ofgem

Making a positive difference
for energy consumers

To all interested stakeholders

Email: priceprotectionpolicy@ofgem.gov.uk

Date: 3 October 2023

Dear all,

Review of additional wholesale costs in the default tariff cap: update

1. Context

1.1 Wholesale gas and electricity prices remain historically high but have fallen significantly since the peaks reached in the second half of 2022 and early 2023. In addition, prices have been stabilising. Given the significant change in market conditions, we are refocussing our approach to retail regulation to adapt to the changed situation for the sector, including reviewing the default tariff cap ('cap') formula to ensure it mirrors the costs facing suppliers.

1.2 In this vein, in July, we indicated that we would be starting a workstream to review suppliers' wholesale costs for default tariff customers between October 2022 and September 2023.[1] The review will enable us to consider whether an adjustment to the cap is appropriate, in either direction. Following the July open letter, we sent a Request for Information (RFI) to all suppliers in scope of the review, in order to gather evidence and information to consider whether an adjustment to the cap is appropriate, and whether the wholesale allowances continue to reflect the efficient costs a notional supplier may incur.

2. Review timescales and process

2.1 Following our collection and initial analysis of this data, we have decided to reschedule the intended follow-up consultation from late September to late

[1] Ofgem (2023) Price cap – Open letter on reviewing additional wholesale costs. https://www.ofgem.gov.uk/publications/price-cap-open-letter-reviewing-additional-wholesale-costs

November/early December. This will ensure that the analysis and calculations used to consider whether an adjustment is appropriate, are robust.

2.2 Rescheduling the consultation will also move the implementation date of an adjustment, should we decide that one is appropriate, from January 2024 to April 2024, at the earliest. We appreciate the information that stakeholders have provided us with, at pace, and appreciate their ongoing contribution to the review. We hope that these revised timelines will assure stakeholders that we are allowing time to properly consider whether an adjustment is appropriate.

2.3 The change in timescales will also allow us to consult directly with suppliers on the information they provided in the RFI, aiding our understanding and interpretation of the evidence provided.

2.4 In response to our July open letter, some stakeholders suggested that we should share underlying data, either through a confidentiality ring or by other means. We have been carrying out a putback process in advance of our consultation, which entailed providing individual suppliers with our analysis of the data they have provided to us. This process has given suppliers an opportunity to comment on our calculations, analysis and interpretation of their data, before we put forward our 'minded to' positions in the follow-up consultation.

2.5 Coupled with our consultation, we consider that the putback approach provides the required level of transparency and meaningful consultation to enable stakeholders to comment effectively on our analysis and calculations. We therefore do not see it necessary to implement a confidentiality ring in addition to this process.

3. Wholesale cost allowances in the cap

3.1 Wholesale costs account for the largest portion of a customer's bill. Our assessment of wholesale costs in the cap include:

- **Core direct fuel allowance**: we estimate the majority of wholesale costs based on forward contracts for electricity and gas. We measure the prices of these contracts over a period of time before a cap period, which we refer to as an observation window.

- **Additional direct fuel allowances:** we uplift the core direct fuel allowance by an additional set percentage. This set percentage is based on[2]:
    - *Shaping and imbalance costs:* costs of converting less granular forward contracts to more granular contracts closer to delivery, forecast error and imbalance.
    - *Transaction costs*: costs incurred by suppliers when they trade energy.
    - *Additional risk and uncertainty:* set at 1% of direct fuel costs and reflect uncertainty and volatility in market.
    - *Unidentified gas (UIG) and Electricity transmission losses.*

3.2 We calculate and update the core direct fuel allowance each time we update the cap. The additional direct fuel allowances are indexed as a fixed percentage of direct fuel costs, rather than recalculated.

3.3 In addition to considering whether suppliers have incurred additional wholesale costs (or benefits) between October 2022 and September 2023, the review will consider the recovery period for backwardation costs in the cap. We introduced backwardation costs in our previous August 2022 decision on changes to the wholesale methodology, with a six-month recovery period.[3]

4. Framework for considering an adjustment to wholesale allowances in the cap

Overarching principles

4.1 We are developing our thinking on whether an adjustment is appropriate, and if so, the nature of any adjustment. The framework in this section therefore represents our initial views, which we are sharing with stakeholders for comment on our principles.

4.2 We will consult more fully on our approach to considering an adjustment in our consultation. However, in advance of this, early stakeholder comments would be beneficial to help develop our framework. We are particularly

[2] We also provide an allowance for Capacity Market payments, although these are not applicable for this review.
[3] Ofgem (2022), Price cap - Decision on changes to the wholesale methodology. https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

interested in views on how we assess the relative impacts of external events and commercial decision-making.

4.3 We are assuring our analysis and have sought comments from suppliers on our approach through the putback process. We will consult again once we have reached a 'minded to' position. However, indications from our initial analysis of the data suggest that, on average, realised costs may potentially have been lower than the provided allowance over the period (October 2022 to September 2023). There are a number of possible reasons why wholesale costs may have deviated from allowances over the period that we are reviewing, including; weather effects, the impact of commercial decisions (eg hedging strategies) where they vary from the wholesale allowance index, liquidity issues in the wholesale market, or the impact of unexpected demand destruction.

4.4 Below we set out three key principles that will guide our decision making.

Principle 1: Protection of customers

4.5 We set the cap in accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act').[4] Ofgem must exercise its functions under the Act, with a view to protecting existing and future domestic customers who pay standard variable tariffs (SVTs) and default tariff rates.

4.6 When setting the cap, we must have regard to five matters,[5] which include having regard to providing incentives for suppliers to improve their efficiency, and to allowing an efficient supplier to finance its supply activities. Our main focus, when deciding how the cap should be calculated, must be seeking to protect consumers on standard variable and default tariff rates. We must have due regard to the five matters set out in the Act, but we are not under a duty to achieve them.

4.7 We therefore do not need to set the cap at a level that would ensure all suppliers recover their costs.

Principle 2: Any adjustment should be appropriate across suppliers

[4] Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21/enacted
[5] The five matters are set out in section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 https://www.legislation.gov.uk/ukpga/2018/21.

4.8 Under the Act, we can only set one cap across the market. We set this to cover a notional efficient supplier. We cannot set a bespoke cap to cover each supplier's specific circumstances.

4.9 In this context, we will consider whether the sample of suppliers is representative of the market and consider exclusions where appropriate. This would mean that our analysis is using appropriate input data.

Principle 3: We would be more likely to adjust where costs or benefits were the result of external factors, rather than suppliers' commercial choices

4.10 For us to make an adjustment (in either direction), the difference between costs and allowances must be material and systematic. We would assess materiality based on the result of benchmarking.

4.11 When deciding which benchmark to use, one relevant factor would be the extent to which the costs were within suppliers' control or driven by external factors. At a high level, there may be a greater case for suppliers to bear the result of commercial decision making, whether that is a benefit or cost. However, this is likely to be nuanced as there isn't a clear line differentiating commercial decisions from external factors and therefore we will likely consider whether an adjustment is appropriate, and the level of any adjustment, in the round.

4.12 If suppliers take commercial decisions (with the associated risks) which are successful, then there may be a greater case for them to receive the corresponding benefit. Similarly, suppliers should potentially bear the losses of unsuccessful commercial decisions. This ensures that suppliers retain incentives to run their businesses efficiently and to manage costs appropriately. This approach would draw comparisons to network price regulation where companies bear risk of commercial decision making but there is the ability to re-open the price control if there are external events out of the company's control.

4.13 Conversely, if an external development means that suppliers as a group incur higher or lower costs, there might be a case to adjust the cap to reflect their costs. This would include the case where there was a clear way to react to external developments, adopted by many suppliers.

4.14 In practice, some outcomes may be driven by a mixture of commercial decisions and external events. In these cases, we will consider any evidence in the round, alongside design options such as our choice of benchmark and sample of suppliers, which may be able to reflect this balance. For example, in the case of a benefit, an upper quartile benchmark would be a looser benchmark than a weighted average). This would allow suppliers to retain some of the benefits of commercial strategies and could be one way of accounting for uncertainty in our approach.

<u>Practicalities of determining whether an adjustment is appropriate</u>

Differentiating between commercial decisions and external events

4.15 We acknowledge that differentiating impacts between commercial decision making and systematic/external impacts is difficult. We will work through the information provided by suppliers to inform our position. However, we would not seek to precisely apportion between external events and commercial decisions.

4.16 At this stage, we do not intend to pursue the option of forensically working through each supplier's actions to understand how they relate to each supplier's individual costs and whether there was a systematic driver behind them. We consider this would be a disproportionate exercise requiring much more information than we have currently collected, and in any case, we cannot adjust the cap according to individual supplier's costs so this exercise would not be he helpful in making a market-wide adjustment.

4.17 Additionally, we do not intend to produce a specific model which sets out granularity on what we may have expected a notional supplier to do in response to market movements, given actions suppliers take will depend on both the market situation and their own business need. This, and the approach set out in paragraph 4.16, were not followed in previous adjustments, and so our decision to exclude them from the framework this time, is consistent with past approaches.

4.18 Instead, we intend to consider factors such as wholesale market indicators, expectations on demand and customer movements, and supplier narratives, to explain trends in data and understand what may have been an overall rational approach, rather than set out specific actions of a notional supplier. This will inform our choice of benchmark and allow us to assess the overall level of uncertainty.

Considering the symmetrical nature of previous adjustments

4.19 We have previously made upward adjustments to the cap, where appropriate, because notionally efficient costs turned out to be higher than we had assumed they would be for any given period. If circumstances arise where allowances are greater than costs, then we should be prepared to make a downward adjustment for symmetry. If we only made upward adjustments, then over time the cap would be set too high, which would not protect customers.

4.20 In our February 2022 and August 2022 adjustments, we took a decision with a greater degree of uncertainty than normal, given prevailing circumstances. If we were considering a downward adjustment in future, it would therefore not be feasible to ensure that any further adjustments are precisely symmetrical. Nevertheless, we consider that adjustments should be symmetrical where practically possible.

Considering positions taken in previous wholesale adjustment decisions

4.21 In assessing any potential adjustment, we will also consider our positions from the previous additional wholesale cost adjustments.

4.22 In our August 2022 decision,[6] we noted a wide variance in demand forecasting and hedging strategies designed to manage the risk of greater numbers of fixed priced contract customers defaulting onto the cap than forecast. We decided not to adjust the allowance for the effectiveness of these strategies, as the market circumstances were unprecedented. However, in our accompanying guidance[7] we noted that we expected suppliers to respond to the now-known risks of customer demand variance and would take that into account if we make a future allowance for unexpected customer demand.

4.23 A future decision could therefore take a more stringent approach to assessing suppliers' costs, where these related to a risk suppliers had faced before. We intend to consider whether the situation leading to any under or over-allowance was similarly unprecedented.

4.24 Additionally, in our August 2022 decision we recognised that suppliers had to manage risks through deciding what proportion of their expected demand to

[6] Ofgem (2022) Price Cap - Decision on possible wholesale cost adjustment. https://www.ofgem.gov.uk/publications/price-cap-decision-possible-wholesale-cost-adjustment
[7] Ofgem (2022) Price Cap - Guidance on treatment of reasonable risk management practices in future default tariff cap proposals. https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals

hedge. As previously stated, we do not consider that moving away from hedging for expected SVT customer numbers is necessarily inefficient, although the decisions suppliers make could still involve different degrees of efficiency.[8]

4.25 Where we previously placed emphasis on improving resilience in the market for past adjustments, we could consider placing greater emphasis on customer interests by recovering any over-allowance for a future adjustment. We consider this would be a symmetrical approach to considering the balance of risk in the market at the time of taking the decision.

5. Stakeholder questions

5.1 To what extent do you agree or disagree with the overarching principles we have set out? Are there any additional principles you think we should consider when making a decision? *Please fully explain your answer.*

5.2 Given that Ofgem must exercise its functions under the Act with a view to protecting existing and future customers on standard variable and default tariffs, to what extent should suppliers be able to retain benefits or bear costs from (relating to principles 1 and 3):

a) overall market movements (eg in SVT demand or price driven demand destruction), that are outside of their control?

b) commercial decisions (eg hedging strategies), that deviate from the assumed behaviour in the price cap? Does your answer differ whether the impact is a cost or a benefit to suppliers? If so, why?

5.3 To what extent should we align to the approach taken for previous wholesale decisions? Has suppliers' ability to mitigate risks changed over time, or are there other relevant changes in circumstances which would impact suppliers' ability to mitigate risks?

5.4 Are there other considerations we should have when differentiating between an overall market movement (eg customers remaining on SVT tariffs), as opposed to an individual supplier's risk management strategy (ie between systemic and idiosyncratic risks)? To what extent should this include consideration of the number of suppliers who adopted a particular strategy?

[8] Paragraph 3.50 in Price Cap - Decision on possible wholesale cost adjustment. https://www.ofgem.gov.uk/publications/price-cap-decision-possible-wholesale-cost-adjustment

5.5 Do you agree with our high-level approach to differentiating between impacts caused by commercial decisions and external events? Where we see discrepancies between costs and allowances, what evidence should be considered to distinguish between the impact of commercial choices versus the impact of market movements outside of a supplier's control?

5.6 Given the variability in supplier approaches, and that Ofgem can only set one price cap level, how should we weight the commercial decisions made by some, but not all, suppliers? *For example, if all suppliers benefited from market movements outside their control but only some suppliers also took commercial decisions which created further benefit.*

5.7 Before adjusting for any gains or losses, are there any particular factors that we should consider offsetting through other allowances (eg headroom)? *If suggesting an offsetting allowance, please explain why.*

5.8 What benchmark approaches should we consider and why? Should the approach differ based on the direction of a potential adjustment?

5.9 Please also provide any additional views that may not be captured by the outlined questions.

6. Next steps

6.1 We welcome views and comments on the questions outlined by **close of business on Monday 23 October 2023.** Please provide responses by email to priceprotectionpolicy@ofgem.gov.uk.

6.2 Please see the privacy notice in Appendix 1 for information about how we will process your response.

6.3 Once we have completed the further engagement set out in this letter, we intend to proceed to consultation in late November/early December.

Yours faithfully,

Dan Norton

Deputy Director, Price Protection

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".