

Dan Norton
Deputy Director
Ofgem
10 South Colonnade
Canary Wharf
London E14 4PU

17 January 2023

Sent by email to: Dan.Norton@ofgem.gov.uk Cc: PriceProtectionPolicy@ofgem.gov.uk

Dear Dan

RE: Energy price cap wholesale costs review

Thank you for the opportunity to respond to this consultation. We agree with Ofgem's minded-to position to make no adjustment to the price cap for wholesale costs incurred between October 2022 and September 2023. Ofgem has not provided a hypothesis - nor evidence to support a hypothesis - that there was a systematic and material departure between efficient wholesale costs and price cap allowances during this period. However – and as Ofgem recognises¹ - were Ofgem to reopen this review and potentially proceed to benchmarking - it would need to focus on whether price cap allowances were sufficient to enable a notional supplier to recover its efficient costs.

The price cap has been specifically designed to ensure that a notional supplier can recover its efficient costs. Therefore, to assess whether an adjustment to price cap allowances is warranted, Ofgem would need to find a material and systematic difference between:

- a) The efficient costs that a notional supplier incurs; and
- b) The cost allowances designed to enable that notional supplier to undertake those activities envisaged by the price cap (and authorised by the supply licence).

Had Ofgem adopted an approach different to that set out immediately above, it would have represented a departure from good regulatory practice, resulting in a step change in regulatory uncertainty, thereby undermining investor confidence.

For the record, we note that in its comparison between individual supplier costs and allowances, Ofgem included activities undertaken by Centrica that the price cap design does not assume that the notional supplier will undertake. We maintain our position that, were Ofgem to consider making an adjustment in future, any such activities would need to be excluded for the purpose of any benchmarking exercise, for this review and any other.

¹ [Energy price cap wholesale costs review \(ofgem.gov.uk\)](#) Paragraphs 4.88 and 4.89

The types of activities that are more pertinent to benchmarking are those that the price cap explicitly assumes or even forces the notional supplier to undertake. For example, in the past the lag between the hedge in the price cap and spot wholesale prices forced the notional supplier to manage irreconcilable and competing risks of wholesale prices rising and falling – the “SVT hedging dilemma”. Ofgem rightly intervened in this instance to ensure that the notional supplier could recover its efficient costs by providing additional wholesale allowances. Whilst the allowance was calculated using actual costs, the need for the allowance was grounded in the circumstances faced by a notional supplier.

In light of the above, we wish to make clear that while Centrica agrees with the outcome of the consultation process and the ‘minded-to’ position as set out in the consultation document of 15 December 2023, this is without prejudice to the methodological approach Ofgem has followed during this process. If Ofgem were to change its minded-to position for any reason, we reserve all our rights to challenge the methodological approach Ofgem takes in considering any adjustment to the price cap.

We note with some concern Ofgem’s negative comments regarding confidentiality rings in its consultation document. Ofgem has used confidentiality rings on a number of occasions in the past, and in many cases the use of those confidentiality rings has identified the need for adjustments to be made which made a real difference to the outcome of the consultation exercise concerned.

The use of confidentiality rings in appropriate circumstances also helps Ofgem to meet its legal duties of fair consultation and transparency. What determines “appropriate circumstances” will need to be assessed on a case-by-case basis in light of Ofgem’s statutory duties. It will be more likely that confidentiality rings are appropriate for a price cap allowance review when:

- Any potential adjustment is material;
- The methodology and/or calculations Ofgem uses to assess and determine any allowance are complex, for example using a computer model;
- There are potential data comparability issues between suppliers; and/or
- Ofgem is proposing to exercise judgement in deciding where to set the allowance – for example by benchmarking rather than passing through costs.

To inform this debate, we ask Ofgem to review all previous disclosure processes using confidentiality rings inside and outside the price cap to see whether any errors were identified or improvements made as a result. Ofgem is in the best position to do this, not least because suppliers were required to destroy all material pertaining to the 2018 smart metering data room.

We have answered Ofgem’s specific questions in the Appendix below. We hope that Ofgem will address the defect in the CfD allowance which means that a notional supplier systematically and materially risks being unable to recover its efficient costs.

I would also like to thank your team for its willingness to meet and openly discuss the issues raised during this review. We hope to continue to have an open and constructive dialogue with Ofgem on price cap design.

Yours sincerely

Alun Rees

Head of Wholesale and Retail Market Design and Policy

Appendix – responses to consultation questions

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?

Yes. Please see cover letter.

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

No. Ofgem should prioritise a review of the CfD allowance methodology. We have highlighted to Ofgem on a number of occasions that the CfD allowance methodology creates a material and systematic risk that a notional supplier cannot recover its efficient CfD costs. We reattach to this response our confidential submission to Ofgem of 28 July 2023 which provides analysis and evidence to support this concern. We also refer Ofgem to our response to question 8 from our confidential response to Ofgem's EBIT consultation submitted on 5 January 2023.

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

The CfD allowance should be the top priority for review.

The second priority should be the transaction allowance, particularly given the significant liquidity challenges in the wholesale electricity market and the move from the six monthly to the quarterly price cap.

The third priority should be the interaction between the price cap and fundamental changes in the market, including half-hourly settlement. Please see enclosed our confidential submission on the future of wholesale and retail market design, which we sent to Ofgem in July 2023 and subsequently.

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

Please see answers to questions 1 - 3 above.

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

Yes. Please see answers to questions 1-3 above and the attached supporting analysis and evidence.

We are comfortable with the proposed change to how demand shares are communicated in Annex 2; this change is an improvement.