

Ofgem  
10 South Colonnade  
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17/1/24

Dear Dan,

Energy UK welcomes Ofgem's minded-to decision not to make an adjustment to the cap to wholesale cost allowances between October 2022 and September 2023.

As we have stated previously, the price cap sets an ex-ante allowance to ensure that a notional efficient supplier can recover its costs.

Ofgem has previously committed to a policy of making adjustments to the price cap where "a change in the costs facing suppliers is material and systematic, considering the market as a whole"<sup>1</sup> and where "the type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes".<sup>2</sup>

It is right that Ofgem places a high weight on the "material and systematic" tests in arriving at its decision on any allowance adjustment, and the evidence adduced suggests that there is not a case to make an adjustment in this situation. However, there are further reasons that a downward ex-post adjustment would not have been appropriate:

- 1. Threat to investor confidence.** Any potential for ex-post downward adjustments damages the incentive on suppliers to make commercial decisions that benefit customers, for example: pricing tariffs below the cap or taking on SOLR customers. Where a supplier has been able to successfully reduce their costs below the level of the cap allowances, this enables the supplier to price competitively below the cap. This price competition benefits consumers and would likely result in switching towards the successful supplier that they could be penalised for if there is an ex-post downward adjustment. An ex-post adjustment would potentially punish such a supplier in two ways, firstly through clawing back savings that had already been passed on to customers and secondly by clawing back revenue from customers that were with a different supplier during the period of over-recovery.

Such impacts do not apply to upward adjustments. The nature of the cap is such that in periods of under-recovery suppliers have no choice but to charge beneath their efficient costs, selling energy at a loss. Conversely in any periods of systematic over-recovery, price competition should erode excess returns as suppliers can price below the cap to attract new customers.

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<sup>1</sup> 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-potentialimpact-increased-wholesalevolatility-default-tariff-cap>

<sup>2</sup> Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

2. **Regulatory risk.** Due to the factors above, simply by raising the prospect of ex-post downward adjustments, Ofgem risks damaging competition and investment in the sector through dramatically increasing regulatory risk. This is especially problematic at a time when Government wants to see the retail sector unlock billions of pounds of investment to help customers transition to net zero.

This risk was exacerbated by Ofgem's signalling in its open letter. For example, in saying *"We would be more likely to adjust where costs or benefits were the result of external factors, rather than suppliers' commercial choices"*<sup>3</sup> Ofgem is signalling that it may look to make an adjustment even if deviation of costs from allowances were a result of commercial decision making. This is an extremely concerning signal which on its own has negative impacts on investment and incentives and therefore customers.

Regulatory risk is also exacerbated by any lack of confidence in the robustness and transparency of Ofgem's processes. In a consultation of this nature, we would expect Ofgem to adhere to an extremely robust process for collecting evidence from the industry, given the commercial sensitivities involved and the risk to future investment.

Work undertaken on Ofgem's putbacks highlighted some errors which needed correction. Further to this, we remain concerned that the highly technical and heterogeneous nature of wholesale costs mean that suppliers are likely to have taken different approaches to responding to Ofgem's RFI, making a robust market-wide analysis of incurred costs versus allowances extremely challenging.

It is vital therefore that industry and investors are fully confident that Ofgem enables full and proper scrutiny of its analysis. While we accept that onerous approaches such as data-rooms are not always appropriate, Ofgem could and should have committed early and openly to apply such an approach in the eventuality that a highly sensitive downward ex-post adjustment were to be consulted on. Such an approach also requires consultation periods enable adequate time for effective input and scrutiny.

3. **A clear hypothesis.** While Ofgem has found that there was no "systematic or material" over-recovery, this has only been found to be the case after an extensive and costly process. With that in mind, alongside the regulatory risk impacts described above and the questionable legal basis, it is not clear that Ofgem should have drawn such a broad scope for review of wholesale allowances at all. Any adjustment to the price cap should start with a clear hypothesis as to the cause of deviation of costs from the existing allowances being investigated.

Instead, Ofgem's approach has been to search for deviation that was systematic and material and then, if such deviation was found to attempt to prescribe a cause to it. This is a dangerous precedent, and risks moving the price cap towards an actively managed price control. It would open Ofgem up to constant challenge to examine allowances on an almost ongoing basis, in search of any deviations. Such an approach could easily lead to a price cap that was effectively managed as a repeated

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<sup>3</sup> <https://www.ofgem.gov.uk/sites/default/files/2023-10/Review%20of%20additional%20wholesale%20costs%20in%20the%20default%20tariff%20cap%20-%20update.pdf>

“float and true-up” (a mechanism which, while sometimes appropriate for lack of workable alternatives, is sub-optimal even in its occasional use).

The above reasoning mirrors the conclusion Ofgem came to in its 2018 decision document on updating the cap, Ofgem stated *“we do not have a provision to correct for over-recovery... we consider that to do so would risk distorting competition and is therefore not appropriate or proportionate... For example, a negative retrospective adjustment (e.g. to correct for the cap being set too high in the previous period) could lead to a cap being set beneath an efficient level of costs. This would distort customers’ incentives to engage in the market, suppliers’ incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market.”*<sup>4</sup>

We urge Ofgem to re-confirm this position, given the uncertainty created by this review. Further, were Ofgem ever to deem an ex-post downward adjustment appropriate in future, we would expect Ofgem to clearly set out clearly, up front, the legal basis for such an intervention. We are concerned that ex-post downward adjustments would frustrate the parliamentary intention that the cap would operate as a maximum price below which effective price competition could occur.<sup>5</sup>

In summary, we support Ofgem’s decision to make no adjustment, however, we urge Ofgem to reflect carefully on the process and rationale. We believe there is scope, at decision stage, for Ofgem to mitigate some of the uncertainty and risk that has resulted from this process.

Kind regards,

Danny Portis

Deputy Director, Retail

Energy UK

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<sup>4</sup> [Default Tariff Cap: Decision: Appendix 3 – Updating the cap methodology, 6](#)

<sup>5</sup> [https://hansard.parliament.uk/commons/2018-03-06/debates/CC8390CB-EEFD-43D9-8E35-805EE8EA9072/DomesticGasAndElectricity\(TariffCap\)Bill](https://hansard.parliament.uk/commons/2018-03-06/debates/CC8390CB-EEFD-43D9-8E35-805EE8EA9072/DomesticGasAndElectricity(TariffCap)Bill) col 237 and col 257.