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Dear Dan,

Price cap - Statutory consultation on changes to wholesale methodology

Wholesale market conditions over the last 12 months have exposed significant flaws in the design of the price cap. Many of these flaws result from the overall structure of the cap, set out in the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the “Tariff Cap Act”), which Ofgem interprets as requiring a bottom-up, absolute cap on SVT and default tariffs. This effectively means every single customer in the market, whether on an SVT tariff or not, benefits from the cap because of the free option it provides. It is the value of this free option, alongside Ofgem’s attempt to achieve the impossible by designing a cap that updates frequently but without a seasonal cost element, that drives much of the exceptional cost that Ofgem is now having to address.

Within the constraints of the current Tariff Cap Act, Ofgem’s choices are limited; there are significant trade-offs Ofgem has had to balance and, as we have set out in previous consultations, all of Ofgem’s proposed options have significant downsides. However, we agree that change is necessary in the short term to address the unmanageable risks that suppliers face that would otherwise lead to significant costs for customers. Looking further ahead, there is a need to review the role of the cap in the future market, in terms of its overall design, the customers it is designed to protect, and what “protection” really means.

- **There is a significant risk of under-recovery of backwardation and other adjustments in Ofgem’s proposal**

Although described as ex-ante, the backwardation proposal recovers costs for each quarter over 12 months, so the majority of costs are still recovered ex-post. Alongside other adjustments, such as unexpected SVT, which are also ex post there is a significant risk of under-recovery as customers who have driven 100% of the costs could switch before those costs are recovered. The adjustments themselves,

added to the SVT cap, encourage customers to switch away. We set out in Appendix 1 how Ofgem can address this risk.

- **Moving to a quarterly cap drives operational cost that needs to be captured in the operational cost allowance**

There are tangible costs that suppliers incur each time the cap changes, including more frequent communication, demand into call centres and payment adequacy reviews. With a quarterly cap, these costs have doubled so should be reflected in the operational cost allowance.

- **Ofgem's analysis of the impact of the market stabilisation charge (MSC) is flawed**

Although not explicitly part of this consultation, we would highlight that Ofgem's analysis of the impacts of the MSC in its decision document assumes an arbitrary "acquisitions benefit" to improve the notional supplier's EBIT by 0.9%. There is no justification for this adjustment nor has there been any consultation on it. We'd highlight that without this benefit, all of Ofgem's MSC options result in a negative EBIT for the notional supplier.

- **Liquidity is an issue that needs to be addressed**

The price cap effectively forces suppliers to hedge in a specific way, requiring them to purchase long term contracts if they wish to hedge their price cap exposure. This hedging strategy is public, and there is no equivalent requirement on generators to hedge in a certain way. This one-sided wholesale market increases costs for customers, and is made worse by the quarterly cap requiring suppliers to purchase 5 quarters ahead. Ofgem should introduce market making in the wholesale market which aligns to the products suppliers are required to purchase to hedge the price cap.

We set out more detailed thoughts on the issues raised in the consultation in Appendix 1.

Yours sincerely,

Steve Davies
Head of Regulation

APPENDIX 1

Ofgem needs to address a significant risk of under-recovery of backwardation and other adjustments

The principle of recovering exceptional costs (such as backwardation and unplanned SVT costs) via adjustments to the price cap alone, often sometime after those costs have been incurred, means non-switching customers who remain on SVT tariffs (which are likely to include a higher proportion of vulnerable customers) will be subsidising active customers who save by switching.

In October, the price cap is likely to include a number of adjustments which increase each customer's SVT price. Whilst we agree that these adjustments are necessary, recovering them via the price cap alone increases the incentive for customers to switch away from the price cap to avoid them. Most of the adjustments are retrospective in nature, meaning that customers who drive these costs are incentivised to switch before they have repaid them.

These unrecovered costs are left behind when a customer switches, but they are real costs that someone has to pay. Ofgem has correctly judged that, were suppliers expected to pick up the exceptional costs resulting from price cap design, this would lead to further supplier failure and another transfer from non-switching (more likely to be vulnerable) customers to switching customers. To avoid this, and using Ofgem's own logic, it is essential that the risk of under-recovery is addressed.

The fairest way to recover these costs would be through a market-wide levy that recovers costs from all customers, recognising that all customers benefit from the existence of the cap. Whilst there are ways to implement this without the need for a new levy (such as using existing network charging methodologies) we recognise that a market-wide levy would be challenging to implement in time for October.

In the short term, the MSC should be adjusted to fairly allocate the exceptional costs to the customers who drive them.

The assessment of suppliers' energy costs within the MSC should be extended to include adjustments made to the price cap to reflect additional exceptional wholesale costs resulting from price cap design (such as backwardation and unexpected SVT demand).

When comparing a supplier's cost of energy against prevailing market prices, the MSC trigger and sharing factor should be based on this adjusted wholesale cost, updating regularly to account for costs incurred and amounts repaid by any customer who switches at any point in time. The MSC is already designed to update on a weekly basis, this means that an accurate view of costs incurred and repaid could easily be included. For example;

- a customer who switches on 1st Jan 2023 will have driven 100% of Q4 2022 backwardation costs but only repaid 25%. The MSC in this example would include 75% of Q4 2022 backwardation costs (adjusted for average consumption patterns).





The MSC provides a mechanism to fairly allocate the exceptional costs to the customers who drive them. It can ensure that costs driven by customers who subsequently switch





follow them when they switch, rather than being left behind for non-switching customers to pay.



We also note that Ofgem proposes to include a deadband when calculating the backwardation adjustment. As outlined in our response to the original policy consultation we do not believe a deadband is justified. It exposes suppliers to a proportion of basis risk for no apparent reason. It is based on an assumption that benefits and costs will balance each other out – this is not necessarily the case. The size of the deadband itself is arbitrary.

The operational cost allowance should be updated

The move to a quarterly cap will result in significant operational cost increases, as both the volume of customer communications and the level of demand will increase around the cap setting periods. The knock-on impact of more frequent price changes is likely to play through to direct debit reviews, with more frequent changes required to ensure customers continue to pay the correct amount. This will in turn lead to further customer communication costs and demand into call centres which will drive operational cost increases.

In normal circumstances, we would expect to see a response from around  of our SVT customers when the price cap changes. An energy specialist is able to take roughly  calls per day. Based on this, we estimate the cost of managing demand off the back of a 6 monthly cap at . Other things being equal, the increased frequency that quarterly updates brings will therefore increase annual costs by .

We currently have  of our residential customer base on SVT and of those  customers who will need a cap letter. At a cost of roughly  per letter, the two additional price changes each year would increase annual costs by around .

DD communications are more challenging to estimate as they are subject to how many customers require a review. A prudent estimate is that we could have around  customers who we would need to write to about a DD review each time the price cap changes. This means an additional annual cost of around .

We do not agree with Ofgem that a move to quarterly updates will allow suppliers to offset an increase in operational costs using the headroom allowance as it scales with increased commodity cost. Although the headroom allowance may now represent a higher absolute cost figure, the risk and uncertainty suppliers are currently managing already outstrip the % headroom allowance set within the price cap.

Likewise, the volume risks Ofgem has partially addressed by moving to a quarterly cap are extreme. These costs have not been removed; they have been reduced but remain significant so a reduction does not offset an operational cost increase.

Ofgem should adjust the operational cost allowance to ensure that legitimate increase in cost as a result of a move to a quarterly cap are included in the in a fair and appropriate manner.

The implied hedging methodology is increasingly difficult to meet

We are concerned about the availability of products in the wholesale market required to meet the implied hedging methodology within the quarterly cap. Current market conditions mean there are significant challenges in securing peak liquidity in the seasonal products, as well as quarter+1. There are similar struggles even securing baseload for the front season and quarter. There is no indication that these challenges will correct themselves when we transition towards the quarterly cap methodology. As Ofgem recognises, the new methodology requires suppliers to purchase quarters up to 5 periods ahead, these products are generally not available.

Given these challenges, there may be a requirement for suppliers to use seasonal products to hedge the quarterly cap (on the basis that those seasonal products are more liquid). This will result in increased shaping costs as suppliers then seek to exchange the seasons for more granular products closer to delivery.

On that basis we would be interested in seeing any evidence Ofgem have to substantiate their expectation that the move to a quarterly cap will result in lower shape cost for suppliers.

Liquidity has been a significant issue for suppliers for some time, recent events have exacerbated an existing problem. We have been talking to Ofgem for some time about the role of market making in the wholesale markets and how this could address the current imbalance between suppliers, who are effectively required to use a prescribed and public hedging strategy (the price cap) and generators, who are not. A market maker could be specifically tasked with making sure the products required to hedge the cap are available and liquid. This service would benefit all players in the market so its costs should be shared amongst all, this is likely to reduce costs to customers overall.

We recommend Ofgem take this into consideration and review the current shape allowance within the cap, remaining mindful of the fact that we cannot provide accurate data on shape costs incurred until after the period in question.

The MSC provides insufficient protection

Although not strictly part of this consultation, the interaction of the MSC with the broader price cap reforms is an important consideration. Ofgem's analysis underpinning its *Decision on changes to the Market Stabilisation Charge* is based on an arbitrary assumption with no evidence. Ofgem assumes suppliers receive an "acquisitions benefit" worth 0.9% EBIT based on an assumption that "*most switchers will probably end up with one or other of the existing firms*" and that firms are "*likely to be able to capture a proportion of the benefit of*

the falling prices transitionally as competition adjusts". Ofgem presents no evidence to support this assumption and has not consulted to assess whether any such benefit exists. Without this 0.9% "acquisitions benefit", Ofgem's own analysis shows that its proposed parameters (10% trigger, 85% sharing factor) lead to negative EBIT for the notional supplier: -0.5% in a flat fall, -0.8% in a sharp fall.

The MSC should be set to a level that, at the very least, prevents a supplier making negative EBIT. Discounting the unevidenced "acquisitions benefit", none of Ofgem's proposals do this. Ofgem should review this analysis and, in the absence of robust justification of an "acquisitions benefit", should remove this from the analysis and propose parameters that ensure suppliers are not loss making. This is likely to mean a 0% wholesale cost trigger, and a 100% sharing factor. This would robustly mitigate the volume risk that is imposed upon suppliers as a result of the price cap methodology for the duration of the MSC, noting that this is currently a temporary mechanism.