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Sent by email to: [Dan.Norton@Ofgem.gov.uk](mailto:Dan.Norton@Ofgem.gov.uk); [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk)

Dear Dan

## **Price cap - Statutory consultation on changes to wholesale methodology: NON-CONFIDENTIAL VERSION**

We welcome Ofgem's recognition that it is in the interest of consumers for suppliers to be able to recover efficiently incurred costs. With the principle of efficient cost recovery in mind, our main comments on Ofgem's proposals relate to (a) mitigating and recovering backwardation costs, (b) monitoring and recovering any future unexpected SVT demand costs and (c) ensuring accuracy of the cap allowances through appropriate disclosure.

Looking further ahead than the structure of the price cap from 1 October 2022, we believe that a more fundamental review of the purpose and nature of price regulation is needed to consider the appropriate balance between competing objectives, to ensure the best protection for consumers over the longer term. Particularly in the context of the forthcoming Energy Security Bill, we encourage BEIS and Ofgem to engage with all relevant stakeholders to define the characteristics of the energy market that best protect current and future consumers, and then design price regulation to deliver those objectives. 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.

### **Mitigating and recovering backwardation costs**

- We strongly support Ofgem's "ex ante" approach to backwardation costs because it will lower the overall costs to consumers by mitigating the risk in advance. The provision of certainty that is provided through the ex ante as opposed to an ex post approach is extremely important to ensuring the stability of the market and service for customers in the short term, as well as investability over the longer term. ✕
- We continue to believe that the use of any "deadband" is arbitrary and irrational. Ofgem's justifications for the deadband do not stand up to scrutiny. The deadband is not needed to levelise costs across seasons because levelisation can be done entirely through the recovery

mechanism. Ofgem asserts that “normal market conditions” will return - and that when they do - backwardation costs will be netted off by contango benefits within the life of the cap. These assertions cannot be justified. The ex-ante approach should be simple to calculate, mechanical to implement and be a pass-through of efficiently incurred costs like most of the other components of bill; the deadband is an unnecessary complication that is not in the consumer interest.

- Ofgem’s proposal to spread backwardation costs for any given period over 12 months will not ensure recovery of efficient costs unless it takes into account (a) customers moving on and off the cap, (b) working capital costs and (c) that the cap may end prior to the end of any given 12 month recovery period.

### **Monitoring and recovering any future unexpected SVT demand costs**

We agree that reducing the lag between the hedging index assumed in the cap and spot wholesale prices will reduce volume risk. However, there will still be a lag and therefore significant volume risk will remain, particularly if the Market Stabilisation Charge (MSC) is loosened or removed. Therefore, Ofgem should keep under review unexpected SVT demand costs and provide an allowance if necessary.

### **Appropriate disclosure**

We welcome Ofgem’s use of disclosure to allow suppliers’ representatives to review, in a constructive manner, its calculations related to price cap cost allowances. For example, Ofgem has recently allowed suppliers’ representatives to review the COVID debt true-up models and the SMNCC models, providing useful feedback. Such disclosure has to date not happened for backwardation costs, unexpected SVT demand costs or shaping and imbalance costs that are feeding through to Ofgem’s decisions on allowances. In the interests of transparency, we urge Ofgem to permit disclosure for these costs, or otherwise provide a justifiable explanation as to why disclosure would not be appropriate for these costs.

We include some additional technical points in the Appendix below.

Yours sincerely

Tim Dewhurst  
**Director of Regulatory Affairs and Policy**

## Appendix – additional technical points

This appendix describes additional technical issues which Ofgem will need to have regard to when it amends the cap methodology, which have not already been covered elsewhere such as in the CfD costs consultation<sup>1</sup>. These include:

- how the potentially higher transaction costs associated with a move to quarterly updates should be addressed;
- how the impact of customer churn away from SVTs should be accounted for in the backwardation adjustment;
- how the CPIH indexation should be adjusted in the context of quarterly updates; and
- comments on Annex 4 (Policy Cost) and Annex 2 (Wholesale Cost) that we have not already provided bilaterally to Ofgem.

### Transaction costs

Ofgem is not minded to update the allowance for transaction costs. ✂

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We also disagree with Ofgem's expectation that possible transaction costs will be offset by the benefits of lower volume risk and collateral requirements:

- Despite the apparent lower volume risk, the cap was never intended to deal with the magnitudes of volume risk that we have experienced of late. Indeed, this is the reason for the introduction of the Market Stabilisation Charge and we expect a *higher* volume risk with the quarterly approach in the current environment than with the seasonal approach at its outset.
- We expect the reduction in collateral costs to be low compared to the higher transaction costs. ✂

Given the uncertainty in these costs, it is possible that an efficient supplier following Ofgem's hedging guidance will incur costs that cannot be recovered under the cap. We suggest that Ofgem mitigates this risk as follows:

- For cap periods 9A, 9B, and 10A, Ofgem should monitor the transaction costs incurred by suppliers on an ex-post basis (for example, by collecting data on bid offer spreads). If these costs materially exceed the allowance in the cap, an ex-post adjustment will be required. Such an ex-post adjustment should be carried out through the adjustment allowance, together with an amendment to the MSC to ensure that suppliers can recover these costs even in the event of switching from SVTs to FTCs. It is important to recognise that a quarterly cap period has not been observed before, and the second quarter in a year is a challenging period to hedge.
- For subsequent cap periods, Ofgem should have sufficient information to determine whether the ex-ante allowance in the cap should be adjusted.

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<sup>1</sup> [Consultation on amending the methodology for setting the Contracts for Difference \(CfD\) cap allowance | Ofgem](#)

## Impact of customer churn on backwardation adjustment

While we welcome Ofgem's introduction of an ex-ante adjustment for backwardation costs, it is important that suppliers are still able to recover these costs even if customers move off the cap onto FTC products. This risk is especially pertinent now due to the substantial volatility in the market, and the large number of customers who have historically been on FTCs but are currently on default tariffs.

The costs that need to be recovered (relating to basis risk) are costs relating to purchasing energy for customers currently on SVTs. It would therefore be most equitable to ensure that these costs are faced by all customers currently on SVTs, not just those who may remain on SVTs after any reversion of the market back to historic patterns.

The Market Stabilisation Charge provides a simple way to ensure that this occurs: Ofgem should ensure that, if and when SVT customers switch supplier, the supplier that receives a customer is required to compensate the customer's original supplier for the element of the backwardation adjustment which the customer would otherwise pay under the price cap. This could be operationalised as follows:

- a. For each week, Ofgem would calculate the total backwardation adjustment set to be recovered over the following four quarters. We denote this figure, in £/MWh, as  $bk$ . For example, for the period commencing in October 2023 and a customer leaving on the 15<sup>th</sup> of November 2023, this would include:
  - i. The full backwardation adjustment for the period (to be recovered over four quarters) owed due to backwardation costs calculated for the period commencing in October 2023 and incurred during the supply period of 1 Oct 23 to 14 Nov 23.
  - ii. Three quarters of the backwardation adjustment calculated for the period commencing July 2023.
  - iii. Two quarters of the backwardation adjustment calculated for the period commencing April 2023.
  - iv. One quarter of the backwardation adjustment calculated for the period commencing January 2023.
- b. The MSC calculation would be amended as follows:

$$A = x \cdot l \cdot t \cdot c + bk \cdot u$$

Where  $u$  accounts for the headroom, EBIT, and PAP components which would be applied to the adjustment allowance and would be unrecovered if a customer churned away – i.e.

$$u = 1 + HAP(1 + EBIT + PAP) + EBIT + PAP$$

## Electricity SLC 28AD.11 and Gas SLC 28AD.10

It appears that Ofgem needs to update Electricity SLC 28AD.11 and Gas SLC 28AD.10. The existing licence conditions refer to Subsequent Charge Restriction Periods running from April to September, and October to March. These will need to be amended to match the new definitions of Subsequent Charge Restriction Periods. More generally Ofgem should ensure that the new definition of Subsequent Charge Restriction Periods is accurately reflected throughout the electricity and gas supply licences.

## Comments on Annex 4 (Policy Cost) and Annex 2 (Wholesale Cost)

- Annex 4 Policy Cost:
  - Tab 3h Losses: Ofgem has chosen an approach of completely removing (deleting) everything CfD related from this Annex, but has left in the CfD losses in table 2 of tab 3h. Ofgem should delete table 2 of tab 3h as it is now redundant.
- Annex 2 Wholesale Cost:
  - Tab 7C CfD input: Ofgem has added new sections relating to “Payments forecast (£)” and “Expected Levy Payment (£/MWh)” but nothing links to these new sections and so we are not able to validate how Ofgem intends to use these new inputs. It is also not clear why the Payments forecast (£) section is needed if Ofgem is adding a section for the Expected Levy Payment (£/MWh). ✗
  - If the forecast CfD payment is negative then the Green Excluded Energy uplift should not be applied, to reflect that suppliers would be acting irrationally if they submitted certificates to exempt themselves from a credit. A simple change to the formula to apply the uplift only if the quarterly cost is positive would fix this.

## Other operational considerations

We are considering the interaction of the reduced price cap period and notification requirements with existing licence conditions and will revert to Ofgem separately if we identify any issues.