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Leonardo Costa
Ofgem
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Dear Leonardo,

Price cap - consultation on possible wholesale cost adjustment

Ofgem is right to identify a number of areas of exceptional costs that suppliers are facing as a result of the extreme volatility we see in the market today. Ofgem needs to take action to ensure suppliers can recover these legitimate costs and prevent further supplier failure which would increase costs to customers overall and place a disproportionate share of those costs on customers who haven't driven them and are more likely to be vulnerable.

In our response to Ofgem's statutory consultation on changes to the wholesale methodology we highlight a significant risk that allowances will be under-recovered because Ofgem is adjusting the price cap rather than recovering the exceptional costs from all customers in the market (on the basis that all customers benefit from the price cap by virtue of the free option it provides). This principle is equally true for adjustments proposed in this consultation, Ofgem needs to address this risk of under-recovery and ensure fair allocation of the costs to customers who drive them by recovering costs market-wide. For an interim period, until this can be achieved, we outline in our response to Ofgem's statutory consultation on changes to the wholesale methodology how the market stabilisation charge can be adapted to account for allowances for unrecovered exceptional costs when assessing a supplier's hedged costs.

We set out detailed thoughts on the issues covered in the consultation in Appendix 1 but would highlight the following:

- **The cost of unexpected SVT demand remains significant and Ofgem should include an adjustment for cap period 8 when setting the next price cap.**
  We have seen ✂. The volume risk suppliers are exposed to continues to build which will also drive higher costs as the market falls. We note that Ofgem's current

parameters for the MSC result in the notional supplier making negative EBIT when stripping away the unevidenced "acquisitions benefit".

- **Shaping and imbalance costs are likely to be significant, but conclusions cannot be drawn until delivery is complete**
  We are concerned that Ofgem has reached an initial view that costs for period eight do not warrant an adjustment, we cannot see that robust evidence could support this view given that costs will not be known until period eight is over. Ofgem should keep open the possibility of the need for adjustment and note that early indications show the costs for period nine are likely to be significant.

- **Offsetting of costs with existing allowances is not reasonable**
  Recent market conditions have driven numerous costs and risks for suppliers; some of these are being partially addressed by Ofgem, many are not. It is not appropriate to use existing allowances to offset some costs unless all other costs are addressed in full (and we are a long way away from this). If anything, recent experience has shown that existing allowances are insufficient and should be reviewed with a view to increasing them, reflecting the level of risks suppliers now face.

- **Any benchmarking needs to be based on prudent risk management**
  We are concerned that an approach to benchmarking that focuses on lowest costs could encourage reckless risk taking as suppliers are forced to gamble in order to meet cost benchmarks. Any benchmarking must reflect prudent risk management and discount extreme outcomes driven by inappropriate risk management.

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

The cost of unexpected SVT demand remains significant and adjustment for Summer 2022 is necessary

As Ofgem outlines in its consultation, the data we submitted in our RFI response in April remains broadly reflective of our costs. For summer 2022, ✂. We'd highlight that our updated Winter 2021/22 ✂.

Given the uncertainties involved, we would only be able to provide a more accurate view for cap period eight in October, when our customer number position is better understood.

The volume risk suppliers face in the current market remains extremely difficult to predict and manage in both possible scenarios; if prices rise or stay high there is a risk of even higher unexpected SVT, if prices fall suppliers are exposed to selling back into a falling market.

The continued position of SVT as the cheapest available product has meant that the "SVT bubble" has continued to grow, which not only means a higher unexpected SVT cost for the Summer 22 period, but also increases the risk range for cap period nine due to wide ranges in potential outcomes in relation to the number of customers that will be on the SVT product across Q4 & Q1.

Despite the introduction of the MSC and the move to a quarterly cap, significant volume risk in both rising and falling price scenarios remains. As highlighted in our response to the statutory consultation on changes to the price cap methodology, we note that 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.

Shaping and Imbalance is expected to be one of the most significant costs for suppliers this winter

Estimating shaping and imbalance costs in advance of delivery is not possible with any degree of accuracy given the volatility we continue to see in wholesale markets. We would caution against Ofgem drawing conclusions on the need to adjust or not until delivery is complete. While basis risk can be calculated in advance, the combined impact of shaping and imbalance costs can only be accurately measured post-delivery.

Ofgem states its initial view is to not adjust for shape and imbalance costs in cap period eight. We are concerned that this initial view is being taken based on incomplete and statistically unsound data. ✂ we cannot see how any other supplier could provide Ofgem with a robust forecast. There is a high risk of inaccuracy in any data gathered at this stage as a result so Ofgem must keep this question open until delivery of period eight is complete.

✂. However, early indications show shaping and imbalance is likely to be one of the most significant costs for suppliers in Winter 22. Therefore, there is a high risk that the current allowance will not be sufficient and Ofgem needs to prepare for further adjustment once costs are known.

Whilst we recognise the difficulty Ofgem faces in trying to ensure that suppliers are not unduly exposed to risks during these temporary challenging market conditions, we are seeking a firm commitment that the review of the shaping and imbalance costs versus allowance will continue to be carried out and the appropriate adjustments will be implemented.

Ofgem needs to strike a balance between the many challenging trade-offs it faces, and E.ON is committed to continue offering support and sharing data to ensure the fairest mechanism is achieved.

Offsetting unexpected SVT costs against additional allowances or savings

Additional risk allowance

We acknowledge that part of the rationale for the 1% additional risk allowance was the potential for unexpected shocks; however, the costs resulting from the recent volatility in the wholesale market are numerous and significant. Ofgem has partially addressed some of these costs, but many have not been addressed at all or to levels that reflect the actual costs incurred (for example, suppliers are still exposed to significant backwardation costs as a result of the deadband, as outlined above, the MSC parameters still result in negative EBIT for the notional supplier). The 1% allowance is no longer sufficient given the current market environment, the multitude of risks not covered by the price cap and the increased cost of purchasing strategies that suppliers are required to use in order to hedge the demand volumes in line with the SVT cap mechanism

The risks suppliers face in the current market are extremely difficult to predict and manage and not comparable to the 2018 market conditions.

Alongside increased price volatility, a significant reduction in wholesale market liquidity, as communicated on multiple occasions, has heightened the volume and spread risk faced by suppliers. This is preventing suppliers from hedging in accordance with the SVT cap mechanism. In order to achieve a level of risk protection, suppliers have to use proxy hedging (e.g.. by purchasing seasons instead of quarters or a different fuel in order to hedge) which increases both risk and transaction costs. These difficulties, exacerbated by the move to a quarterly cap, and coupled with an insufficient shaping allowance and various other risks not adequately priced into the cap are already exceeding the existing 1% risk allowance.

It is therefore inappropriate for Ofgem to suggest that this allowance could be used to cover some of the costs incurred because of unexpected SVT demand or shape and imbalance risk. It should not be used to offset one particular cost that Ofgem identifies without a thorough understanding of every single cost that suppliers face. Any question of using the 1% as an offset would only be reasonable if Ofgem were compensating suppliers for every single cost resulting from the current extreme volatility, we are far from this position.

Switching costs

We agree that switching rates have fallen significantly due to the cap being the cheapest tariff available for most customers, however a significant proportion of any associated cost saving is simply a deferral due to an expectation of a significant increase in switching when the wholesale market stabilises (noting that Ofgem's approach to recovering allowances via the SVT cap, rather than a market-wide levy as we have suggested, will drive switching even without falling wholesale prices).

If Ofgem were to offset unexpected SVT costs based on a reduction in switching costs, it would be logical to then add an allowance to account for increased switching costs when the market returns to a more normal state. This outcome would be perverse, therefore any perceived saving in switching costs should not be used to offset unexpected SVT costs.

By considering lower switching costs incurred by suppliers, this could potentially create a situation where the cost of increased switching in future periods is paid for by less engaged customers, who receive no benefit from increased switching rates.

Similar to the SoLR costs, and the lagged recovery of backwardation and unexpected SVT demand, customers who are not causing the unexpected SVT costs in the first place would disproportionately be shouldering the burden by paying for them compared with more engaged customers who are likely to switch without paying for the costs which they have driven.

Reducing the switching allowance in times of lower churn could set an expectation for it to be continuously adjusted and increased in times of higher churn. This does not seem a sensible thing to do. If an allowance is to be linked directly to specific churn levels, there needs to be more detailed analysis of what constitutes "normal" churn. Increasing the allowance in times of higher churn will mean that SVT consumers will be subsidising the costs incurred by suppliers offering cheaper tariffs, which is not in line with the purpose of the price cap in converging market prices between capped and non-capped tariffs.

CfD benefit

In line with our prior consultation responses and models shared with Ofgem, we do not support Ofgem's view that all suppliers should have obtained a potentially deductible CfD benefit. We assume most suppliers will hedge CfD costs, therefore there is very little CfD benefit being realised by suppliers despite costs reversing as the hedge will have offset any benefit that would have been obtained.

Similar to Ofgem's expectations around suppliers managing wholesale risk by having a hedge in place, we believe that a well-managed supplier would have a CfD hedge that protects them from significant movements in costs and therefore there should not be any assumed benefit or netting against CfD for cap period eight.

This view has already been raised and acknowledged by Ofgem as part of the December wholesale consultation.

EBIT and Headroom allowances should not be used to offset costs

In absolute terms, the indexed allowances have increased in line with higher wholesale costs, however, the overall percentage is maintained. As outlined above, there are numerous costs and risks that have increased as a result of current wholesale market conditions and the state of the economy more generally, many of which are not addressed by Ofgem.

The increased costs across a suppliers' business are too numerous to list but examples of those not addressed by Ofgem include increased cost of capital, increased bad debt, increased wholesale credit cover and increased RO mutualisation.

At the time of establishing the EBIT and headroom allowances the market was much more stable. Suppliers are now active in an extremely volatile, higher risk environment which raises a question of whether the current allowances are sufficient.

Any benchmarking of suppliers' costs should be linked to prudent risk management

An assessment mechanism based purely on cost outcome (i.e. weighted average, lower quartile) does not provide a suitable methodology for establishing the benchmark of an efficient supplier. A purely beneficial cost outcome in the current context of extreme market volatility is not a true reflection of a prudent and efficient supplier. If irresponsible or ad-hoc decision making as opposed to prudent risk management has led to a one-off benefit or lower cost in a specific market context, this should not be the standard approach favoured by the regulator and used as an example to protect consumers in the longer term. Following this approach encourages reckless risk taking as suppliers are forced to gamble in order to meet cost benchmarks.

The assessment of an efficient supplier should be based on what Ofgem view as effective and prudent risk management. We propose that Ofgem uses several benchmarking ranges based on the timeline of when it would have been reasonable and prudent for a supplier to have topped up SVT volumes as a result of market price evolution for each cap period. Alternatively, if this proves to be too complex, we believe the weighted average of reasonable approaches should be used and figures resulting from poor risk management practices should be excluded regardless of any benefit (or higher cost) a supplier may have observed as a result.