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Dear Leonardo,

PRICE CAP – CONSULTATION ON POSSIBLE WHOLESALE COST ADJUSTMENT

We are pleased to respond to your consultation on whether/how to adjust the cap from cap period 9 to account for additional unexpected Standard Variable Tariff (SVT) costs and shaping and imbalance costs incurred during periods 8 and 9. Our response to Ofgem's consultation is in Annex 1, but we summarise the main points below.

Unexpected SVT

We remain of the view that Ofgem should allow suppliers to recover actual unexpected SVT costs incurred, rather than applying a standard price cap allowance as is proposed. Under Ofgem's current approach, including in its decision on the April 2022 price cap adjustment for Winter 21/22 costs, suppliers have been significantly over- or under-compensated for unexpected SVT costs, creating a massive and unjustifiable market distortion. We believe that 'non-efficiency' factors (notably the proportion of Fixed Term Contract (FTC) customers and indeed the timing of product maturities) are the primary drivers for cost differences. The extent of 'efficiency' in suppliers' hedging decisions is severely over-stated in this consultation and should not be seen as a reason not to allow actual cost recovery, we consider this in more detail in section 4 of the annex. As previously explained¹, Ofgem has the ability to adopt a levy-based approach to enable suppliers to recover the actual costs incurred.

Notwithstanding our position on the need to institute a levy mechanism, Ofgem must progress with its initial view to correct for unexpected SVT costs from cap period 8 and it is essential that Ofgem considers the costs incurred without judging suppliers' hedging decisions with the benefit of hindsight or claim efficiency based on how suppliers forecast SVT customer numbers in advance. The structure of the cap is such² that suppliers have to accurately forecast the number of SVT customers well in advance of the price cap period and are liable to make losses on both price increases (when unexpected customers join) and price decreases (when customers unexpectedly leave). This impact will be repeated, with additional losses and gains throughout the price cap period and it is only with the benefit of hindsight that a particular response can be judged relative to

¹ Letter from Andrew Ward, ScottishPower to Jonathan Brearley, Ofgem, of 25 March 2022

² This was so for the 6-2-12 price cap structure and remains true for the proposed 3-1.5-12 price cap structure although with lower associated risks.

other responsible alternatives. Experience of incurring costs for unexpected SVT in one period does not make a supplier more or less able to forecast prices and the supplier is likely to be punished for either choice made depending on the actual outcome, potentially leading suppliers to have little confidence in hedging ahead. Indeed, Ofgem has recognised this issue in its decision on the market stabilisation charge³ in February 2022. [X]

Shaping and imbalance

We do not believe that moving to a quarterly cap addresses all the issues associated with the shaping and imbalance allowance in the cap. The data this allowance was based on in 2018 is no longer applicable and we believe Ofgem should work with suppliers and expert advisors to develop an ex-ante approach that more appropriately estimates shaping and imbalance costs.

Other matters

We welcome Ofgem's commitment to address bad debt and EBIT allowances in separate consultations.

We also welcome Ofgem's commitment to review the evidence relating to backwardation costs from cap period 7, in light of errors identified by suppliers in Ofgem's interpretation of their data, and to make a decision on amending the allowance for this.

With the increased level and volatility of National Grid ESO's Balancing Services Use of System (BSUoS) charges, it is vital that Ofgem provides timely confirmation of the move to fixed BSUoS charges from 1 April 2023 (by implementing CUSC mod CMP361) to remove this additional source of risk for suppliers, one which has increased with the approval of CMP 308.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy

³ [Decision on short-term interventions to address risks to consumers from market volatility | Ofgem](#) para 3.55

**PRICE CAP – CONSULTATION ON POSSIBLE WHOLESALE COST ADJUSTMENT –
SCOTTISHPOWER RESPONSE**

1. Introduction

In its 4 February 2022 decision Ofgem decided that *“the existing methodology of the cap did not fully account for the costs, risks and uncertainties currently facing suppliers. We considered that changing the methodology was in the long-term interests of consumers.”* ScottishPower considers that the rationale Ofgem employed in this decision still stands: the market has remained volatile since February and indeed prices peaked again unexpectedly in early March 2022, a consequence of the tragic war in Ukraine. As a result, suppliers have again been faced with significant additional efficient costs in cap period 8 and beyond. This annex comments on Ofgem’s proposed approach to unexpected SVT costs and imbalance and shaping costs, as well as its approach to implementation.

2. Unexpected SVT costs and benchmarking approach

Our unexpected SVT costs for cap period 8 comprise costs committed at two distinct periods of time (Table 1):

- **July to December 2021:** Costs for cap period 8 that were committed/hedged at the same time as those that were covered by Ofgem’s 4 February decision which focused on cap period 7. In response to Ofgem’s November consultation, we submitted our unexpected SVT costs for cap period 7 and cap period 8 due to the fact that the observation window had already begun (highlighted in yellow in Table 1 below). [X]
- **March 2022:** Costs for cap period 8 that were related to the price spike at the start of the Ukraine war where, instead of prices coming down as was expected, prices increased and our customer forecasts changed as a result. It is worth noting that further costs for cap period 7 were also committed / incurred at this time (£[X]m), and we believe that Ofgem should allow us to recover these period 7 costs in full. The March price spike was unexpected: suppliers and Ofgem were preparing for price decreases⁴ and looking at the market stabilisation charge (MSC) as a way of reducing these risks. At this point also, the MSC was set to recover so little of supplier losses that in our view it would not have achieved its goals.

⁴ And/or at least some convergence of fixed term tariff prices and SVT.

Table 1: ScottishPower unexpected SVT costs (as per April 2022 RFI response)

	Cap period 7 Oct 21 – Mar 22 (£m)	Cap period 8 Apr-Sep 22 (£m)	Cap period 9 Oct 22 – Mar 23* (£m)
Power (Jul to Dec)	[X]	[X]	
Gas (Jul to Dec)	[X]	[X]	
Total (Jul to Dec)	[X]	[X]	
Power (March)	[X]	[X]	[X]
Gas (March)	[X]	[X]	[X]
Total (March)	[X]	[X]	[X]
Total	[X]	[X]	[X]

The remainder of this section considers Ofgem’s rationale and arguments relating to why a benchmark below the weighted average may be selected and the offsets.

Benchmarking – views on causes for differences behind costs

Ofgem stated in February that *“Going forward, we expect suppliers to respond to the now-known risks of customer demand variance and will take that into account if we make a future allowance for unexpected customer demand.”*⁵ In this consultation (paragraph 3.24), it states “With this experience and additional time to respond, suppliers should have been able to manage these costs more efficiently for cap periods eight and nine”. Ofgem appears inclined to use this expectation to justify its approach to judging the efficiency of supplier decisions, namely, that having experienced and suffered losses from the risk of customer demand variance, a supplier would be able to make improved decisions.

Ofgem has further highlighted non-efficiency factors that it considers are not within a supplier’s control as well as several efficiency factors that it considers are within a supplier’s control, on the basis of which it argues that an efficient supplier would incur lower costs (Table 2). Ofgem says it is considering whether suppliers with lower unexpected SVT costs are more efficient and have better used their prior experience of unexpected demand. If this is the case, then Ofgem could use a lower quartile benchmark for unexpected SVT costs or indeed exclude some supplier costs from a weighted average calculation or apply an efficiency discount to costs.

Table 2: Ofgem list of efficiency and non efficiency factors

Non efficiency factors	Efficiency factors
(i) Starting proportion of FTC customers (ii) Engagement of base (iii) Methodological (iv) Natural variation	(i) Update customer forecasts frequently (ii) Adjust traded position frequently (iii) Aim to hedge for expected SVT (iv) Hedging strategy for FTC customers (v) Delivery efficiency

We strongly consider that the non-efficiency factors and a large amount of luck outweigh any possible impact of efficiency factors. We comment in detail on Ofgem’s assessment of non-efficiency and efficiency factors in sections 3 and 4 respectively.

⁵ ‘[Price Cap - Guidance on treatment of reasonable risk management practices in future default tariff cap proposals](#)’, Ofgem, 4 February 2022, p4.

It appears that one supplier reported zero unexpected SVT costs. Ofgem should satisfy itself that this is a genuine measure of economic cost and not an artefact of the suppliers internal reporting or trading arrangements.

Ofgem noted in its consultation (para 3.24) that experience should have enabled suppliers to manage costs more efficiently: *“However, suppliers already had significant levels of unexpected SVT demand in cap period seven. With this experience and additional time to respond, suppliers should have been able to manage these costs more efficiently for cap periods eight and nine”*. We do not believe that managing the process more efficiently should necessarily lead to lower outturn costs since Ofgem is equating efficiency and low outturn cost which is not correct as we describe below⁶.

In summary, we consider that virtually all the differences between suppliers are outside suppliers’ control (either because of differing customer bases or differing luck) and it would be entirely inappropriate to benchmark on a lower quartile (LQ) basis. If Ofgem is to allow recovery via an allowance in the price cap (rather than the fairer levy linked to actual cost basis), then Ofgem should base that allowance on suppliers’ weighted average costs.

3. Unexpected SVT - non-efficiency factors

Ofgem has identified four factors by which suppliers’ cost may have varied that it considers would be largely outside a supplier’s control.

(i) Starting proportion of FTC customers

We agree with Ofgem that a supplier’s starting proportion of FTC customers is the most important non-efficiency factor driving unexpected SVT costs – and we believe this is a key reason why Ofgem should adopt a levy-based approach to cost recovery.

Ofgem says (para 3.28) that having a high proportion of FTC customers is *“at least a neutral feature of a supplier’s business rather than a sign of pre-existing inefficiency”*. We acknowledge that new entrant suppliers may have had a high proportion of FTC simply by virtue of their customer acquisition approach, but in the case of incumbent suppliers (which still account for the majority of the market), a high proportion of FTC customers is predominantly a result of the supplier making greater efforts to engage its customers, as both Government and Ofgem have encouraged them to do.

(ii) Engagement of customer base

We agree that level of engagement is also a relevant non-efficiency factor, though in practice we would expect it to correlate with the starting proportion of customers on FTC.

(iii) Methodological

We agree that this is unlikely to be an important non-efficiency factor, at least for period 8 where cost estimates are based on actual out turns rather than forecasts.

⁶ However, we do consider that the experience of previous price spikes, including learning from customer behaviour, could impact on the decision-making process and ScottishPower found this to be the case in some process improvements when prices spiked again in March as a result of the Ukraine war.

(iv) Natural variation

As noted below, we believe Ofgem is wrong to categorise what are essentially lucky or unlucky hedging decisions as efficiency factors. In our view, they have more in common with the example given by Ofgem for natural variation, namely cost differences due to small differences in timing of purchases.

4. Unexpected SVT - efficiency factors

Ofgem has identified five 'efficiency factors' where supplier's costs may have varied for reasons that Ofgem considers would be largely within a supplier's control

(i) Update customer forecasts frequently

Ofgem says (para 3.34).it did not identify any particular concerns about suppliers' approaches in this area, and there was some evidence of suppliers acting more quickly in current market circumstances. We agree; this is certainly our view in the case of ScottishPower.

(ii) Adjust traded position frequently

Ofgem says (para 3.35) it did not identify any particular concerns about suppliers' approaches. We agree with this finding based on ScottishPower's experience.

(iii) Aim to hedge for expected SVT customer numbers

Our principal objection to Ofgem's categorisation of hedging decisions as a matter of efficiency (and hence suitable for a benchmarking approach other than weighted average) is that most of the decisions in question can only be identified as 'good' or 'bad' with the benefit of hindsight. The best that a supplier can do is reduce the risk associated with its hedging decisions, not the expected (in a statistical sense) cost.

Ofgem appears to acknowledge (para 3.33) that the main factor under suppliers' control is the risk (or variability of outturn costs), not the expected cost, but argues that higher costs resulting from riskier strategies should not be compensated because customers would not benefit from lower costs:

"Suppliers may adopt approaches with different degrees of riskiness. Some behaviours may or may not be inefficient in the sense of having higher expected costs in the long run, but may still increase the variability of outturn costs. Suppliers are subject to the cap, and we expect suppliers to manage risks prudently in this context. We do not consider that it would protect default tariff customers to compensate suppliers through an adjustment for incurring high costs as a result of risky strategies. This is because customers would be unlikely to benefit from an offsetting adjustment in circumstances where the strategies led to low costs."

We disagree with Ofgem's reasoning on two grounds:

- Ofgem appears to assume that strategies which lead to higher costs are likely to be riskier. There is no reason why that should be so in the case of unexpected SVT: a less risky strategy could easily outturn worse (or better) than a riskier strategy – the degree of risk will only be revealed in the *variability* of the outturn over multiple iterations.

- Ofgem is wrong to assume that customers ‘*would not benefit from lower costs*’. If Ofgem were to calculate an unexpected SVT allowance based on a weighted average of supplier costs, suppliers who have incurred lower costs would bring down the weighted average. This is illustrated in the stylised example below, where suppliers with lower outturn costs would reduce the overall weighted average.

In summary, we believe Ofgem is wrong to equate efficiency with lower outturn costs in the context of unexpected SVT. To illustrate this point, Table 3 and Table 4 show stylised pay-off matrices for different hedging decisions under different market outturns for business as usual SVT (largely disengaged customers) and for ‘unexpected SVT’ (engaged customers) respectively.

Table 3: Payoff matrix for business as usual SVT (generally disengaged customers)

	Δ cost relative to price cap allowance		
	Wholesale prices increase	Wholesale prices remain flat	Wholesale prices fall
Hedge straight away	neutral	neutral	neutral (customers stay on SVT so still recover costs through allowed revenue)
Delay hedging	-£££ (higher hedging costs than allowed in cap)	neutral	+£££ (lower hedging costs than allowed in cap)

Table 4: Payoff matrix for unexpected SVT (highly engaged customers)

	Δ cost relative to price cap allowance		
	Wholesale prices increase	Wholesale prices remain flat	Wholesale prices fall
Hedge straight away	neutral	neutral	-£££ (have to sell energy at a loss when customers don't move to SVT as expected)
Delay hedging (until customers default)	-£££ (higher hedging costs than allowed in cap)	neutral	neutral (no revenue benefit as SVT customers don't materialise)

Table 3 (BAU SVT) demonstrates the impact of the behaviours of many failed suppliers who chose not to hedge their SVT customers’ demand in advance and did very well during falling markets but came unstuck when markets rose. In this case, the ‘delay’ strategy has either a large positive or negative payoff and is clearly riskier than the ‘hedge straight away’ strategy which is more or less neutral for all market outturns (absent backwardation costs). We agree that suppliers should not be compensated if such risk-taking turns out badly.

Table 4 (unexpected SVT) demonstrates the dilemma faced by suppliers in the period October to December 2021, who had to decide whether to hedge straight away for customers who were expected to default onto SVT *if* prices remained high, or wait until the customers had actually defaulted on maturity. As the table shows, suppliers faced downside risk with either strategy: if prices increase, they face large unexpected SVT costs and if prices fall they face large costs as customers migrate off SVT (or do not default onto SVT as expected)⁷. At this time (prior to the invasion of Ukraine) it seemed equally (if not more) likely that prices would fall than increase; indeed, suppliers were asking Ofgem to move forward urgently with measures like the MSC in case this happened. In contrast to the previous payoff matrix, **neither strategy is obviously riskier than the other**. Both strategies have similar risks and

⁷ At this stage Ofgem was only consulting on the MSC and there was no guarantee it would be introduced. Even if it had been introduced, the parameters Ofgem was then proposing would have made it ineffective.

each will pay off under one market outcome but not the other. As we know with the benefit of hindsight, prices continued to rise in an unprecedented manner, and suppliers who opted for the delay (until customer default) strategy incurred additional costs relative to those who hedged straight away for the forecast volumes – but it could have gone the other way. In this context, we believe it is entirely reasonable for suppliers to be compensated for these costs as there is no sense in which their behaviour was risky, imprudent or inefficient.⁸

Ofgem suggests (para 3.36) that an ‘efficient’ supplier would hedge for expected SVT customer numbers in full and as soon as forecasts change. In evidence to a recent BEIS Select Committee,⁹ Kwasi Kwarteng and Daniel Osgood respectively highlighted the riskiness of hedging when markets are volatile:

“The issue with hedging is that it is very risky because, essentially, you are taking a bet or trying to insure yourself against price movements.”

“Forward markets then were extremely high. Markets have been quite volatile since then and, in many cases, have been lower, so the question of hedging or not hedging does not in itself lead to a lower cost outcome”

Ofgem CEO Jonathan Brearley has also noted the risk of making price predictions.

“When you look at the forward prices right now, there is upward pressure still, so you may see a rise in October....But the caution I have in predicting that, is I went back and looked at what we predicted in August, and the difference between those predictions - which were that the price cap would stay roughly level - versus what we’ve seen, are huge.”

In the consultation, Ofgem goes on to concede that in scenarios such as discussed above, different considerations may apply, but says it does not have sufficient evidence to conclude suppliers’ approaches were efficient:

“an efficient supplier would aim to hedge for its expected SVT customer numbers. If a supplier was not doing so, this could be a sign of inefficiency, unless there was a clear justification. In response to the RFI, there were cases where suppliers indicated that they had not hedged to their expected SVT customer numbers, at least at particular points in time. We recognise that suppliers were seeking to manage an uncertain situation, including policy uncertainty on the MSC, which mitigates the impact of falling wholesale prices. However, at this stage, we do not have sufficient evidence to conclude that suppliers’ approaches were efficient.”

For the reasons we set out above, we do not think it is possible to conclude in these circumstances that suppliers’ approaches were either ‘efficient’ or ‘inefficient’ – it is not obviously more ‘efficient’ to procure energy straight away for customers who are expected to default onto SVT and the confidence in forecasts of expected SVT customer numbers was low especially further into the future, decreasing confidence in hedging. The fact that the government, managing its own energy company, is not certain of the benefits of hedging shows that Ofgem should not be taking steps with the benefit of hindsight to declare supplier approaches to be efficient or inefficient without being very certain. In fact, Ofgem has recognised, in its decision on MSC¹⁰ that there are reasons suppliers may be more or less

⁸ Indeed, it may have been more prudent to take some time to see if price increases were a short term spike or likely to be more persistent, whilst analysing customer behaviour

⁹ <https://committees.parliament.uk/oralevidence/10332/pdf/>

¹⁰ “Importantly, the existence of the MSC should give suppliers greater confidence to hedge more fully for this summer, reducing the risks to consumers in the scenario of rising prices.” Para 3.55, Decision on short-term interventions to address risks to consumers from market volatility, 16 February 2022

confident to hedge more fully for expected SVT numbers and the MSC was proposed on 15 December 2021 to address that. There is no reason therefore not to compensate the costs or amend the approach to benchmarking.¹¹

Finally, we would note that from ScottishPower's perspective, the decisions we took were subject to thorough internal discussion and were reviewed on a weekly basis and reflected our experts' best assessment of the risks at the time. Scottish Power would challenge any suggestion from Ofgem that, based on the information available at the time, our decisions were less 'prudent' or 'efficient' than any other suppliers.

(iv) Hedging strategy for FTC customers

Ofgem notes (para 3.7) that if suppliers hedge ahead for FTC customers in a rising market, this could reduce the costs associated with hedging for unexpected SVT. It goes on to ask (para 3.37) whether and how suppliers have considered changing their hedging approach for FTCs.

All energy bought for FTC customers is a hedge, most frequently for one year but sometimes for two or three years depending on the tariff.

[3<]

In the most recent period of market volatility, the FTC market was moribund and FTC hedging and SVT hedging became two sides of the same coin, ie hedging ahead for FTC customers had the same effect as hedging for a forecast increase in numbers of SVT customers. For suppliers this is the same dilemma as we have discussed above in section (iii) and one for which no supplier unexpected SVT costs should be disregarded.

(v) Delivery efficiency

Ofgem speculates (para 3.38) that even where suppliers have similar strategies, there may be differences in delivery efficiency (eg how accurately they forecast demand) which may affect suppliers' costs. We doubt that this will be a material consideration. In the context of hedging activity, the main impact of forecasting accuracy will be on risk rather than expected costs. Any given forecasting error could work out positive or negative for the supplier, depending on how markets move, but higher forecasting errors are likely to lead to greater variability of outturn.

¹¹ Although our example above focused on the period around December 2022, before the MSC had been introduced, similar considerations would have applied following its introduction and until Ofgem's decision to strengthen the parameters. Even with the stronger MSC, the risk is only partially mitigated and suppliers cannot ignore the risks of a falling market.

Overall therefore, the above evidence supports our view that that the impact of Ofgem's proposed non efficiency factors on costs vastly outweigh the impact of any efficiency factors and therefore using a weighted average is the only appropriate approach

5. Unexpected SVT – Offsets

Ofgem says it wishes to consider whether there have been any other changes in supplier costs as a result of increased wholesale prices which it should offset against suppliers' unexpected SVT demand costs. We comment below on the potential cost categories identified by Ofgem.

1% additional risk allowance

Ofgem estimates (para 3.65) that the 1% additional risk allowance is worth £3 per dual fuel customer over cap period 8 (£9 annualised) and proposes to deduct 10% of the value in period 8 from any unexpected SVT allowance. The 10% figure is calculated on the basis that the 1% allowance is intended to reflect costs over time and a single 6 month period represents 10% of a notional 5 year price cap term. We would consider that risk and contingency allowances are already fully utilised.

Switching costs

Ofgem argues (para 3.72) that switching costs have fallen as a result of increased wholesale prices, due to fewer commission payments to intermediaries and lower internal administrative costs.

Although suppliers may have experienced slightly lower switching costs, the savings are likely to be less than they might appear at first sight for two reasons.

First, suppliers are likely to face a huge upswing in switching volumes (and hence commission fees to intermediaries) when wholesale prices eventually fall. Unless Ofgem is prepared to offer suppliers an allowance for these above average costs, it would be unfair to penalise suppliers at times of below-average costs. We think it would be simpler and fairer to recognise that these costs are likely to average out in the long run and exclude them from any offset.

Second, suppliers are likely to have incurred significant costs in standing down sales teams (and the processes that sit behind them) and will potentially face further costs in re-establishing them again. We do not expect the net cost savings to be particularly material, but if Ofgem does choose to request information via an RFI, it should take these additional considerations into account.

CfD benefits

Ofgem says (para 3.78) it intends to consider the CfD benefit in Period 8 alongside other costs in deciding whether there is a case for adjusting the cap, and commits to taking into account the latest estimates of CfD costs. This is very important given that the latest update from the LCCC suggests CfD receipts may be up to £500m lower this year as a result of delays in developers commencing CfD agreements.

Other allowances

We do not believe that any of the three other allowances identified by Ofgem should contribute to an offset:

- The **payment method uplift** reflects the increased bad debt, administration and working capital costs associated with payment by standard credit. All these costs will have

increased in line with (and probably faster than) increases in wholesale costs and there will be nothing left over.

- The **EBIT** allowance is intended to cover the necessary capital costs of running a retail business (which were woefully underestimated by the CMA as a result of making no allowance for risk capital). There is nothing spare here – indeed Ofgem has committed to reviewing the EBIT allowance in view of current perceptions of supplier business risk and we would like to see timescales for this process.
- ScottishPower's retail business made a loss of £294 million in 2021, a loss of £64 million in 2020¹², and [X] in 2022. In face of these losses, it is untenable to argue that there is additional capacity within the **headroom allowance**.

6. Shaping and imbalance costs

Ofgem says (para 4.44-45) that it is not minded to adjust for shaping and imbalance costs in cap period 8 because costs reported by suppliers were not material and systematic. For cap period 9, Ofgem considers there is currently too much uncertainty around suppliers' estimates to justify an adjustment. We have some sympathy with this view. [X]

Table 5: ScottishPower forecast of shaping and imbalance costs in Period 8 and 9 (whole domestic portfolio)

	Shaping & imbalance costs		
	P8	P9	P8+P9
Power (£m)	[X]	[X]	[X]
Gas (£m)	[X]	[X]	[X]
Total (£m)	[X]	[X]	[X]

Drivers of difference between suppliers

We agree with Ofgem that differences between suppliers' forecasts are almost certainly driven by differences in forecasting methodology as much by fundamental differences between suppliers.

As with unexpected SVT costs, we would expect non-efficiency factors to outweigh efficiency factors in explaining differences in outturn between suppliers. [X]. All of these elements minimise the risk but are likely to impact the average cost in the long run in only a small way. We therefore consider that a lower quartile benchmark would not be appropriate –cheaper costs are not equivalent to more efficient in this case.

Ex post or ex ante?

We can see two potential approaches that Ofgem could adopt to allow suppliers to better recover shaping and imbalance costs in periods of market volatility:

- **Ex post:** retain the existing fixed percentage allowances and provide additional allowances, as required, based on ex post true up of actual costs incurred against the allowance.

¹² Figures for aggregate supply business from CSS

- **Ex ante:** update the existing percentage allowances so that they can vary dynamically with market conditions. These allowances would reflect the expected value of costs (in a statistical sense) but might vary significantly from actual outturn costs in any given year, eg due to weather.

The ex post approach is potentially less risky for suppliers, as excess costs should be recovered in the year in which they are incurred, but could involve substantial administrative costs for both Ofgem and suppliers. It may also involve significant effort in developing an assessment methodology if the assessment of costs is to be put on a more robust basis.

The ex ante approach would be less burdensome for Ofgem and suppliers, but its feasibility would need to be investigated further. For example, in our follow-up RFI submission of 24 April, we provided details of our [\propto] based approach to estimating costs due to weather variability, for which the [\propto] was a key input. This suggests to us that it may be possible to create more dynamic ex ante percentage allowances which take into account observed volatility in the market.

We would encourage Ofgem to commission independent consultants to do a thorough ex post analysis of market data (including the most recent periods of volatility) and different suppliers' forecasting approaches, to understand how shaping and imbalance costs are likely to vary with market conditions, and consider how best this could be reflected in more dynamic allowances. With a better understanding of what may be possible in an ex ante approach, Ofgem could then consult on the relative merits of ex post and ex ante.

7. Implementation

Where suppliers have incurred excess costs through no fault of our own and as a result of the flawed design of the price cap, we would expect to be made whole for those costs in full, and with minimum delay. Suppliers should not be expected to continue to bear the brunt of a poor cap methodology and severe market volatility. As noted above and recently explained¹³ Ofgem has the ability now to adopt a **levy-based approach** to enable suppliers to recover the actual costs incurred. This would recognise the level of non-efficiency factors as well as the element of luck in the level of costs accrued by suppliers. We are extremely disappointed that Ofgem's consultation does not consider use of a levy, and if costs are considered to be efficiently incurred then creating winners and losers again is an untenable position.

Notwithstanding our views on a levy, our comments on Ofgem's specific implementation proposals are as follows:

- We support the proposal relating to the **format** of any adjustment which is to amend the 'adjustment allowance' in the cap model.
- We consider that separate adjustments by fuel, payment type (PPM/non-PPM), and electricity region, not meter type (single-rate/multi-register) seems appropriate. Application to the unit rate also seems appropriate.
- The **nature of any adjustment** – ie whether this would be a fixed amount, or whether Ofgem would true it up later by making a further adjustment once more data became available. Whilst we consider a fixed amount adjustment seems appropriate now, no one can predict the future and therefore we do not believe that Ofgem can or should prohibit any further changes should some further unexpected events occur. In those

¹³ Letter from Andrew Ward to Jonathan Brearley of 25 March 2022

circumstances, Ofgem should seek at the time to ensure any necessary adjustment is implemented; and

- The **duration over which to apply any adjustment:** As noted above, we believe suppliers should be made whole for costs with minimum delay. However, if Ofgem insists on recovering costs over a 12-month period, we have two key things to point out.
 - Whilst suppliers may be able to manage the cashflow impacts better than customers, this access to and use of capital is not a free resource and Ofgem must include the time value of money in its calculation at an appropriate rate. We note that Ofgem is proposing that the time value of money, increased working capital costs and funding of additional debt is a “free” option for suppliers. This cannot be the case and we urge Ofgem to consider its treatment of these costs and amend its approach to include the time value of money in its decisions. Supplier finances are already strained with parent companies bearing the brunt of losses and the assumption that they have unquantified cash at no cost and with no other uses for it to manage cashflow impacts is wrong.
 - In addition, there is a risk that if Ofgem does not adjust between price caps periods for changes in customer numbers, then suppliers will not be able to recover all of the allowance (or indeed may over recover). Ofgem must address for this by either changing the customer numbers in the allowance at each quarterly cap announcement ex-ante, or (as we prefer) an ex-post correction.

ScottishPower
June 2022