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for energy consumers

All interested stakeholders

Email: priceprotectionpolicy@ofgem.gov.uk

Date: 18 July 2023

Dear all,

Review of additional wholesale costs in the default tariff cap

In our price cap programme of work update in April, we signalled that, following a delay to the wider wholesale cost review, we would consider carrying out a short-term review of additional wholesale costs by winter 23/24. The intention was that such a review could consider whether there have been additional wholesale costs incurred over winter 22/23 that were materially and systematically different to the allowances.[1]

Following on from this, we are starting a workstream to review suppliers' wholesale costs for default tariff customers between October 2022 and September 2023. This will allow us to consider whether an adjustment to the default tariff cap ('cap') is necessary, in either direction. This open letter informs stakeholders about our next steps on this workstream. It also provides stakeholders with an opportunity to comment on our intended scope and rationale for this review.

Starting this review also aligns with the CEO open letter we published on 4 July 2023 on changes in the energy supply market.[2] As part of this letter, we set out that we expect the sector will move into profit this year. As it does so, we highlighted that we will continue to monitor and adjust the cap to ensure it continues to protect customers and fairly reflects the efficient costs of supply. In particular, we said that we will consider examining areas where risks that led to costs last year may contribute to a benefit this year, and ensure adjustments are considered on a symmetrical basis.

[1] Ofgem (2023), Price Cap – Programme of Work: Update, Table A1.1.
https://www.ofgem.gov.uk/publications/price-cap-programme-work-update
[2] Ofgem (2023), Changes in the energy supply market and Ofgem's approach to regulation.
https://www.ofgem.gov.uk/publications/changes-energy-supply-market-and-ofgems-approach-regulation

Context

The cap protects existing and future domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy. The cap is set out in legislation through the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act').[3]

We periodically review cap allowances. When doing so, we consider "whether a change in the costs facing suppliers is material and systematic, considering the market as a whole".[4]

We have made a number of adjustments to the cap in the context of exceptional events in recent years (the COVID-19 pandemic and wholesale price volatility linked to the Russian invasion of Ukraine). These adjustments have recognised that a notionally efficient supplier would have incurred increased costs, and have helped to support market stability.

Of particular relevance for this review, we previously made two temporary adjustments to recognise increased wholesale costs.

- In our February 2022 wholesale decision, we made an adjustment for increased wholesale costs during cap period 7 (October 2021 to March 2022).[5]
- In our August 2022 wholesale adjustment decision, we made an adjustment for increased wholesale costs during cap period 8 (April to September 2022).[6]

These adjustments covered three areas.

- Both adjustments included unexpected standard variable tariff (SVT) demand costs. Suppliers may incur these costs when more customers than expected move to or remain on SVTs, to the extent that they need to buy additional energy at a cost above the cap wholesale allowance. Suppliers could, in principle, instead incur benefits if the cost of buying additional energy was below the cap wholesale allowance.
- The February 2022 wholesale decision additionally included an adjustment for shaping and imbalance costs being above the allowance in the cap. Suppliers incur shaping and imbalance costs from refining their hedged positions to meet

[3] Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21
[4] Ofgem (2021), Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 4.16. https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap
[5] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[6] Ofgem (2022), Price Cap – Decision on possible wholesale cost adjustment. https://www.ofgem.gov.uk/publications/price-cap-decision-possible-wholesale-cost-adjustment

customers' demand. In principle, shaping and imbalance costs could instead be below the allowance in the cap.

- The February 2022 wholesale decision also included an adjustment for backwardation costs. However, we have since changed the cap methodology to include backwardation costs on an ongoing basis.[7] This is a symmetrical adjustment – the cap is higher due to backwardation costs in some periods and lower due to contango benefits in other periods.[8] We therefore do not need to consider further temporary adjustments.

For further information about these adjustments, please see the relevant decisions (ie those described and linked above).

In aggregate, these adjustments were worth £108 per dual fuel customer with benchmark consumption (or £105 per dual fuel customer with current typical consumption).[9] These were therefore significant interventions. We made these adjustments following careful consideration of customers' interests, with a view to ensuring that customers pay a fair price that reflects the efficient underlying cost to supply the energy. However, these adjustments have also clearly benefitted suppliers (relative to a counterfactual of not intervening).

Conditions in the retail market have now stabilised as wholesale prices have fallen. However, wholesale prices remain historically high, placing significant pressure on customers. As set out in our CEO's letter of 4 July, we are keeping the price cap formula under review to ensure that customers continue to pay a fair price that reflects the underlying efficient cost to supply the energy and it does not over-reward suppliers where a fall in prices may lead to benefits.[10] This includes the subject of this review – examining areas where suppliers were allowed to recover costs from last year to understand whether a similar 'benefit' has been created in current market conditions which should be recovered for customers.[11]

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[7] Ofgem (2022), Price Cap – Decision on changes to the wholesale methodology. https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

[8] For example, the backwardation adjustment in the cap was an additional cost in the first half of 2023 (cap periods 9b and 10a), but is currently negative in cap period 10b reflecting backwardation costs and contango benefits respectively.

[9] Benchmark consumption is 3,100kWh for single-rate electricity and 12,000kWh for gas. The £108 figure includes £61 from the February 2022 wholesale decision, £41 from the August 2022 wholesale adjustment decision, and the £6 adjustment to the previous allowance for cap period 7 backwardation costs, which we also implemented through the August 2022 wholesale adjustment decision. The current Typical Domestic Consumption Values are 2,900kWh for electricity and 12,000kWh for gas.

[10] To note, a fall in prices does not always benefit suppliers. For example, a fall in prices could increase shaping costs when demand is lower than expected, as suppliers would have to resell energy bought at a higher price.

[11] Ofgem (2023), Open letter on changes in the energy supply market and Ofgem's approach to regulation. https://www.ofgem.gov.uk/publications/changes-energy-supply-market-and-ofgems-approach-regulation

Intended scope of this review and rationale

We intend to review wholesale costs for the year starting in October 2022 (cap periods 9a to 10b). In this section, we explain the main rationale for reviewing costs in each of these quarterly cap periods. This is simply our rationale for carrying out a review – it does not mean that we have formed a view at this stage on whether any adjustment is required. We will develop our position on whether an adjustment is required based on our analysis and consideration of stakeholder feedback.

Cap periods before October 2022

We do not intend to review costs for earlier cap periods. We have already provided adjustments in relation to cap periods 7 and 8. We do not currently see a rationale for reopening these adjustments. We therefore do not consider that it would be proportionate to gather further data in relation to these cap periods.

Cap periods 9a and 9b

Wholesale prices remained volatile over autumn and winter 2022. For cap periods 9a and 9b (October 2022 to March 2023), we therefore intend to review whether wholesale price volatility has affected shaping and imbalance costs. This review takes into account previous feedback received from stakeholders in response to our February 2023 call for input on reviewing the additional wholesale allowances.[12] In that call for input, stakeholders raised concerns about costs which may have been incurred over the winter.[13]

Shaping and imbalance costs in any particular cap period will not necessarily align with the allowances provided. This reflects that near-term costs will vary, for example due to weather conditions. Such fluctuations in demand and prices are a normal risk for suppliers to manage (for which there are other risk allowances in the cap), and are not generally a systematic issue. However, suppliers may incur exceptional costs in volatile markets, which may not net out over time.

While stakeholders also mentioned transaction costs in response to our February 2023 call for input, we do not intend to include transaction costs within this review. This is for consistency with our previous wholesale adjustments. However, we may consider comparing any supplier data against the transaction cost allowance in the cap in the event that suppliers are unable to exclude these costs from their data submissions.

[12] Ofgem (2023), Price cap: Call for Input on Additional Wholesale Allowances Review. https://www.ofgem.gov.uk/publications/price-cap-call-input-additional-wholesale-allowances-review
[13] For a summary of responses, see: Ofgem (2023), Price Cap - Programme of Work: Update, p5. https://www.ofgem.gov.uk/publications/price-cap-programme-work-update

For a general review of the transaction cost methodology, we would review this on a forward-looking basis as part of any long-term review of the additional wholesale allowances, as signalled in our price cap programme of work update.

Cap period 10a

In March 2023, the government announced that the Energy Price Guarantee (EPG) would remain at £2,500 per year for a typical dual fuel customer for three further months, rather than increasing to £3,000 per year as previously set out.[14]

Prior to the government announcement, suppliers may have expected that it would be possible to offer fixed tariffs below the EPG level during cap period 10a (April to June 2023). Suppliers may therefore not have hedged for customers who they expected to move to fixed tariffs.

In practice, customers largely remained on default tariffs during cap period 10a. To the extent that this may have created unexpected SVT demand for suppliers, the impact will be dependent on the prevailing market prices. For example, if the prevailing wholesale prices were lower than those captured in the cap wholesale index, then there would be a saving from unexpected SVT demand. This is the opposite of buying additional volumes when wholesale prices are higher than those captured in the cap wholesale index, for which we previously provided adjustments.

We consider this a clear reason to explore whether the EPG changes led to unexpected SVT demand, and any consequent differences between allowances and costs. In our previous guidance, we said that we expected 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".[15] We consider that an unexpected change in government policy is a different type of risk to wholesale price volatility, and therefore could be seen as sitting outside of this reasoning.

Cap period 10b

Switching to fixed tariffs has remained low in recent months. As set out above, this may in part reflect the impact of the unexpected extension to the EPG, which took place during the observation window used to determine the wholesale index for cap period 10b.

[14] HM Treasury (2023), Energy Price Guarantee extended for an extra three months. https://www.gov.uk/government/news/energy-bills-support-extended-for-an-extra-three-months

[15] Ofgem (2022), Price Cap - Guidance on treatment of reasonable risk management practices in future default tariff cap proposals, p4. https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals

We therefore intend to review whether unexpected SVT demand has materialised during cap period 10b, and whether this has led to any consequent differences between allowances and costs.

Forecasting customer numbers is a normal task for suppliers. However, in certain circumstances such as unexpected changes in government policy, the impacts could be systematic.

Backwardation recovery period

In addition to reviewing potential additional wholesale costs as outlined above, we intend to also review the recovery period for the backwardation costs in the cap.

In our August 2022 decision on changes to the wholesale methodology, we introduced backwardation costs in the cap and allowed suppliers to recover them over a six-month period.[16] This was a shorter period than the 12 month recovery period we consulted on. Our change in position was to support market resilience and stability given the high level of backwardation we observed last winter, which could have created acute risks. However, this did focus the bill impacts for customers over a shorter period and introduce some wholesale price seasonality into the cap. In this decision it was noted that we intended to review this approach in future to determine whether a six-month recovery period is the best approach for customers on an enduring basis.

Now that we have seen prices begin to stabilise and fall, we consider that this is a good opportunity to review whether a six-month recovery period is still appropriate or whether we should increase the recovery period (eg to 12 months) to reduce the seasonal bill impacts for customers going forward.

Additional scope points

The paragraphs above explain the main reasons why we intend to review wholesale costs for the period October 2022-September 2023. For completeness, we also intend to gather data on unexpected SVT demand costs in cap periods 9a and 9b, and shaping and imbalance costs in cap periods 10a and 10b. However, at this stage, we do not expect that these would show a systematic difference from cap allowances.

In line with the 4 July CEO letter, our overall aim is to ensure that the cap continues to protect consumers and fairly reflects the efficient costs incurred by suppliers.

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[16] Ofgem (2022), Price cap - Decision on changes to the wholesale methodology. https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

Next steps

We welcome comments on this open letter by **COP 14 August 2023**. Please provide any comments by e-mail to priceprotectionpolicy@ofgem.gov.uk. We also welcome any wider views stakeholders may have in relation to the 4 July CEO letter, including with regard to any other material changes in market conditions that lead to systemic and symmetrical benefits or costs. Please see the privacy notice in Appendix 1 for information about how we will process your response.

We have also sent a draft request for information (RFI) to larger suppliers alongside this open letter. After considering any comments, we intend to issue this in early August as a mandatory RFI to suppliers with over 100,000 domestic default tariff customers. If any suppliers below this size would like to provide information voluntarily, please contact us to obtain a copy of the RFI template. If other stakeholders have any immediate views on the scope of the information we should gather, then please feel free to provide these comments by 24 July 2023, so that we can consider these alongside comments on the draft RFI.[17]

Should our analysis of the data suggest that an adjustment is necessary, we intend to publish a statutory consultation in late September, and propose allowing four weeks for responses. We would then plan to publish a decision by late November, to allow for implementation in January 2024 (cap period 11b).

We recognise that this is a fast-paced review, but consider that in the circumstances this timetable allows suppliers sufficient time to respond to the RFI and stakeholders to respond to the statutory consultation. Progressing this review at pace is aligned with our approach to previous wholesale adjustments and is now a well established process. Therefore, we consider it appropriate to proceed straight to the statutory consultation stage. Furthermore, progressing the review at pace means that any adjustment (if required) can be made as close to the time of the costs being incurred, reducing recovery risks for both customers and suppliers. This would be in the interests of customers – either by returning money to them or by supporting suppliers' financial resilience.

Yours faithfully,

Dan Norton

Deputy Director – Price Protection

[17] For the avoidance of doubt, we will consider all comments received in response to the open letter. We are just indicating to stakeholders that there is an opportunity for early comments to inform our planned data gathering.

Appendix 1 - Privacy notice

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the open letter.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. ie a consultation.

4. With whom we will be sharing your personal data

We may share your consultation responses with the Department for Energy Security and Net Zero.

5. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for 6 months after the project, including subsequent projects or legal proceedings regarding a decision based on this open letter and/or resulting statutory consultation, is closed.

6. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties

• tell us your preferred frequency, content and format of our communications with you

• to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

7. Your personal data will not be sent overseas

8. Your personal data will not be used for any automated decision making.

9. Your personal data will be stored in a secure government IT system.

10. More information

For more information on how Ofgem processes your data, click on the link to our "ofgem privacy promise".