up energy at higher prices to meet demand.
- If wholesale costs fall then savings become available to customers and they switch away. Suppliers then lose incur a sellback impact given the lower wholesale cost.

This risk could be very significant, and the current Market Stabilisation Charge does little to mitigate these effects. This could be resolved by implementing an MSC with a much lower trigger point than currently proposed, ideally 0%; and increasing the derating factor, ideally to 100%. In the absence of such an improvement to the MSC we believe the volume risk associated with price cap contracts without exit fees is too great.

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

We agree with Ofgem that quarterly updates reduce (but do not remove) volume risk. Given the ineffectiveness of the MSC our view is that addressing volume risk through the cap design should be a priority. However, Ofgem's own analysis shows the impact that the quarterly update option would increase basis risk from ~£150 per customer in the status quo to well over £200 per customer with the quarterly cap (figure 4.2 in the Consultation on Medium Term Changes to the Price Cap Methodology).

Whilst Ofgem's basis risk adjustment is more effective at addressing basis risk than the MSC is at addressing volume risk (notwithstanding our detailed comments on the basis risk adjustment in this response), we are concerned that the retail sector cannot manage the cashflow impact of an ex-post adjustment for such a significant cost. Any option that leaves suppliers exposed to significant levels



of basis risk (which includes the status quo, but particularly the quarterly cap) must be accompanied by ex-ante adjustment for basis risk. These costs are measurable in advance so there is no justifiable reason to not pass them through as such and base the calculation on a modelled view of basis risk rather than a supplier weighted average.

Ofgem should now be acutely aware of the limits of supplier financing, having witnessed the turmoil created by mass supplier exits over the past year. Ofgem needs to consider very carefully how much financial risk they believe the remaining suppliers can carry.

To mitigate the impact on customer bills and prevent the volume risk problem being made worse by increasing the differential between SVT and FTC prices, the cost of backwardation should be recovered across all customers in the domestic retail market, for example via network charges or a similar mechanism. This ensures all customers pay their fair share and does not unfairly penalise disengaged customers who remain on SVT tariffs when others who have had the benefit of the option of remaining on the price cap product while it was cheaper, move onto cheaper fixed rates. Failure to do this would be akin to introducing a regulated loyalty penalty for the customers who can least afford to pay it.

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.

Our analysis shows that engaged customers prefer a fixed direct debit payment method as it enables better financial planning and gives a degree of certainty over their outgoings. More regular price changes (quarterly) would mean more regular DD reviews and thus more frequent changes to a customer's payment amount. This is likely to be unwelcome to those customers, especially during periods of increased price volatility where there is a risk that the increased price updates create a 'yo-yo' effect on payments which lag behind the cap.

Prepayment customers may find more regular changes to prices disruptive and budgeting harder.

However, should wholesale prices fall then obviously customers will see the benefits more quickly.

The 12-month contract option provides price stability, but in a falling prices scenario it does not respond as quickly to the wholesale market. The disconnect between falling wholesale prices and the static nature of the price cap contract is likely to lead to an increased volume of complaints when wholesale prices fall and place more pressure on customer finances than would be seen on a quarterly cap. It is also likely to lead to increased pressure for mid-period reductions to the level of the cap if prices fall off quickly and customers do not see the benefit (noting any adjustment would drive a cost for suppliers who have already hedged).

Ultimately there is no simple answer to this question. There is likely to be long-term value for stability which is likely to mean, other things being equal, that prices that move more slowly are better for customers on average. But prices that move slowly are more useful when they rise and prices that move quickly are more useful when they fall. The price cap cannot be designed to do both things at the same time.

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?

Notwithstanding our view that price cap contracts maintain or increase unacceptable levels of volume risk given the ineffectiveness of the MSC, we do not believe the concept is unfair. Engaged



customers who enter fixed term contracts already experience this difference depending on when they agree their contract. Similarly, fixed and SVT customers already experience different prices. One way to limit the difference would be to group customers into cohorts to transition onto contracts based on their regional PES area (so all customers in a particular region move to a price cap contract at the same time). This way all customers within a region would have the same rate, even if there were differences across regions.

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.)

Quarterly Updates

This option will lead to an increase in communications with customers because of more frequent price changes. This could have two opposing effects:

- More regular communication may increase price awareness and drive more engagement from some customers
- Other customers may be turned off by the repeated communication because of communication or price fatigue

Without clear messaging, this option could increase negative sentiment due to the perception of constantly changing prices along with persistent communication and coverage. The cycle of announcement, communication and DD/bill change up to four times per year could lead to customer apathy and give the impression of prices consistently going up due to the skewed external optics on price increase versus price decrease.

If Ofgem were to select this option, careful consideration should be given to the method for notifying customers, and whether the current process of price change notification is suitable.

Contract (6 or 12)

This option could lead to increased supplier demand and complaints from customers who do not understand the methodology behind the option, or who challenge the fairness of a cap which does not respond to falling prices. This could be compounded by pressure from other stakeholders who may be concerned that any future falls in the wholesale market are not passed through quickly enough to customers at a time of increased financial burden. Noting that Ofgem is proposing to allow for in-period adjustments to the cap, any in-period adjustment to price cap contracts in this falling price scenario would have a financial cost for suppliers who have hedged prudently.

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

The costs of delivering the letters and other communications required in line with the current cap methodology for a supplier like E.ON is between £100k. The quarterly update option has the potential to double these costs, which would need to be reflected in the overall operational costs allowed for in the cap.

We base our operational planning around a 100 customer response, and an energy specialist being able to take 100 per day. This drives between £100k of operational cost each time the SVT price changes. A further two price change events in the case of a quarterly update could double these costs. Again, this would need to be reflected in the overall operational costs allowed for in the cap.



Price cap contracts are a significant deviation from the current price cap approach, with prices changed each month for groups of customers. This is likely to drive customer contact when prices change so is likely to increase operational costs to some extent. Overall though, the frequency of price change per customer reduces (at least with the 12 month price cap contract).

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

Advance warning must be given to allow any changes to be managed, and Ofgem must allow sufficient time to transition from one hedging strategy to another, depending on the option chosen. For example we would expect at least one month would be necessary but Ofgem must consult with suppliers as liquidity in wholesale markets could be an issue and affect suppliers' abilities to transition their hedges.

It is also important that, following any decision, no further changes that affect hedging strategies are subsequently made for a period of time. We require absolute clarity on the methodology being implemented, and time allowed to make the required changes in a controlled manner. Any transition must only apply to future periods and take account of positions a prudent supplier will have taken to hedge the existing price cap. Any transition should be based on these positions as a starting position rather than requiring suppliers to sell existing hedges to be bought back at a later date (which incurs various transaction fees).

Deviations from those principles risk suppliers incurring transaction fees from having to manage a change to their hedging strategy, due to a mandated transition being implemented once suppliers are already exposed.

Operationally, doubling the frequency of price updates to quarterly will place added pressure on the time frames to deliver the required changes and send notification to customers, especially where the notification period is reduced. As outlined above, Ofgem would need to review existing licence conditions on price changes to ensure they were fit for purpose.

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?

It is our view that current market liquidity would not support this purchasing strategy, and any attempts to engineer this will likely increase wholesale prices meaning customers pay more than they need to.

In addition, where energy requirements cannot be met because of a lack of liquidity, open positions would have to be carried by suppliers for a significant period which increases their costs. This would lead to the need for an introduction of significant risk premiums, again to the detriment of consumers.

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?

If Ofgem were to implement the price cap contract option, doing so with a staggered start would be essential to the success of the implementation and ongoing viability of the option. To do anything else would be ignoring the liquidity risks inherent in the 'big bang' option, where suppliers are forced



to purchase all their energy needs in one go. It would also create ongoing market distortions around a singular observation window that could be open to manipulation in the wholesale market. Creating a single point of contract renewal would also create a significant churn risk for suppliers to manage.

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

If Ofgem were to implement the price cap contract option, the following options for customer allocation should be considered:

- End of existing contract for current fixed term customers
- Allocation based on geographical area (utilising PES area)
- Allocation based on supply start date with current supplier
- Segmentation of Vulnerable customers to avoid any unintended consequences for these customer groups

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

As we highlight throughout this consultation response, there is no easy solution to the problems the price cap is creating. Aligning the wholesale price reference period to the price cap period helps to reduce basis risk, but introduces seasonality in pricing which may be challenging for customers and increases volume risk (as a seasonal SVT price is likely to look expensive in winter versus a 12 month FTC). Likewise, extending the price cap period to 12 months helps reduce basis risk but increases volume risk.

Exit fees could be used to address volume risk in options that reduce basis risk (e.g. 12 month price cap options) however we recognise the challenge in introducing exit fees for default tariffs, noting that these exit fees would need to be significant to address the risk. The market stabilisation charge would have been a more effective way to address volume risk but its current design means it has very limited impact, it would need to be set with a trigger much closer to 0% and a derating factor closer to 100%. As we highlight above, given the flaws in MSC our view is that the only option to address volume and basis risk sufficiently is to focus price cap design on reducing volume risk whilst at the same time improving the adjustment for basis risk.

Chapter 5 – Reducing the notice period to a minimum of 28 days

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

We do not believe that this change will have a material impact on the issues that this consultation seeks to address. The proposal does however reduce the time we have to inform our customers of a price change, which would compress mailing times and could lead to operational challenges as it concentrates response demand into a shorter period. It may also mean that customers do not have the requisite time to act in response to the notification of the change. It would need to come with a review of existing licence conditions covering price changes.

If implemented alongside a quarterly cap which would see a price change in January, the option will create resource planning problems for activity to deliver the cap change over the Christmas period. There is also the issue of customer impact, especially in a rising price scenario, of a bill shock during the holiday period and the associated fallout from a media and political perspective.



Ofgem should consider the alignment with lead times for customer renewal notifications also, to ensure that the notice period does not create unintended consequences for suppliers when communicating cheapest tariff messages to customers coming towards the end of their contract.

Consideration should also be given to the ability of prepayment infrastructure providers to operate to the proposed effective dates in a shortened notification window and successfully deliver the required price updates to prepayment meter customers in time. Ofgem need to be mindful of how any scheduled system maintenance or annual work within the industry would interact with both the increased frequency of change (quarterly) and condensed notice period.

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?

Further to the risks highlighted above, this option would reduce the time a customer has to respond to a price change notice, without obvious benefit to the supplier from the price lag between observation and price setting.

Current price protection rules in licence may need to be lengthened to protect customers who cannot respond in time; however this may have the unintended consequence of rolling the price protection into the next cap period if not managed correctly.

Chapter 6 – A new mechanism for managing backwardation costs

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

The current dead band is being introduced at a time of extreme market backwardation meaning that suppliers will bear the cost of £16 per customer with no corresponding upside for years to come.

Basis risk is entirely calculable in advance of the price cap being published. Therefore, if Ofgem do not design basis risk out of the price cap itself, it should be adjusted for ex ante and be reflected in the price consumers pay. We do not see why a deadband is necessary, basis risk can be adjusted for in each cap period (whether it provides a cost or a benefit for customers).

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

E.ON have already provided Ofgem with a model that calculates basis risk based on market index prices. All suppliers will use different methodologies to calculate their backwardation costs, there is a high risk of using non-comparable numbers from each supplier leading to incorrect calculations when using a weighted average.

Suppliers may make different decisions when hedging risks imposed by the price cap. Some may benefit, some may lose; but this is completely separate to the underlying basis risk the price cap introduces. Using a supplier weighed average basis risk adjustment encourages high risk hedging strategies which could result in supplier failure.



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.

An ex-post adjustment requires suppliers to bear the cost of basis risk until the adjustment is made. This will introduce significant cashflow burdens on suppliers and we are concerned about some suppliers' abilities to withstand those pressures which could drive further supplier failure

Recovering costs fairly, after they are incurred, also relies upon the customer who drove those costs remaining on SVT. If a fall in wholesale market drove customers to switch away from SVT, before backwardation costs had been recovered, costs will either be under recovered (as there are fewer customers left on SVT) or have to be recovered over a smaller number of customers which means those left on SVT paying an unfair amount. In addition, including the costs within SVT creates further distortion between SVT and FTC, making SVT relatively more expensive and increasing volume risk.

An ex-ante adjustment is therefore essential. The specific costs resulting from the price cap methodology can be calculated in advance, as the observation window closes before price adjustments would be announced, removing any notion of a supplier receiving a windfall benefit and therefore any reason to not implement an upfront adjustment.

We recognise that recovering basis risk from customers via an adjustment has an impact on bills. Making the adjustment ex ante doesn't change this impact but does bring it forward. We'd also highlight that the cost of backwardation is one that is driven by all customers on capped tariffs during the observation window. If wholesale prices fell and some customers switched to FTCs it is not right that SVT customers pick up the cost. Likewise, adding the cost of backwardation to SVT customers only increases the differential to FTCs so makes the volume risk, and likelihood of customers switching away from SVT worse. To mitigate this, the basis risk adjustment should be recovered from all customers, not just SVT, for example via network charges or similar mechanism on the basis that all customers benefit from the free option to take up the capped product, whether they exercise that option or not.

This would reduce the annual bill increase per customer significantly and ensure all customers pay a fair share for the protection that the price cap has afforded during this period of volatility. We note that Ofgem was proposing a within-period adjustment of network charges when looking at options to mitigate the impact of the SoLR levy on customers, a similar adjustment could be made to allow for ex ante recover of any winter 22 basis risk from October.