

Dan Norton
Deputy Director, Price Protection Policy
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

24 January 2024

Dear Dan

ENERGY PRICE CAP WHOLESALE COSTS REVIEW

Thank you for the opportunity to respond to your minded-to position on the energy price cap wholesale costs review. We support Ofgem's minded-to decision not to adjust the price cap for wholesale costs incurred between October 2022 and September 2023.

Our responses to the stakeholder questions are in Annex 1 to this letter, however we would like to highlight the following points:

- A sound regulatory environment is one where the principles behind regulation are clear, allowing licences, codes, and guidelines to evolve in predictable ways. Promoting sustainable competition maximises consumer protection in the longer term and promotes true efficiency.
- We are broadly happy with the scope of future work planned and have suggested some potential areas of focus for this work in our response to Question 4.
- We support the minor technical changes to the structure of Annex 2, both to improve the transparency of the demand weightings used to inform the backwardation allowance, and to account for a change of inputs used in the Capacity Market Cost Allowance Methodology.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

**ENERGY PRICE CAP WHOLESALE COSTS REVIEW
- SCOTTISHPOWER RESPONSE**

Q1. Do you agree with our minded-to position to make no adjustment to the price cap for wholesale costs incurred between October 2022 and September 2023?

We welcome Ofgem's minded-to position to make no adjustment to the price cap for wholesale costs incurred between October 2022 and September 2023. We particularly appreciate the confirmation that any decision to make an adjustment to the price cap must consider both the short and medium-long term impacts, with a view to protecting existing and future default tariff customers.

Ofgem has made it clear that for an adjustment to be made (in either direction), the difference between costs and allowances must be material and systematic, noting that the assessment of materiality would be based on the result of benchmarking. From the evidence presented, it appears that changes in wholesale costs between October 2022 and September 2023 did not meet these criteria:

- suppliers as a group did not see costs shift in one direction;
- it was difficult to distinguish between the impact of commercial decisions and other drivers of costs (external events).

Ofgem's response outlines how upward and downward adjustments to the cap may have different impacts. We note that there is also inherent asymmetry in the impacts of market shocks. Market movements that increase costs to suppliers may result from unforeseeable shocks associated with geopolitical events or natural disasters. Events that reduce costs to suppliers tend to fall within reasonable business expectations. This means that situations where it is appropriate for adjustments to be made to claw back wholesale cost allowances are less likely to occur.

The longer-term interests of consumers are served by a stable supply market, with participants able to plan and invest to deliver the system of the future. This is supported by a predictable regulatory regime with robust processes, which supports efficiency in both investment and allocation of risks across the sector.

Furthermore, Ofgem has a duty to carry out its regulatory activities in a way that is transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed.¹ It is not obvious from the information provided on the analysis undertaken on the wholesale cost allowances that these criteria could have been met, given the acknowledged data quality and comparability issues (para 4.9).

Although Ofgem notes that, in practice, assessing whether an "error" is systematic and material are the two main judgements, Ofgem also reaffirms the principle that it would consider an adjustment appropriate if a systematic error is identified which is unforeseen, clear, material, and necessitated change (para 3.8). It would be helpful if Ofgem could clarify further how it interprets "unforeseen".

¹ S3A(5A)(a) Electricity Act 1989 [Electricity Act 1989 \(legislation.gov.uk\)](https://www.legislation.gov.uk/ukpga/1989/29/section/3A/5A/a)

Q2. Are the three topic areas identified for medium-term review the right priorities? If not, what alternative topics should be considered?

The three topic areas that Ofgem has outlined for medium term review are:

- i. Wholesale allowance methodologies;
- ii. Review of the policy to move to quarterly cap updates;
- iii. Wholesale methodology under market-wide half hourly settlement (MHHS).

We agree that these three topic areas are appropriate for medium term review. First on the list is the wholesale allowance methodologies. We hope that this will address issues such as the Unidentified Gas (UIG) allowance being too low, leading suppliers to consistently under-recover costs. Similarly, there is a consistent trend of 'losses' from the Group Correction Factor (GCF) that suppliers are not able to recover under the cap.

The move to quarterly price cap updates has brought clear benefits in terms of suppliers' exposure to fluctuations in wholesale costs. Although conditions have been calmer in recent months, the risks associated with high levels of price volatility in the wholesale energy markets remain. Further volatility has the potential to drive large adverse variances in the cost of balancing customer demand profiles at delivery relative to the cost implied by forward pricing.

Wholesale methodology under market-wide half hourly settlement (MHHS) is a topic worthy of inclusion in an Ofgem review although, as noted in response to Question 6, we would encourage caution around the timing of that.

Q3. What is the relative order of priority between the three broad areas identified for review?

We agree with the current ordering in terms of relative priority and note the point made in Question 4 that high uncertainty around the impact of MHHS means the timing of its review will be uncertain.

Q4. Within each topic, are there any specific areas of focus you consider should be in scope?

Wholesale Cost Review:

As noted above in response to Question 2, we would encourage Ofgem to assess the appropriateness of the current allowance for UIG. Our view is that it is too low.

Ofgem should consider the impact of settlement processes on supplier margins and in particular the effect of the GCF losses on suppliers' cost recovery. There appears to be increasing disparity in the pre- and post-settlement GCF energy costs.

Ex post adjustment for the Contracts for Difference (CfD) allowance under the price cap could be used to reconcile actual costs with forecast costs. This would reduce the price and volume risk which suppliers face, reduce hedging costs² and improve transparency in how these costs are recovered. Suppliers can only hedge for price risk relating to CfD payments and cannot hedge for changes in generation volume relative to LCCC's forecast, or for changes in customer numbers. This means that a reconciliation mechanism for CfD allowances should improve the GB energy sector's resilience to market shocks.

² With a reconciliation mechanism in place, suppliers would not be exposed to the cost of hedging CfD allowances for price cap customers.

The assumption that 30% of electricity consumption is in peak hours should be reviewed. As noted previously, we believe the proportion of demand in peak hours to be higher than this. This could be useful analysis to carry out prior to the introduction of MHHS.

Allowances in the price cap are intended to be accurate on average, over time. Ofgem should keep the underlying weather-related assumptions regarding seasonal normal demand under review so that weightings remain reflective of actual demand shape. Ofgem notes its expectation that under-recovery of wholesale costs is more likely in winter periods due to seasonality in shaping costs (paras 4.21 and 4.79). More information on how this is being addressed would be appreciated.

The liquidity of peak power products should also remain under review.

Quarterly Cap Updates

The quarterly cap has worked well in an environment of declining prices and price volatility. It provides suppliers with some mitigation of volume risk, which was a major issue in 2021/22 when the seasonal cap was operating.

Mandatory Half Hourly Settlement (MHHS)

We look forward to the introduction of MHHS and the more flexible (net zero) electricity system it can help deliver.

Given the change to consumption patterns and, by extension, supplier hedging requirements that MHHS has the potential to bring, we welcome Ofgem's recognition that the impact of MHHS on wholesale allowances is a topic worthy of future review.

Given the significant uncertainty around how MHHS will impact consumer behaviour, how long it will take behaviours to stabilise, and what the response of the wholesale market will be, it will be hard to predict the impact and hence the timing of a review in advance. However, even if the future impact is uncertain, it should still be possible to adjust the wholesale cost allowance methodology so that, for example, it adapts automatically to changes in the consumption profile for non-ToU tariffs, eg the mix of peak versus baseload.

We would also note that suppliers will face a significant capital outlay in the coming year to facilitate delivery of MHHS. It is crucial that this is recognised in the design of allowances under the energy price cap and we assume that this will be covered by Ofgem's ongoing review of the opex allowance.

Q5. Do you have any initial views to share on the topics identified, or more broadly?

We would welcome a clear commitment to transparency from Ofgem. Participants in the retail energy market need to have confidence in the regulatory framework to enable timely investment, productive risk-taking and efficient financing costs.

ScottishPower
January 2024