

# Consultation

## Reassessing the wholesale allowance in the first default tariff cap period

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**Response deadline:** 11pm, 2 March 2020

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We are consulting on our initial thinking regarding a reassessment of the wholesale allowance in the first cap period and potential adjustments. We would like views from people with an interest in the default tariff cap. We would also welcome responses from other stakeholders and the public.

Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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## Executive summary

### Reassessing the wholesale allowance

In November 2019, the High Court concluded that Ofgem should reconsider the wholesale allowance for the first cap period of the default tariff cap (“the Cap”), and make such adjustments as we consider appropriate. We should conduct that reconsideration in the light of information we now have, or require, on suppliers’ wholesale costs in the relevant period.<sup>1</sup>

We intend to introduce any adjustments that are necessary in cap period five (1 October 2020 to 31 March 2021), with a statutory consultation on the issues and relevant licence modification in May 2020.

This consultation sets out our approach and initial thinking on several of the analytical challenges involved in the reassessment. We seek stakeholders’ views to inform our proposals. We split the assessment into three questions:

- What were suppliers’ relevant wholesale costs?
- What was an appropriate wholesale allowance for the first cap period?
- How should we adjust the allowance in future cap periods?<sup>2</sup>

### Suppliers’ costs

The High Court concluded that our approximation of suppliers’ typical wholesale costs for the transition period of the Cap did not characterise suppliers’ circumstances. We will reassess suppliers’ wholesale costs for this period. We propose to take a different approach. We intend to estimate wholesale costs for each large supplier separately, based on their hedging strategies for winter 2018-19. We have collected information for each supplier to calculate an initial estimate using a common methodology. We intend to discuss these initial estimates, and additional evidence suppliers consider relevant, with suppliers bilaterally in February and March 2020.

There are three challenges, which we discuss in this consultation: which suppliers to consider in our assessment; which cap periods we should consider; and how to ensure that suppliers’

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<sup>1</sup> [2019] EWHC 3048 (Admin): <https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html>

<sup>2</sup> This adjustment would be a standalone adjustment in a limited number of cap periods to account for the error, if any, in the first cap period. The ongoing wholesale methodology has not been challenged and it will continue unmodified in future cap periods.

costs are comparable to the allowance (which, for example, adjusts for seasonal prices).

## **An appropriate allowance**

Given our reassessment of costs, we will consider whether the wholesale allowance in the first cap period was appropriate, or whether we should have set it at a different level.

The key challenge is that each supplier will have had different wholesale costs, yet we must set the same level of allowance for all suppliers. It is not possible to set an allowance that is appropriate for *each* supplier. We call this the “transition problem”.

The Domestic Gas and Electricity (Tariff Cap) Act 2018 (“the Act”) requires that we protect customers on standard variable tariffs and default tariffs (“default tariffs”), and in doing so, we must have regard to four statutory “needs”, including an efficient supplier’s ability to finance its activities. The recent judgment made clear that (a) the primary focus of the Cap is on consumer protection; (b) the requirement to have regard to the four statutory needs does not mean that they must all be achieved; and (c) it is for Ofgem to balance the considerations reflected by those needs.

In considering whether the wholesale allowance was appropriate or not, to have regard to efficient suppliers’ costs across the board, which means the allowance may be lower than some suppliers’ costs and higher than other suppliers’ costs.

## **An appropriate adjustment**

If we consider that the allowance in the first cap period should have been different, then we propose to make a standalone correction to a limited number of future cap periods to account for that discrepancy. The number and composition of default tariff customers has changed since the first cap period, and changed to different extents for each supplier. It will not be possible to reverse the impact of the first cap period for each customer and supplier equally.

We consider two specific challenges: what an appropriate adjustment charge would be, given the changes in default tariff customer numbers; and what an appropriate adjustment period would be, given that the Cap could expire at the end of 2020, or each subsequent year until 2023 at the latest. We are likely to propose a 12 month adjustment period (in cap periods five and six, 1 October 2020 to 30 September 2021).

For the avoidance of doubt, the ongoing wholesale methodology was not challenged and shall apply in future cap periods.

## 1. Introduction

### What are we consulting on?

- 1.1. This consultation sets out our initial thinking for reassessing the wholesale allowance in the first cap period<sup>3</sup> and if necessary, how we might adjust the Cap in future cap periods.
- 1.2. We discuss the main policy questions involved in the reassessment:
  - What were suppliers' wholesale costs for the relevant periods?
  - Considering those costs, what would an appropriate level for the wholesale allowance have been?
  - How should future cap periods be adjusted, if required?
- 1.3. Reassessment and adjustment is not straightforward. Each of these questions contains policy challenges. In this consultation we seek stakeholders' views in general, and specifically on five key challenges that we summarise below.

#### Section 1: Estimating suppliers' wholesale costs

- 1.4. In this section we reconsider our estimate of suppliers' hedged wholesale costs for the first cap period. We explain the process we propose to take in order to discuss these costs with suppliers bilaterally during February and March 2020.
- 1.5. We discuss three key challenges:
  - Challenge 1: which suppliers we intend to assess. In our 2018 decision on the design of the Cap ("Decision"), we estimated costs for the six largest suppliers, serving around 90% of customers on default tariffs.<sup>4</sup> Using updated data on market shares during the first cap period, this approach would include seven suppliers.

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<sup>3</sup> Subject to the consideration in paragraphs 2.21 and 2.22 regarding the impact the transition challenge had on the second cap period.

<sup>4</sup> Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.132.  
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

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- Challenge 2: which cap periods we should consider costs for. The transition problem mainly affects the first cap period, but will also apply (to a lesser extent) for the second cap period if any supplier purchased contracts for summer 2019 before 1 August 2018 (the start of the observation window adopted in our Decision).
- Challenge 3: how to ensure we assess cost estimates that are comparable with the allowance: we need to ensure that suppliers' costs and the allowance adjust for seasonal prices, shaping, forecast error and other factors in comparable ways.

## **Section 2: Reconsidering the appropriate allowance level**

1.6. In this section, given our reassessment of suppliers' costs, we reconsider whether the allowance in the first cap period was appropriate, and if not, at what level an appropriate allowance would have been.

1.7. We consider one challenge:

- Challenge 4: variation in suppliers' costs. Each supplier had different costs, so we could not set the allowance at the level of *each* suppliers' costs. For example, if we had set the allowance at the level of average costs, some customers would be have paid less than the underlying efficient costs of their supplier and other customers would have paid more than the underlying efficient costs of their supplier. This is an inevitable feature in setting a single cap for all suppliers.

## **Section 3: Setting an adjustment to future allowances**

1.8. If we consider that we should have set the allowance in the first cap period at a different level, then we need to adjust the Cap in future cap periods. In this consultation we consider two key challenges relating to any adjustment.

- Challenge 5: how to consider the impact on customers and suppliers in aggregate and individually. The exercise is to reverse the impact of any error in the cap level as much as practicable, but this is not a straightforward exercise. The number and composition of default tariff customers, in total and for each supplier, has changed. We set the Cap per customer and per unit of energy. This means that the revenue generated by a supplier by the Cap in Q1 would be different from the amount generated in a subsequent cap period, even if the cap levels were the same.

- Challenge 6: what time period to adjust the cap level over. The Cap could expire at the end of 2020, or it could be extended for at least 12 months beyond this. The length of the adjustment period changes the potential impact on customers and suppliers.

## Context and related publications

### The Cap

- 1.9. We introduced the Cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as “default tariffs”). The Cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.
- 1.10. We set the Cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 (“The Act”). The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to four statutory “needs”, including an efficient supplier’s ability to finance its licensed activities.<sup>5</sup>
- 1.11. The Cap comprises several allowances, each relating to different costs categories. We update the level of each allowance every six months, to reflect changes in the underlying costs. The Act requires that we set one cap level for all suppliers.<sup>6</sup>

### The wholesale costs allowance

- 1.12. We include an allowance in the Cap to recognise the underlying cost to suppliers of purchasing the gas and electricity that their customers consume (suppliers’ wholesale costs). We explain the methodology for the wholesale allowance in Appendix 6 of our Decision.<sup>7</sup>

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<sup>5</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6).

<http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>

<sup>6</sup> Domestic Gas and Electricity (Tariff Cap) Act 2018; section 2(2).

<http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

<sup>7</sup> Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale.

<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

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1.13. In normal circumstances, the 'one-size-fits-all' requirement of the Act is relatively straightforward with regard to the wholesale allowance. We base the wholesale allowance on the average price offered during a six month long "observation window" for certain forward energy contracts. Suppliers know, in advance, which forward contracts we will observe to calculate the allowance. Each supplier can purchase those contracts in the predetermined proportions when they are sold on the wholesale market. When we calculate the average price of the forward contracts sold in a particular observation window, that average price should reflect the average cost of the contracts that each supplier purchased during the observation window. Broadly, each supplier will have similar costs and those costs will reflect the level of the allowance.

### **The transition problem**

1.14. In the first cap period, the 'one-size-fits-all' requirement was a challenge with regard to the wholesale allowance. Some suppliers had already purchased a significant proportion of the energy contracts for winter 2018-19 before we set the observation window, and they had purchased those contracts to different extents at different times.<sup>8</sup> Therefore each supplier would incur costs that differed from each other, which would not necessarily result from inefficiency. As a consequence, the single wholesale allowance would never reflect all suppliers' costs and those suppliers would not be able to adjust their costs to reflect the allowance. This challenge was an unavoidable outcome of transitioning from a pre-cap period (when suppliers had pre-existing and different purchasing strategies) to a cap period (where each supplier could follow the single pre-arranged approach). We call this challenge "the transition problem".

1.15. In our Decision we set the wholesale allowance using our normal observation window for a winter cap period (February to July). We estimated what suppliers' typical costs for winter 2018-19 were.<sup>9</sup> With that in mind, we concluded that the allowance would approximate suppliers' costs on average, although, inevitably, some suppliers would

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<sup>8</sup> We specify winter 2018-19, rather than Q1 2019 in isolation, to ensure we account for seasonal prices in a way that is comparable to the Cap. For a discussion of this issue, see paragraphs 2.23 to 2.29.

<sup>9</sup> In the original decision, we used 'typical' interchangeably with 'average', which is common in our publications and the energy industry. For instance, a 'typical' customer is a customer with consumption at the Typical Domestic Consumption Value (TDCV), the median level of consumption.

only partially recover their wholesale costs. In seeking both to protect customers and to have regard to suppliers' costs, we considered the allowance appropriate.

### **Reassessing our decision**

- 1.16. British Gas successfully challenged our decision on the transition wholesale allowance, on the basis that our estimate of suppliers' costs relied on an incorrect assumption that we had not consulted suppliers on. To estimate suppliers' costs we took an approximation of suppliers' average purchasing strategy for energy delivered in 2016 and applied it to the relevant wholesale prices for forward contract delivered in winter 2018-19. Our consultation had not made it clear to suppliers that we would assume their purchasing strategies for winter 2018-19 would broadly reflect the ones they had used for 2016. Suppliers argued this assumption was wrong. There was evidence that, in the period following announcements about the intended Cap, some or all large suppliers had changed their purchasing strategies, affecting their cost base.
- 1.17. The court concluded that we should reconsider the allowance for the first cap period, and make such adjustments as we consider appropriate.<sup>10</sup> That reconsideration should be conducted in the light of the information we now have, or require, on suppliers' wholesale costs in the relevant period.
- 1.18. The judgment also stated that: the primary focus in setting the price cap should be on consumer protection; the provisions of section 1(6) do not require Ofgem to achieve all the statutory "needs" but to have regard to them; and it is for Ofgem to decide what information to request from suppliers: Ofgem need only obtain enough information to verify its material modelling assumptions, rather than all supplier strategies.<sup>11</sup>

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<sup>10</sup> [2019] EWHC 3048 (Admin). <https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html>

<sup>11</sup> [2019] EWHC 3048 (Admin); paragraphs 14 and 85.  
<https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html>

## Related publications

1.19. The following publications provide more detailed background:

- An overview of our Decision: Ofgem (2018), Default tariff cap decision – Overview. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>
- A detailed description of our wholesale methodology: Ofgem (2018), Default tariff cap decision – Appendix 4: wholesale costs. [https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix\\_4\\_-\\_wholesale\\_costs.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf)
- The High Court’s judgement: British Gas Trading Ltd, R (on the application of) v The Gas and Electricity Markets Authority & Ors [2019] EWHC 3048 (Admin) (13 November 2019). <https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html>

## Consultation stages

### Initial consultation

1.20. This consultation sets out our initial thinking. We invite stakeholders to submit representations on or before **2 March 2020**.

### Data gathering and disclosure of estimates

1.21. Four of the largest suppliers submitted information on their approach to purchasing energy for winter 2018-19 during the Judicial Review. In January 2020, we collected data from the other large suppliers that had not already been provided in the previous consultation responses or court proceedings.

1.22. Using that data (including evidence provided during the court proceedings) we intend to estimate costs for each large supplier. For each of those suppliers, we intend to disclose our initial estimate of their costs as a starting point for bilateral discussions in **February and March 2020**. Suppliers are free to submit additional evidence and analysis for discussion and consideration.

## Statutory consultation

1.23. We intend to present proposals for statutory consultation in **May 2020**. We expect this consultation to last around six weeks.

1.24. The proposals will be informed by suppliers' representations to this initial consultation and our bilateral discussion relating to suppliers' costs.

## Decision

1.25. We seek to publish a decision **at the end of July 2020**, with effect from 1 October 2020 (the fifth Cap period).

1.26. We have published a consultation on the process for making modification to the licence condition relating to the Cap. Should we not proceed with that proposal, we will reconsider our timetable and update stakeholders in **mid-March 2020**. Under a revised timetable, we would publish a decision on or before **12 June 2020**, in order to still introduce changes in time for cap period five.

## How to respond

1.27. We want to hear from anyone interested in this consultation. Please send your response to [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk) before **11pm on Monday 2 March 2020**.

1.28. We will publish non-confidential responses on our website at [www.ofgem.gov.uk/consultations](http://www.ofgem.gov.uk/consultations).

## Your response, data and confidentiality

1.29. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.30. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to

your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.31. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.32. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

## **General feedback**

1.33. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?


Please send any general feedback comments to [stakeholders@ofgem.gov.uk](mailto:stakeholders@ofgem.gov.uk)

## **How to track the progress of the consultation**

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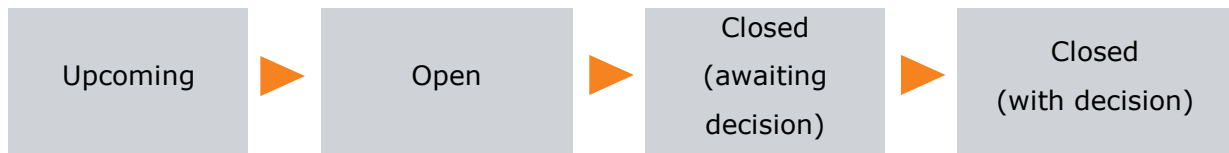
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## 2. Suppliers' wholesale costs

### Section summary

In this section we consider the key issues for estimating suppliers' relevant wholesale costs. We set out our initial considerations and plans for bilateral discussions with suppliers about their costs. We seek suppliers' views on our considerations in general, and the two challenges we highlight specifically.

## Our approach

### Methodology

2.1. To reassess whether the wholesale allowance was appropriate, we need to estimate suppliers' wholesale costs for the relevant period. In our Decision we calculated the costs of a notional supplier with a 'typical' hedging strategy. We used the costs of the notional supplier as an approximation of suppliers' costs on average. For this review, we propose a different approach.

2.2. We propose to estimate each supplier's relevant costs separately. Each supplier has provided its wholesale purchasing strategy for winter 2018-19 to us, or in its evidence to the High Court. As an initial step, subject to further discussion with suppliers, we propose to use this information to estimate the comparable wholesale costs for each large supplier. To do this, we intend to use the wholesale allowance methodology, replacing the observation window with a supplier's own strategy.

2.3. In section 3, we consider these estimates of suppliers' costs, individually and on average, when reconsidering whether the wholesale allowance was appropriate.

### Disclosure and bilateral discussions

2.4. We intend to share our calculations with each relevant supplier in **February 2020** for review and bilateral discussions. We seek to reach a decision on each supplier's costs, after considering their representations, by **the end of March 2020**.

2.5. Our estimates are a starting point. We seek to ensure that we assess suppliers' costs using a consistent approach and produce a wholesale allowance accordingly, we start with a common methodology that is comparable to the way the wholesale allowance accounts for

seasonal prices and shaping costs. We welcome and will consider further evidence and analysis from suppliers.

### **Analytical challenges**

2.6. In this section, we set out our considerations relating to three challenges:

- which suppliers to include in the scope of our analysis;
- which cap periods we should consider; and
- how to ensure that cost estimates are comparable with the allowance.

2.7. We encourage stakeholders to submit representations on these issues in particular.

### **Challenge 1: suppliers in scope**

2.8. Our first challenge is deciding which suppliers to include in our reassessment of costs.

#### **Considering small suppliers**

2.9. We do not propose to consider small suppliers' wholesale costs quantitatively.

2.10. In our Decision, we considered small suppliers, but did not estimate their costs.<sup>12</sup> We concluded that, although these suppliers likely had higher wholesale costs than the allowance, we would not increase the allowance on that basis.

2.11. In summary the reasons for our conclusion are, we considered that:

- few default tariff customers were with small suppliers, so these suppliers had less effect on the protection default tariff customers required (on average);

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<sup>12</sup> Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.167-3.169. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>



- most small suppliers had few default tariff customers as a proportion of their customer base, so their finances were less exposed to the level of the Cap; and
- these suppliers mostly set tariffs below the level of the Cap, so their high wholesale costs were offset by cost differences in other parts of their business, or other pricing considerations. (In other words, the level of the Cap was not a binding constraint on their pricing in practice).

### **Considering the cost of large suppliers**

#### *Our previous approach*

2.12. In our Decision we sought to consider the costs of larger suppliers.<sup>13</sup> These suppliers' tariffs are the ones that affect most of the customers in scope of the Cap. In addition, these suppliers tended to have many default tariff customers, so their finances were more exposed to the level of the Cap than smaller suppliers.

2.13. On that basis we sought to approximate the costs of the six largest suppliers of default tariff customers (British Gas, EDF, Eon, Npower, Scottish Power, and SSE). Using data available at the time, these suppliers appeared to serve nearly 90% of customers on standard variable tariffs ("SVTs").

#### *Changing circumstances*

2.14. We propose to analyse the market as it was during the first cap period. This allows us to understand the impact that the Cap had in its first cap period.

2.15. Since the first cap period, there has been consolidation and change in the market. We propose to consider suppliers as they were at the time of the first cap period.

2.16. We are considering whether to expand our analysis to seven suppliers, rather than six suppliers. Data is now available on market shares in January 2019 and April 2019. **Tables 1 and 2** show that, due to the rapid expansion of one supplier – which was the fourth largest

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<sup>13</sup> Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.153-3.166. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

supplier of gas customers with variable tariffs and seventh largest for electricity – seven suppliers served nearly 90% of the customer in scope of the Cap, not six.

**Table 1: Market shares of gas default tariff customers in the first cap period**

Gas supplier	January share	April share	Average share
British Gas	37.0%	36.2%	36.6%
SSE	15.4%	14.7%	15.1%
E.ON	11.3%	11.2%	11.2%
Bulb	7.0%	8.1%	7.6%
Scottish Power	6.8%	6.5%	6.7%
EDF	6.1%	6.1%	6.1%
npower	5.8%	5.9%	5.8%
<b>Total</b>	<b>89.4%</b>	<b>88.7%</b>	<b>89.1%</b>

**Table 2: Market shares of electricity default tariff customers in the first cap period**

Electricity supplier	January share	April share	Average share
British Gas	22.2%	21.7%	22.0%
SSE	19.0%	18.1%	18.6%
E.ON	15.3%	15.2%	15.3%
EDF	10.1%	9.9%	10.0%
Scottish Power	8.5%	8.1%	8.3%
npower	7.7%	7.9%	7.8%
Bulb	6.8%	8.2%	7.5%
<b>Total</b>	<b>89.7%</b>	<b>89.1%</b>	<b>89.4%</b>

**Table 3: Dual Fuel SVTs for the first cap period**

Supplier	Average SVT <sup>(1)</sup>	Difference to the Cap
British Gas	£1,135	-£2
Bulb	£1,013	-£124
E.ON	£1,137	£0
EDF	£1,136	-£1
npower	£1,137	£0
Scottish Power	£1,137	£0
SSE	£1,137	£0

Note: "Average SVT" is a simple average of dual fuel SVTs on 28 January, 28 February, and 28 March 2019.

Source for tables 1, 2, and 3: Energy Helpline data

### *Considering scope*

2.17. We are considering whether it is appropriate to include all seven of the suppliers listed in the tables above in the scope of our assessment. Our considerations include:

- Scope of the Cap: All customers with variable or default tariffs are within scope of the Cap.<sup>14</sup>
- Relationship between the tariff and the Cap level: Most default tariffs and SVTs were set at the level of the Cap; we assume that the level of allowance in the first cap period and future cap period affected these tariffs directly (Table 3, above). However, at least one variable tariff (across the market) was competitively set, and their relationship to the Cap may differ. Had the Cap been higher, competitively set tariffs may not have differed at all.
- Whether costs are representative: we will consider whether suppliers with outlying wholesale costs (in either direction) should be excluded on the basis that they are for some reason entirely unrepresentative of the costs of serving customers on default tariffs, and/or liable to distort a proper assessment. We will also consider whether wholesale costs can be considered in isolation, or for some suppliers they need to be considered in the context of other factors (such as using efficiencies in other costs categories to offset the impact of temporarily higher wholesale costs).

2.18. On that basis, we consider that the six large suppliers that set their SVTs and default tariffs at the level of the Cap, or near it, are clearly relevant to our assessment of wholesale costs. Had we set the Cap higher, we assume that their tariffs would have been increased by the same amount.

2.19. It is not clear to us that Bulb's variable tariff is relevant to our considerations. Bulb offers a variable tariff that is technically in the scope of the Cap, but it is competitively set; it is not a default tariff. During the first cap period its tariff was around £125 lower than the Cap (Table 3 above). Its relationship to the Cap and the relevance of its wholesale costs to

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<sup>14</sup> There are specific exemptions from the Cap – see section 3 of the Act. Domestic Gas and Electricity (Tariff Cap) Act 2018. <http://www.legislation.gov.uk/ukpga/2018/21/section/3/enacted>

customers that are protected by the Cap may be significantly different. We will continue to consider these issues in our bilateral discussions.

## **Challenge 2: relevant cap periods**

2.20. In our Decision, we explained that the transition mainly affects the first cap period, but that it could also affect the second cap period for some suppliers – depending on how far in advance suppliers started purchasing energy for summer 2019.<sup>15</sup> For any supplier that purchased some contracts for summer 2019 *before* 1 August 2018 (the start of the observation window for the second cap period), their net costs (including the profits or losses from selling those excess contracts) would not align with the observation window for the second cap period.

2.21. In principle, some suppliers may have purchased contracts for winter 2019-20 (cap period three) before February 2019 (the start of the relevant observation window), in which case the transition problem would also affect cap period three. Based on suppliers' evidence for winter 2018-19, we would expect any impact, if there is any at all, to be slight.

2.22. We are considering whether to assess the impact of the transition challenge on multiple cap periods, or just the first cap period. We intend to discuss this issue with suppliers in the bilateral discussions and consider their representations on whether they purchased summer 2019 contracts before August 2018 and how their costs relate to cap period two. Our initial cost estimates will likely focus on the first cap period only, as that is the period where the effect is greatest and the methodological issues should be common. However, in principle, we do not initially consider there to be clear reasons to not consider the impact of the transition problem on cap period two.

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<sup>15</sup> Ofgem (2018), Default Tariff Cap Decision: Appendix 4 – Wholesale costs, paragraph 3.166. [https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix\\_4\\_-\\_wholesale\\_costs.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf)

## Challenge 3: estimating comparable costs

### Comparing costs

2.23. Our second challenge is that we need to assess costs in a comparable way to the allowance. In particular, we need to ensure we account for seasonal prices, shaping costs, and forecast error consistently.

2.24. The wholesale allowance adjusts for seasonal prices (high wholesale costs in winter and low wholesale costs in summer). By design, the allowance under-recovers suppliers' wholesale costs in winter and over-recovers them in summer. Suppliers' costs for January to March 2019 in isolation are therefore not comparable to the allowance for that period, as it is seasonally adjusted.

2.25. The wholesale allowance standardises the treatment of shaping costs and forecast error. In any given period, a supplier may have higher or lower costs than the allowance depending on how its actual demand and activity to 'shape' non-granular forward contracts (i.e. for energy in a particular season or quarter) into granular contracts (i.e. for energy in particular day of half-hour period) varied. Over the long run, these variances broadly offset. This means we cannot, in isolation, compare the reported costs for January to March 2019 (i.e. the cost in hindsight), with the allowance, which estimates hedged costs. This distinction between hedged costs and costs 'with hindsight' should be maintained to ensure consistency.

### Our approach

2.26. We cannot assess suppliers' costs by looking at the cost they incurred in the first quarter of 2019. These reported costs will not be seasonally adjusted, and will include the impact of shaping and adjusting to changes in demand (including changes in customer numbers) that may have been more favourable or costly than suppliers expected.

2.27. Broadly, we propose to estimate suppliers' seasonally-weighted hedged costs for the cap period by using the wholesale allowance methodology (as described in our Decision), except that we would replace the observation window with a supplier's hedging strategy. The contracts purchased and the treatment of shaping costs and forecast error would be consistent. The timing of when contracts were purchased and in what quantities would reflect the supplier's actual approach.

2.28. For instance, if a hypothetical supplier started purchasing contracts for winter 2018-19 using a linear 24 month hedging strategy, and then switched to the April-September

observation window on 1 July 2018, we would take the following approach to calculate our starting point estimate:

- Purchase period: we would replace the observation window in the wholesale methodology with the high level purchasing strategy. In this case, the hypothetical supplier would purchase 75% of their demand evenly between 1 January 2017 and 30 June 2018 and then purchase 50% of their demand evenly between 1 July 2018 and 30 September 2018.
- Adjusting volumes and prices on alignment: when our notional supplier switched strategy on 30 June 2018 they needed to align to a new strategy, half of which is already in the past. On that new strategy, by 30 June 2018 they would hold 50% of their demand at an average costs reflecting the prices between 1 April 2018 and 30 June 2018. To align volumes and costs to that strategy we would make two adjustments. First, selling the excess volumes at the market price on 30 June 2018; recognising a profit (or loss) against the average purchase price. Second, adjust the costs of the contracts actually purchased between 1 January 2017 and 30 June 2018 to the weighted average cost had those contracts been purchased between 1 April 2018 and 30 June 2018. The difference would be a loss or gain.<sup>16</sup>
- Contract prices: the contract prices we would analyse are the same as those in the wholesale allowance methodology: seasonal contracts for electricity and quarterly contracts for gas, covering a 12 month delivery period.<sup>17</sup>

2.29. Suppliers may have invested gains made on the sale of excess contracts or taken action to mitigate losses. In principle, our starting point is that we are indifferent to how suppliers invested that money. We consider the gain relevant, regardless of whether those funds were subsequently used to protect market share, invest in services, or contribute

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<sup>16</sup> Where a supplier has provided information about the precise timing of its hedging decisions, we intend to use this in our analysis. Otherwise, our default assumption for our initial analysis is that a supplier hedges to the middle of the delivery season. This would deliver its desired hedge on average, even though the proportion hedged for individual months at any point in time will vary.

<sup>17</sup> We use a 12 month "delivery period" to offset the impact of seasonal prices that would occur if we used the six month cap period only. We do not expect suppliers to have actually purchased the contracts for the second half of the 'delivery period'. Those months are included in the first half of the "delivery period" for the subsequent cap period.

dividends. Those are all business decisions that would not have otherwise been possible if wholesale costs had not been lower than expected.

2.30. Some suppliers' purchasing strategies are more complicated than others'. We will discuss each supplier's specific circumstances with that supplier to understand whether our approach is appropriate, accounting for seasonal prices, shaping costs and forecast error, and other differences in a reasonable way.

## **Next steps**

2.31. Suppliers are welcome to prepare representations on their costs in advance of receiving our estimates, and can contact [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk) to discuss their availability or preferred method of engagement.

## 3. Reconsidering the wholesale allowance

### Section summary

In this section we consider the key issues for reassessing an appropriate wholesale allowance in the first cap period. We set out our initial considerations. We seek suppliers' views on our consideration in general, and the key challenge we highlight specifically.

## Our approach

### Methodology

3.1. In our Decision, we considered whether our proposal to use the standard observation window for a winter cap period (February to July) would set an appropriate allowance, that better reflected suppliers' costs compared with the observation window we proposed in our May 2018 consultation.<sup>18</sup>

3.2. We propose to consider at what level we should have set the wholesale allowance in the first cap period, independently of the observation windows we proposed in the original consultation process. That appropriate level may not be the product of any observation window or specific hedging strategy. It could be any level that we consider appropriate based on our consideration of suppliers' costs.

### Analytical challenge

3.3. In this section, we consider the challenge around the variation in suppliers' efficient costs. We encourage stakeholders to submit representations on this issue in particular.

## Challenge 4: variation in costs

3.4. There will be no level of the allowance that will reflect *each* supplier's costs. The Act requires that we set a single allowance for all suppliers, whereas suppliers will have different

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<sup>18</sup> In our May 2018 consultation we proposed to use an observation window between April and September 2018. Ofgem (2018), Default tariff cap: policy consultation – Appendix 6 Wholesale costs. <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-policy-consultation-overview>



costs. At whatever level we set the allowance, some suppliers will be at an advantage compared to others. This is the transition problem (see paragraphs 1.14 to 1.15).

### **Criteria for an appropriate allowance**

3.5. We propose to consider the appropriateness of the wholesale allowance in the first cap period with reference to the customer protection and the statutory “needs” set out in section 1(6) of the Act. In seeking to protect customers, we will consider whether the allowance would mean that customers pay more or less than their supplier’s costs. In having regard to an efficient supplier’s ability to finance its activities, we consider it desirable that the allowance is at the level of suppliers’ costs, but not that this needs to be achieved. Indeed, it cannot be achieved for each supplier at the same time.

3.6. In principle, we do not consider the variation in wholesale costs to indicate that some suppliers are more efficient at purchasing energy than others. In general, suppliers did not know how prices would develop, and had prices fallen rather than increased, the impact on suppliers may have been reversed. However, we will consider whether suppliers with outlying costs (in either direction) should be excluded on the basis that they are for some reason entirely unrepresentative and/or liable to distort a proper assessment.

3.7. We also propose to consider the level of approximation and uncertainty in our estimates. For reasons discussed in Section 2 (see ‘Estimating comparable costs’, paragraphs 2.23 to 2.30) the assessment of suppliers’ costs will contain some uncertainty. In this reassessment, the uncertainty should be less than it was for the approach we used for our Decision (when we used a different methodology to estimate typical costs).

### **Considerations**

3.8. We consider it straightforward that we should not set the allowance above the level of the supplier with the highest costs and we should not set the allowance below the level of the supplier with the lowest costs.

3.9. Setting the allowance at the level of the supplier with the lowest cost would protect customers – no customer would have paid more than their underlying wholesale costs. However, for each of the customers served by other suppliers, the Cap would have depressed charges too much and would not have been representative of their wholesale costs. Their supplier would have only partially recovered its wholesale costs.

3.10. Setting the allowance at the level of the supplier with the highest cost would protect the customers *of that supplier* – they would not have paid more than their underlying wholesale costs – but the customers of all other suppliers would not be sufficiently protected, they would pay more than their underlying costs. The suppliers of those customers would be able to recover more than their costs.

3.11. We consider the appropriate allowance would be in between the highest and lowest costs. The exact level would depend in part on the distribution of costs. In our Decision we intended to have regard to suppliers' costs on average, and we propose to take that approach. With estimates of each supplier's costs, we could calculate and have regard to, the average level of costs for the group of suppliers.

3.12. There are various averages we could use: simple average, weighted average, or median. Our proposal would depend on the distribution of costs. Our starting position is that we would have regard to a weighted average (accounting for market share) as this would reflect the average position *from the customers' perspective*. However, we might consider using a simple average, or median, if we considered that the weighted average was distorted by the costs of an outlying supplier. For example where there are outliers in the sample (large suppliers with very unusual strategies and results) and/or disproportionate effects of one or two large suppliers in the sample (if a weighted average is used).

3.13. We intend to have regard to the average costs. Our starting point is that the allowance would reflect the average costs. In principle, the allowance could differ from average costs if we consider that appropriate. For instance, to account for uncertainty and approximation in the estimates, or to improve protection for customers depending on the distribution of specific suppliers.

## 4. Adjusting future allowances

### Section summary

In this section we consider the key issues for adjusting future allowances, if we conclude that the allowance should have been different. We set out our initial considerations. We seek suppliers' views on our consideration in general, and the two key challenges we highlight specifically.

### Our approach

#### Methodology

4.1. If we conclude that we would have set a different wholesale allowance, we will consider how to adjust the level of future cap periods to correct for the difference.

4.2. We propose to introduce a new sub-allowance into the wholesale allowance, which would make an adjustment in a limited number of future cap periods. We call this correction the "Adjustment Allowance". If, for example, the original allowance was lower than it should have been, we will set use the Adjustment Allowance to increase the prices in future cap periods by an appropriate amount for a limited period.

4.3. We propose to apply the Adjustment Allowance so that it increases the maximum variable charge (but not the standing charge) over two cap periods. We apply it to the variable charge only in line with the general approach to wholesale costs.

4.4. For the avoidance of doubt, the ongoing wholesale methodology was not challenged and shall apply in future cap periods (i.e. the 6-2-12 method described in our Decision will still apply as normal).

#### Analytical challenges

4.5. Setting an adjustment is not straightforward. In this section, we consider two key challenges:

- setting an appropriate adjustment charge
- setting an appropriate adjustment period.

4.6. We encourage stakeholders to submit representations on these issues in particular.

## Challenge 5: setting an adjustment charge

### Changing circumstances

4.7. Our challenge is how we should seek to reverse the impact (as much as is possible) of the difference between where the Cap was and where it should have been in the first cap period.

4.8. The difficulty is that we set the Cap using a maximum variable charge per unit of energy and maximum standing charge per customer per day, yet the number and composition of default tariff customers, in total and for each supplier, has changed since the first cap period, and will continue to change. Due to changes in customer numbers and consumption, it is impossible for the impact on *each* customer and *each* supplier in the first cap period to be reversed.

### Customers' perspective

4.9. From customers' perspective, we cannot straightforwardly undo any level of under-allowance in the first cap period.

#### *Consistent customers*

4.10. Most default tariff customers will have been default tariff customers in the first cap period and will continue to be so. For these customers we can simply calculate the amount by which the allowance should have been higher in the first cap period and add an allowance in future cap periods to offset that amount in future periods. However, as we set most of the Cap per unit of energy, it is unlikely that the amount recovered will actually match the under allowance in the first cap period. A customer's consumption changes with the weather (among other factors), they may end up paying back more or less than the level of over protection in the first cap.

4.11. The Cap considers wholesale costs as a unit charge. To calculate that charge, we propose to use the same typical customers' consumption we used when designing the Cap (3,100 kWh for electricity and 12,000 kWh for gas) and seasonal normal consumption patterns in all cap periods (the first cap period and future cap periods).

4.12. However, in practice customers may use more energy or less energy in an adjustment period than they did in the first cap period. The net impact on their bills over the two periods may not net out. Even in aggregate, if there is a change in customers' mean consumption it

may be impossible to disentangle forecast error due to unseasonal weather (which is already standardised in the additional allowances in the wholesale allowance methodology) from underlying changes in consumption.

#### *Subsequently engaged customers*

4.13. Some customers will have been on a default tariff in the first cap period, but then switched to a non-default tariff or supplier. Even if these customers benefitted from a cap level that was too low, any subsequent Adjustment Allowance in the Cap cannot offset that additional benefit for those customers.

#### *New default tariff customers*

4.14. Some customers that are now on default tariffs (or will be when the adjustment is in place) were not default tariff customers in the first cap period. They were not affected by the first cap period. Any correction mechanism would mean that these customers pay charges higher than the efficient cost of supplying energy to them.

### **Suppliers' perspective**

4.15. From a supplier's perspective, having regard to their costs, the issue of reversing the impact of errors in the first cap period is complicated further.

#### *Fewer customers in aggregate*

4.16. There may be fewer default tariff customers in an adjustment periods than there were in the first cap period.

4.17. Theoretically, we could seek to recover the aggregate amount of money that suppliers (considered collectively) did not receive in the first cap period, but would have done had the wholesale allowance been higher. Such an objective would require an adjustment that accounts for the different customer numbers in each period (i.e the adjustment charge would be more per default tariff customer in the adjustment period than the benefit received by each default tariff customer in the first cap period). This additional charge per customer would account to the fact there may be fewer customers.

4.18. However, if we sought to reverse the level of under-allowance that each customer received (i.e. if the Cap was £10 per customer too low, then it should recover £10 per

customer in the adjustment periods), then suppliers in aggregate would only partially recover their costs, because there are now fewer customers to apply the adjustment charge to.

4.19. In theory, the impact on suppliers of the error in the first cap period (and the adjustment charge) may have a further complication. If the allowance in the first Cap had been higher, then the difference between default tariffs and competitive tariffs would have been higher. Theoretically at least, that additional amount may have encouraged more default tariff customer at the margin to switch. Had a supplier charged more, it may have resulted in fewer default tariff customers. The same is true for any Adjustment Allowance. If suppliers increase their tariff, they may increase the differential between their default tariff offer and a competitive tariff and affect their rate of customer retention.

4.20. In practice, it is not clear to us that this last consideration (the differential between the Cap and competitive tariffs) has a significant effect. The customers protected by the Cap are, broadly speaking, less responsive to price differentials – hence the need to protect default customers. Furthermore, if they were price sensitive (at the margins) then the introduction of the Cap should have reduced switching. In fact, switching increased, suggesting that non-price factors (such as marketing and media attention to energy prices) have greater significance for default tariff customers.

#### *Disparate impacts between suppliers*

4.21. Putting aside the aggregate position, the impact of any adjustment will differ for each supplier. We cannot provide to each supplier the money that *they would have recovered in the first cap period*, had the allowance been higher. We can only increase the amount that they can charge the customers *they now have*, and that increase must be the same for each supplier.

4.22. The difficulty is that each supplier's customer base has changed to a different extent. **Table 4** provides an illustrative example.

4.23. We will continue to consider these issues. Under section 1(6) of the Act, we must protect customers on default tariffs and have regard to efficient suppliers' ability to finance their licensed activities. On that basis, our starting position is that, from the perspective of an individual customer, the combined impact of the under-allowance in the first cap period and the adjustment charges in the future periods should net out (i.e. if the cap level under-recovered £20 per typical customer in the first period, then the temporary adjustment to the cap level in future periods should recover £20 per customer).

**Table 4: Illustrative example of how changes in customer bases affect the total amounts recovered**

	Supplier A	Supplier B	Supplier C	Aggregate
Under recovery in first cap period, per customer (£)	-5	-5	-5	
Customers	1.0m	1.0m	1.0m	3.0m
<b>Under recovery in first cap period, aggregate (£)</b>	<b>-5.0m</b>	<b>-5.0m</b>	<b>-5.0m</b>	<b>-15.0m</b>
Recovered in recovery period, per customer (£)	5	5	5	
Customers (m)	0.8m	1.0m	1.2m	3.0m
<b>Recovered in recovery period, aggregate</b>	<b>4.0m</b>	<b>5.0m</b>	<b>6.0m</b>	<b>15.0m</b>
Change in customers	-0.2m	0.0m	+0.2m	0.0m
<b>Net impact on supplier (£)</b>	<b>-1.0m</b>	<b>0.0m</b>	<b>+1.0m</b>	<b>0.0m</b>

## Challenge 6: setting an adjustment period

### Potential expiry of the Cap

4.24. The Cap could expire at the end of 2020, or it could be extended for 12 months. If it is extended, then it may expire in 2021 or be extended again until 2023 at the latest. The Secretary of State will not have made her decision on an extension until after we publish our decision on any required correction.

4.25. If we want to recover costs before the end of 2020 (the earliest point that the Cap could expire) then there would be a considerable risk that suppliers over recover costs. We would need to set an allowance that recovered costs in the three months between October and December 2020 (the first half of cap period five). Should the Cap be extended, that level would still apply in January to March 2021 (the second half of the cap period), charging customers more than we intended.

4.26. If the Cap is extended, then we can spread the adjustment over (at least) the two cap periods up to September 2021. This would smooth the impact on prices, limiting observed

increases and disruption to customers (something suppliers frequently referenced as a concern when discussing other topics).

4.27. We could spread the adjustment over a longer period, further reducing disruption for customers. However, this would involve significant uncertainty around potential cap extensions and will be impacted even more by changes in the default tariff customer base.

### **Declining customer base**

4.28. Each supplier's default tariff customer base is likely to continue changing, although the rate of change is uncertain, in aggregate and for individual suppliers.

4.29. Given the complications caused by changes in default tariff customer bases, discussed above, a longer adjustment period create more uncertainty about the impact of the amounts that would be recovered.

4.30. We could estimate the ongoing decline of default customers, but this is difficult to estimate as the impact of the Cap in the longer term is not clear. Estimating customer numbers could lead to customers receiving more or less protection than intended, and suppliers recovering more or less than intended.

### **Consideration**

4.31. In abstract, we expect a 12 month adjustment period may balance the competing concerns best, but we will consider that in light of various factors, including the actual adjustment required, any development in the potential outcome of this year's review of the conditions for effective competition, and trends in customer numbers.



## Appendix 1 – Privacy notice on consultations

### 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 consultation.

#### 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](mailto: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. i.e. a consultation.

#### 3. With whom we will be sharing your personal data

***(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be as specific as possible.)***

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

Your personal data will be held for ***(be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')***

#### 5. 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 3<sup>rd</sup> 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.

**6. Your personal data will not be sent overseas** (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use “the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this”.

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

**8. Your personal data will be stored in a secure government IT system.** (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

**9. More information** For more information on how Ofgem processes your data, click on the link to our “[Ofgem privacy promise](#)”.

## Appendix 2 – Version history

### Correction

This consultation was published on 31 January 2020. In that publication paragraph 1.27 stated an incorrect date for responding to the consultation. The correct date, 2 March 2020, was stated on the front page accurately.

On 5 February, we published a second version of the consultation to correct paragraph 1.27 so that it reads:

“We want to hear from anyone interested in this consultation. Please send your response to [retailpriceregulation@ofgem.gov.uk](mailto:retailpriceregulation@ofgem.gov.uk) before **11pm on Monday 2 March 2020.**”