

## Executive Summary

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1. Centrica welcomes the opportunity to respond to Ofgem’s consultation on “reassessing the wholesale allowance in the first default tariff cap period”, given the materiality of this issue, and the protracted period over which it has been outstanding.
2. In this Executive Summary, we describe our headline views, including key concerns with Ofgem’s proposed approach as it stands, and views on the most material remaining issues raised in the consultation document. Our detailed response to the “challenges” set out in the consultation document is included in the appendix to this document. We also include a legal annex, setting out the legal basis of the views set out in this response.
3. Overall, we are extremely concerned that Ofgem’s proposed methodology seeks to look at hedging behaviour in periods outside of Q1 2019 when reassessing the wholesale allowance for the first default tariff cap period. Q1 2019 was exceptional in the sense that Ofgem recognised at the very outset in 2018 it required standalone “transitional” treatment because of the timing of the introduction of the cap.
4. We strongly believe that:
  - there is no basis on which it is appropriate for the reassessment to extend to either Q4 2018 (which is the implication of modelling “winter 2018/19” as opposed to Q1 2019 in isolation), or the second default tariff cap period (Summer 2019); and
  - we have severe legal concerns with such an approach, specifically that these proposals are at odds with the Administrative Court’s judgment and are inconsistent with:
    - accepted public law standards by which public authorities are required to act – such as requirements to act rationally and only have regard to information which is relevant;
    - the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act); and
    - Ofgem’s stated objectives in setting the level of the default tariff cap.
5. In addition to being legally unsound, there are no economic or methodological reasons to justify Ofgem drawing winter 2018/19, or summer 2019 into its analysis.
6. Should Ofgem proceed with the methodology as proposed, we consider any subsequent decision which implements these proposals will be liable to be set aside on further legal challenge. We therefore strongly encourage Ofgem to reconsider its proposed methodology as a matter of urgency.
7. In the remainder of this executive summary, we set out our views on:

- including **Winter 2018/19** in Ofgem's modelling;
- including the **second cap period** (i.e. Summer 2019);
- **allowing costs** resulting from Ofgem's decision;
- the appropriate **adjustment period** to apply; and
- issues relating to **variation in costs**.

### **Modelling winter 2018/19**

8. We understand from bilateral discussions that Ofgem is proposing modelling suppliers' hedging strategies, in terms of the timing and volumes of purchases for Winter 2018/19 (i.e. including Q4 2018) in assessing costs for 2019 Q1. This will produce a modelled wholesale costs for each supplier that is based on the average of the hedging strategies that suppliers adopted for the last three months before the cap applied and the first three months in which the cap applied.
9. This approach, if adopted, would be unlawful, and – contrary to Ofgem's assertions – entirely unnecessary.
10. Fundamentally, Winter 18/19 is not a relevant period for Ofgem's analysis as it includes Q4 2018. Including cost to serve customers in Q4 2018 – a period not covered by the price cap – when Ofgem is in fact trying to consider the costs to serve customers in Q1 2019 would introduce a major and unwarranted distortion in Ofgem's analysis. Q4 2018 costs are not wholesale costs which relate to the costs of serving customers on tariffs subject to the price cap. They are irrelevant considerations. A public authority does not have any 'regulatory discretion' as to whether to take account of irrelevant considerations: a decision which takes irrelevant considerations into account is simply unlawful.
11. Further, hedging strategies logically follow the pricing regime in play for the relevant delivery period – there is no reason that a common hedging strategy would have been in place covering a period before the cap (Q4 2018) and a period covered by the cap (Q1 2019). ✗ Combining both periods together is therefore irrational, as this approach will not produce an assessment that is targeted at Q1 2019.
12. Ofgem has suggested a methodology that comprises Winter 18/19 is necessary due to concerns regarding consistency with the seasonality and shaping approaches built into the existing cap wholesale methodology that it is seeking to adapt. However, as we set out in the appendix to this response, such concerns are misplaced as:

- using the appropriate contract prices (which Ofgem has already indicated that it will do) is sufficient to ensure that the estimated comparable costs are consistent with seasonality in the DTC wholesale methodology; and
- to the extent that shaping costs are higher or lower for Q1 2019 than for winter as a whole, this will largely net off over the lifetime of the cap as the final cap period will also be a short 3-month cap covering only Q4 of the final year of the cap.

### ***Including the second cap period***

13. There is no reasonable basis on which Ofgem could rationally and lawfully decide to reopen the second (and potentially subsequent) cap periods on account of the transition issue.
14. Ofgem set the wholesale allowance in the second (and subsequent) cap periods without regard to suppliers' costs and without any reference to the level of the wholesale allowance in Q1 2019. It also considered (at the time) that the Q1 2019 wholesale allowance adequately covered suppliers' costs.
15. In considering reopening later cap periods, Ofgem is therefore contemplating an un-signalled and wholly retrospective regulatory change. Such a change would seek to retrospectively rewrite the reasons for Ofgem's original decision for cap periods two and onwards. The absence of a legitimate and clearly articulated purpose for widening the review beyond Q1 2019 risks either misunderstanding or wilfully mischaracterising the original decision.
16. As set out in more detail in the legal annex to this response, there appears to be no reasonable basis on which Ofgem could rationally and lawfully decide to reopen the second (and potentially subsequent) cap periods in relation to the transitional issue.

### ***Allowing costs resulting from Ofgem's decision***

17. The correct starting point is that that Ofgem must consider whether the allowance for Q1 2019 was sufficient to cover suppliers' costs of supplying energy during that period: see Judgment §29. ✕ The full amount of this ✕ shortfall should be taken into account by Ofgem when determining the effective wholesale costs for 2019 Q1.
18. Ofgem states that in principle its starting point is that it will consider losses and gains made in trading to be relevant regardless of how these funds were invested. We believe such an approach is inappropriate.
19. First, Ofgem has not explained in the consultation document why it considers that any gains made as a result of trading out of previous positions in 2018 are relevant to its present consideration of wholesale costs for Q1 2019 (beyond stating that they may have enabled business decisions that would not otherwise have been possible).
20. Second, this error is compounded by Ofgem's position that it will take account of prior transactions that were not used to supply wholesale energy in Q1 2019 but will disregard how any gains were applied. This penalises suppliers who passed gains onto customers prior to January 2019 and ignores the opportunity costs for suppliers of such decisions.

21. It is not clear how Ofgem's current methodology will allow for these costs to be accounted for, but we believe that if Ofgem has regard to gains made on trading it should also account for these costs when determining the effective wholesale costs for 2019 Q1.

### ***Adjustment period***

22. We consider it appropriate for the adjustment to be applied as promptly as possible (i.e. over a six-month period), given the protracted period over which this issue has remained unresolved.
23. We also note Ofgem will be reviewing the conditions for effective competition later this year, once outcome of which may be a recommendation to the Secretary of the State that the default tariff cap is removed. Ofgem has provided no clarity regarding how suppliers could recover costs due to the period one wholesale issue in such a scenario. This also supports a shorter adjustment period.
24. In any event, we consider adjustment beyond 12 months entirely unacceptable, given:
- the increasing possibility of the default tariff cap being removed; and
  - the risk of exposing suppliers to changes in customer numbers.

### ***Variation in costs***

25. We do not believe Ofgem should exclude any of the six large suppliers from its analysis on the basis that they were unrepresentative. Such an approach would imply some judgment regarding the efficiency of their purchasing strategy, which would be inappropriate in this instance.
26. We strongly support Ofgem's suggestion that a weighted average would be an appropriate way of estimating the level of costs to be used in the adjustment. A weighted average will most closely match the position of the industry in aggregate and will therefore be the fairest approach from the perspective of customers.

## Appendix: detailed response

27. This appendix contains Centrica's detailed response to Ofgem's consultation "Reassessing the wholesale allowance in the first default tariff cap period"<sup>1</sup>. It is structured in six sections corresponding to the six "challenges" set out in Ofgem's consultation document<sup>2</sup>.

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

28. In relation to deciding which suppliers should be in the scope of Ofgem's reassessment of costs Ofgem sets out two issues to decide on in relation to its reassessment of wholesale costs:

- whether to include small suppliers;
- whether to include Bulb.

29. We address each of these two issues in turn.

#### *Small suppliers should not be in scope*

30. We agree with Ofgem that small suppliers should not be in scope of its reassessment of wholesale costs.

31. Ofgem should generally restrict itself to considering how it would have set the cap had it made the appropriate enquires at the time the decision was made. The original reasons that Ofgem gave to exclude smaller suppliers were:

- "Most SVT customers are served by large suppliers"<sup>3</sup>
- "A low proportion of small suppliers' customers are on SVTs"<sup>4</sup>

32. These reasons were not inappropriate at the time and were not challenged. Therefore, Ofgem should not depart from its previous decision to exclude these suppliers.

33. In addition, Ofgem has stated in this consultation that smaller suppliers "mostly set tariffs below the level of the Cap". To the extent that this is true, it is not clear that had the Cap been set higher these suppliers would have set their prices higher. Therefore, it is not clear that these suppliers suffered a financial loss due to the wholesale allowance being set too low.

#### *Bulb should not be in scope*

34. Similar arguments to those that point to the exclusion of smaller suppliers also point to the exclusion of Bulb.

35. At a principled level, Ofgem should only include those suppliers that it would have included if it had made the appropriate enquires at the time the decision was made.

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<sup>1</sup> "Reassessing the wholesale allowance in the first default tariff cap period", Ofgem (31 January 2020).

<sup>2</sup> We use the nomenclature "challenges" purely to be consistent with the terminology used in Ofgem's consultation (rather than signalling any particular difficulty with the issues described).

<sup>3</sup> DTC Decision Appendix 4 – Wholesale costs, para 3.168

<sup>4</sup> DTC Decision Appendix 4 – Wholesale costs, para 3.168

There is no suggestion that Ofgem made insufficient enquires about either the size of suppliers or which suppliers to include at the time of the decision. Therefore, Ofgem should not deviate from its original decision to exclude Bulb.

36. In addition, there is public domain evidence that Bulb has not aligned its wholesale purchasing strategy to the cap index.<sup>5</sup> This means that Bulb's wholesale costs in any period are unlikely to be representative of the wholesale costs of suppliers of default tariff customers in general. If Bulb choose not to align its wholesale purchasing strategies to the cap index, even when given sufficient notice to be able to, then any variance between Bulb's wholesale costs and the price cap wholesale index represents a commercial risk that Bulb choose to take. Sometimes this will result in higher costs and sometimes lower costs for any given period than Ofgem's allowance. However, the outcomes of this commercial decision should not be something Ofgem should adjust for ex-post.
37. Further, Ofgem notes that "During the first cap period its [Bulb's] tariff was around £125 lower than the cap".<sup>6</sup> Therefore, in the same way as is the case for small suppliers, it is not clear that Bulb would have priced higher had the price cap been set higher or that it suffered a financial loss due to the wholesale allowance being set too low.

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

38. In relation to deciding which cap periods are relevant for its analysis Ofgem suggests three possible answers:
- only the first cap period (2019 Q1);
  - the first and second cap periods (2019 Q1, Summer 2019); or
  - the first second and third cap periods (2019 Q1, Summer 2019, Winter 2019/20).
39. Ofgem must consider the first cap period, as it is required to do by the Administrative Court's judgment.
40. There is no lawful basis for reopening later cap periods. The Legal Annex to this submission explains in full the reasons why it would be unlawful for Ofgem to do so. In summary:
- Ofgem's approach either misunderstands or wilfully mischaracterises its original decision. Ofgem set the wholesale allowance in the second (and subsequent) cap periods (i) without regard to suppliers' costs; (ii) having decided that the level of suppliers' actual costs would not have impacted its decision; and (iii) believing, in any event, that the Q1 2019 wholesale allowance adequately covered suppliers' costs.
  - This demonstrates that any decision to reopen later cap periods is an un-signalled and wholly retrospective regulatory change – and a change, furthermore, which seeks to retrospectively rewrite the reasons for Ofgem's decision.
41. An un-signalled retrospective change to a price cap is a startling proposition – one which appears to opportunistically abandon standards of good regulation which have long been respected in the UK. Given the significant long-term costs of this type of regulatory

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<sup>5</sup> "At Bulb, we buy our energy three months in advance so we are protected from short term price spikes like this" <https://bulb.co.uk/blog/wholesale-energy-market-update-feb-20>

<sup>6</sup> Initial consultation – Reassessing the wholesale allowance. Paragraph 2.19



behaviour for consumers, there appears to be no reasonable basis on which Ofgem could rationally and lawfully reopen the second and subsequent cap periods on account of the transition issue.

### **Challenge 3: estimating comparable costs**

42. Ofgem proposes to estimate comparable 2019 Q1 costs for each supplier using the existing wholesale methodology but effectively adjusting the observation period to reflect the timing and volumes of energy by each supplier.
43. This methodology would assume that suppliers purchased the contracts that the wholesale methodology already assumes for the index and then apply the same shaping and forecast error allowances to derive a total comparable cost for the period.
44. In principle we welcome Ofgem's decision to re-estimate the costs of suppliers for 2019 Q1 and compare these to the allowed costs to estimate the under recovery. However, we have material concerns about how Ofgem is proposing to undertake this exercise. These are explained further below initially but we may expand on these points in our subsequent submission on our wholesale hedging strategy due on 9 March 2020.

#### *It is unlawful for Ofgem to take into account Q4 2018 volumes in determining the level of 2019 Q1 comparable wholesale costs*

45. We understand that Ofgem seeks to model suppliers hedging strategies, in terms of the timing and volumes of purchases for 'winter 18/19' (i.e. including Q4 2018) in assessing costs for 2019 Q1.
46. If Ofgem models winter 18/19 purchase volumes rather than 2019 Q1 purchase volumes, then it will calculate a modelled wholesale costs for each supplier that is based on the average of the hedging strategies that suppliers adopted for the last three months before the cap applied and the first three months in which the cap applied.
47. This approach is unlawful. Winter 18/19 is not a relevant period for Ofgem's analysis because it includes 2018 Q4, a period (i) which is irrelevant to the level of costs for Q1 2019 which Ofgem is seeking to determine; and (ii) when the cap was not even in place at all. Q4 2018 costs are not wholesale costs which relate to the costs of serving customers on customers subject to the price cap. They are not germane as to the matter in question (namely the sufficiency of the allowance to cover wholesale costs in the first cap period). They are therefore irrelevant considerations. A public authority does not have any 'regulatory discretion' as to whether to take account of irrelevant considerations or how much weight to give them: a decision which takes irrelevant considerations into account is simply unlawful. If Ofgem is to use its modelled cost approach it must specifically gather information on hedging strategies for 2019 Q1 and must not combine volumes purchased for a period under the cap with those purchased for a period not subject to the cap.
48. If a supplier adopted the same hedging strategy for both 2018 Q4 and 2019 Q1 then modelling purchases for winter instead of Q1 would imply that suppliers started purchasing earlier for Q1 than is realistic. For example, under a 12 month linear purchasing strategy, winter hedging starts 1 October 2017 but for Q1 it starts 1 Jan 2018.

49. If suppliers adopted different hedging strategies for Q1 vs Q4 then averaging the two periods together could materially impact the wholesale cost that Ofgem calculates for suppliers in respect of the first default tariff cap period. Such a calculation would not appropriately estimate suppliers' comparable costs in 2019 Q1.
50. In 2018 Q4 suppliers were not subject to the cap. Therefore, there was no reason, for suppliers to align their Q4 purchases to a cap index.
51. The effect of using winter 18/19 volumes rather than Q1 volumes could be material. It is pricing decisions that lead hedging decisions. ∞. Ofgem must, therefore, distinguish between winter 18/19 hedging and 2019 Q1 hedging. Failure to do so would mean Ofgem was not be having regard to the modelled comparable costs for cap period 1.
52. We understand from a bilateral meeting that Ofgem's desire to use winter rather than Q1 volumes may be motivated by a concern about consistency with the seasonality and shaping approaches built into the existing cap wholesale methodology that it is seeking to adapt. As the Legal Annex explains, in being motivated by 'consistency' Ofgem is acting irrationally, undermining the very purpose of the assessment it is undertaking. However, in any event, any such concerns are misplaced.

*It is not necessary to use winter volumes to preserve methodological consistency*

53. Using the appropriate contract prices,<sup>7</sup> which Ofgem has already indicated that it will do,<sup>8</sup> is sufficient to ensure that the estimated comparable costs are consistent with seasonality in the DTC wholesale methodology.
54. The use of purchase volumes for one period combined with wholesale prices for delivery in another period is already a feature of the cap methodology that Ofgem explicitly recognises in footnote 17 of this consultation document where it says

“we use a 12 month “delivery period” to offset the impacts of seasonal prices that would occur if we used a six month cap period only. **We do not expect suppliers to have actually purchased the contracts for the second half of the ‘delivery period’**” (emphasis added)

55. This is analogous to the use of wholesale purchase volumes for delivery in 2019 Q1 being used in combination with wholesale prices for delivery for the period 1 October 2018 to 30 September 2019.
56. To the extent that Ofgem's desire to use winter 18/19 volumes may be motivated by a concern about consistency with shaping costs, we also consider any such concern unfounded.
57. Although the first cap period was a short 3 month cap period covering only Q1, to the extent that this implies different shaping costs to a full winter cap period, this should be offset by the final cap period. This is because the final cap period will also be a short 3 month cap covering only Q4 of the relevant year. Therefore, to the extent that shaping

<sup>7</sup> Winter season contracts for electricity and a weighted average of the Q4 and Q1 contract prices for gas.

<sup>8</sup> Initial consultation – Reassessing the wholesale allowances, paragraph 2.27



costs are higher or lower for Q1 than for winter as a whole, this will largely net off (subject to possible changes to customer numbers and that the netting off will not occur until the end of the cap) with the corresponding higher or lower shaping costs for the final Q4 cap period.

58. Should Ofgem feel that it would benefit from any further explanation of these points we are happy to explain them in further detail. However, there should be no ambiguity that Centrica considers Ofgem's approach fundamentally flawed. There is no lawful basis on which Q4 2018 volumes can be taken into account for the purposes of the current exercise.

*Ofgem should take into account the costs of decisions made in good faith as a result of its actions*

59. The correct starting point is that that Ofgem must consider whether the allowance for Q1 2019 was sufficient to cover suppliers' costs of supplying energy during that period: see Judgment §29. ✂
60. Ofgem states that in principle its starting point is that it will consider losses and gains made in trading to be relevant regardless of how these funds were invested. We believe such an approach is inappropriate.
61. First, Ofgem has not explained in the consultation document why it considers that any gains made as a result of trading out of previous positions in 2018 are relevant to its present consideration of wholesale costs for Q1 2019 (beyond stating that they may have enabled business decisions that would not otherwise have been possible).
62. Second, this error is compounded by Ofgem's position that it will take account of prior transactions that were not used to supply wholesale energy in Q1 2019 but will disregard how any gains were applied. This penalises suppliers who passed gains onto customers prior to January 2019 and ignores the opportunity costs for suppliers of such decisions.
63. It is not clear how Ofgem's current methodology will allow for these costs to be accounted for, but we believe that if Ofgem has regard to gains made on trading it should also account for these costs when determining the effective wholesale costs for 2019 Q1.

*Ofgem should account for the difference in wholesale modelled costs for single rate and multi rate meters*

64. It is unclear from Ofgem's consultation how it proposes to treat multi-rate meters. However, we assume that it is implicit from the fact that there are separate caps for single rate and multi-rate meters that Ofgem would need to do a separate calculation for each meter type.
65. In calculating the impact on multi-rate meter customers Ofgem must use the appropriate information on consumption levels and seasonal weightings specific to these customers. The greater seasonality for multi-rate meter customers means that we would expect, all

else being equal, the under-recovery in 2019 Q1 will be greater per customer and proportionally per customer<sup>9</sup> than for single rate customers.

#### **Challenge 4: variation in costs**

66. In relation to deciding how to handle variation in costs between suppliers, Ofgem must decide what single estimate to draw from a range of estimated costs for each of the suppliers in scope. Ofgem's starting position is that it "would have regard to a weighted average (accounting for market share) as this would reflect the average position from the customers' perspective".<sup>10</sup> However, Ofgem also notes that its proposal would depend on the distribution of costs, that it may seek to limit the impact of outliers and that it could use simple average, weighted average or median.

*Variation in wholesale costs for Q1 does not reflect efficiency or inefficiency so a weighted average without exclusions is the most appropriate approach*

67. Ofgem states that it does "not consider the variation in wholesale costs to indicate that some suppliers are more efficient at purchasing energy than others."<sup>11</sup>
68. We agree with Ofgem that differences in wholesale hedging strategy do not indicate that some suppliers are more efficient at purchasing energy than others. Given this position Ofgem must not apply any form of efficiency assessment to estimated costs. The exclusion of any of the six largest energy suppliers from the calculation would typically imply some judgment regarding the efficiency of their purchasing strategy. Therefore, Ofgem should not exclude any of these suppliers on the basis that they were unrepresentative and/or liable to distort a proper assessment.
69. If Ofgem nevertheless considers that it has to make exclusions for any reason, then it must do so in a transparent way so that consultees can make informed representations regarding any exclusion and not only the excluded party.
70. In terms of the approach that Ofgem should use to estimate the level of costs to be used, a weighted average will most closely match the position of the industry in aggregate and will be the fairest approach from the perspective of customers. This would most closely align with Ofgem's aim to seek to reverse the impact of the original error as much as possible.
71. We do not expect that the use of a median approach would provide a more appropriate result. However, if Ofgem nevertheless elects to use a median rather than a weighted average the fairest way of doing so would be to base the allowance on the costs of the supplier of the 50% percentile customer (i.e. the median customer), and not the median supplier. This would at least then be a measure of central tendency from the perspective of the customer in a similar way to a weighted average and unlike a simple average or supplier median.

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<sup>9</sup> A higher £/customer level but also a higher percentage of a typical bill

<sup>10</sup> Initial consultation – Reassessing the wholesale allowances, paragraph 3.12

<sup>11</sup> Initial consultation – Reassessing the wholesale allowances, paragraph 3.6

### **Challenge 5: setting an adjustment charge**

72. Ofgem mentions a variety of factors that it must consider when setting an adjustment charge as well as the different perspectives of suppliers and consumers. Based on these considerations and perspectives, Ofgem's stated starting position is not to adjust for any changes in:
- customer numbers at the industry level or supplier level; and
  - possible effects of the level of the price cap on the number of default tariff customers.
73. In addition, the consultation document mentions placing the adjustment on the unit rate part of the cap and calculating recovery and under recovery using assuming standard TDCV and seasonal consumption weights.
74. We address each of these issues in turn below.

*Not adjusting for changes in DTC customers numbers is likely to lead to under recovery of costs for the industry as a whole*

75. Ofgem's consultation suggests that there may be fewer DTC customers in aggregate in the recovery period than there were in 2019 Q1. Data published on Ofgem's retail market indicators confirms this is the case.<sup>12</sup> It is therefore regrettable that Ofgem is proposing not to adjust for this as this will mean that suppliers will have lost out on earning the funds necessary to support their businesses as a direct result of Ofgem's error.

*Ofgem is right not to attempt to adjust for the effect of the level of the cap on customer numbers*

76. It is not clear that the lower level of the cap in 2019 Q1 will have had a significant effect on switching and the actual data on switching rates does not match the theoretical impact. Indeed, the lower level of the cap in the first period is likely to have exacerbated the price increase for cap period 2, prompting higher switching.
77. In addition, to the extent that this factor was real, the impact of a lower low cap in Q1 should be mitigated by the offsetting impact of a higher cap in the recovery period. This further weakens any case to attempt adjustment for this factor.
78. In summary, Ofgem should not make any adjustment in relation to this theoretical impact.

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<sup>12</sup> The number of DTC customers for the SLEFs has declined by 2.3% for gas and 2% for electricity between 2019 Q1 and October 2019.

*It is appropriate for Ofgem to make the adjustment through the variable charge in the cap*

79. Ofgem states that it proposes “to apply the Adjustment Allowance so that it increases the maximum variable charge (but not the standing charge)”.<sup>13</sup> We agree that this is the right approach for two reasons.
80. Wholesale costs are variable costs therefore in principle it makes sense that the adjustment is made in line with the way wholesale costs are treated in general. In addition, making the recovery through the variable costs is consistent with reversing the impact as much as possible. This is because it aligns the recovery of the costs from those that are likely to have derived the most benefit from the original error.

*It is appropriate to consider standard consumption values*

81. Ofgem states that it proposes “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”.
82. We agree that this is a sensible approach. It is consistent with how the cap operates (where it is always linked to the original TDCVs) and is consistent with reversing the impact of the error as far as possible.

### ***Challenge 6: setting an adjustment period***

83. We consider it appropriate for the adjustment to be applied as promptly as possible (i.e. over a six-month period), given the protracted period over which this issue has remained unresolved.
84. We also note Ofgem will be reviewing the conditions for effective competition later this year, one outcome of which may be a recommendation to the Secretary of the State that the default tariff cap is removed. Ofgem has provided no clarity regarding how suppliers could recover costs due to the period one wholesale issue in such a scenario. This also supports a shorter adjustment period.
85. In any event, we consider adjustment beyond 12 months entirely unacceptable, given:
  - the increasing possibility of the default tariff cap being removed; and
  - the risk of exposing suppliers to changes in customer numbers

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<sup>13</sup> Initial consultation – Reassessing the wholesale allowance, paragraph 4.3

## Legal Annex

1. In the Consultation Paper,<sup>14</sup> Ofgem proposes to stray beyond the proper focus of the reconsideration required by the Administrative Court's judgment, which is confined to determining the adjustments needed to the wholesale cost allowance for the Q1 2019 transitional period in order to remedy the "atypical and unrealistic" assumption<sup>15</sup> on the basis of which Ofgem originally estimated suppliers' actual costs during that period.
2. Specifically, Ofgem makes two proposals which would, if adopted, radically alter the scope of the reconsideration, namely:
  - to take into account wholesale purchases for all of winter 2018 rather than solely Q4 2018 ("**the Winter 2018 Proposal**"); and
  - to reconsider the wholesale allowance during subsequent cap periods in addition to the transitional period ("**the Subsequent Cap Periods Proposal**").
3. For the reasons set out below, each proposal would, if adopted, result in a clear error of law. The proposals are at odds with the Administrative Court's judgment, and are contrary to:
  - the accepted public law standards by which public authorities are required to act, in particular the duty to act reasonably and to have regard only to relevant considerations;
  - Ofgem's statutory duties under the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the **Act**); and
  - Ofgem's stated objectives in setting the level of the default tariff cap during the transitional period.
4. If Ofgem proceeds with either of the above proposals, its decision will be liable to be set aside on further legal challenge.

### *Ofgem's Winter 2018 Proposal*

5. In the Consultation Paper, Ofgem indicates that it is minded to take account of the energy costs incurred by suppliers to supply relevant customers throughout the course of winter 2018/19, rather than solely during the Q1 2019 transitional period, which is the proper focus of the reconsideration:<sup>16</sup>

*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. ...*

6. Ofgem's proposal is fundamentally flawed and (if adopted) would be unlawful:
  - it would result in Ofgem having regard to an irrelevant consideration, namely the costs of serving customers outside the relevant period for which costs are being

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<sup>14</sup>Ofgem, 'Consultation: Reassessing the wholesale allowance in the first default tariff cap period' (31 January 2020) (**Consultation Paper**).

<sup>15</sup>See Administrative Court judgment, [73].

<sup>16</sup>Although we note that the Consultation Paper document refers inconsistently to 'winter 18/19' or 'Q4 2018'.

assessed (and, moreover, outside the period when the price cap was in place at all); and

- it irrationally compromises the very purpose of the exercise which Ofgem has been required by the Administrative court to undertake on remittal.

7. First, it is illogical to consider Q4 2018 volumes when assessing whether the Q1 2019 allowance is sufficient to allow cost recovery. The position of suppliers during Q4 2018 is not a relevant consideration.

- The wholesale cost allowance plainly constrains cost recovery during the period for which it is in force and only during that period. The allowance for the first cap period did not constrain suppliers' cost recovery in periods prior to the introduction of the cap, including Q4 2018.
- Ofgem would never have countenanced *increasing* the allowance for the first cap period, to allow for higher costs incurred by suppliers during Q4 2018. Ofgem would rightly have concluded in this context that costs incurred to serve customers before the cap was in place were simply irrelevant.
- This same logic illustrates the absurdity of Ofgem potentially *decreasing* an allowance for Q1 2019 on the basis of lower costs incurred by suppliers when serving customers in Q4 2018.
- In short, Q4 2018 costs are not wholesale costs which relate to the costs of serving customers on tariffs subject to the price cap. They are not germane to the matter in question (namely the sufficiency of the allowance to cover wholesale costs in the first cap period). They are therefore irrelevant considerations. A public authority does not have any 'regulatory discretion' as to whether to take account of irrelevant considerations or how much weight to give them: a decision which takes irrelevant considerations into account is simply unlawful.

8. The irrationality of combining Q4 2018 and Q1 2019 hedging strategies, and the irrelevance of Q4 2018 wholesale costs to Ofgem's assessment, are well illustrated by the underlying context. There are no good reasons to consider that suppliers' Q4 2018 hedging strategies, which fall altogether outside the period of the price cap, would be in any way similar to Q1 2019 hedging strategies.

- Ofgem is fully aware that a supplier would have sought to align its Q1 2019 hedging strategy with suppliers' expectations of the hedging strategy assumed in the cap methodology. Ofgem knows that suppliers had strong incentives to align both to the May policy consultation proposal and the September statutory consultation proposal. Those incentives did not apply to suppliers' Q4 2018 strategies. Suppliers will have had no reason to change their long-term strategies for Q4 2018 before the cap was introduced.
- ✂. The fact that Ofgem expected the start date of the cap to be 1 January 2019 was clear to all suppliers from Ofgem's public announcement on 6 March 2018. This is well before Ofgem had provided any indication of the possible hedging strategy assumed in the cap.

9. The long-term hedging strategies that suppliers adopted for Q4 2018 (and likely maintained until Q4 2018) are therefore obviously inconsistent with the much shorter hedging strategies suppliers are likely to have finally adopted for Q1 2019. The proposal to 'blur' the two together to estimate Q1 2019 costs is obviously flawed and unsustainable and will inevitably lead Ofgem to an incorrect result.



10. Secondly, Ofgem's proposal to take into account Q4 2018 costs for 'consistency' is irrational because it undermines the very purpose of the exercise Ofgem is undertaking:
- Ofgem's starting position appears to be based on an underlying view that suppliers' wholesale costs for Q1 2019 must be assessed on a basis that is consistent with how the wholesale allowance is set under the price cap generally (including after Q1 2019), in terms of seasonality, shaping costs and forecast error.
  - However, no reasons are given in the Consultation Paper for this underlying view; it is simply asserted: see Consultation Document para 2.23.
  - The whole logic of the transitional issue, however, is that the wholesale allowance in the first cap period is bespoke, and is set differently from later ones. The fundamental difference between the first cap period and later periods is that Ofgem set the first cap period having regard to (its understanding of) suppliers' actual costs during that period. Accordingly, as identified by Ofgem and approved by the Administrative Court, the allowance (for the first cap period) should not be set so low that a hypothetical efficient supplier could not recover its costs.<sup>17</sup>
  - Ofgem acknowledged this purpose in its original decision, stating that it aimed to assess the "*financial impact of our decision during the first cap period*".<sup>18</sup>
  - The fundamental question being addressed, therefore, is whether the allowance sufficiently allows recovery of suppliers' relevant costs.<sup>19</sup> That logically requires Ofgem to examine suppliers' costs for the period in question. A desire for 'consistency' cannot reasonably justify an approach that undermines the very purpose for which Ofgem is undertaking the current exercise – i.e. to understand and have regard to suppliers' costs for Q1 2019.
11. For these reasons, Ofgem's Winter 2018 Proposal is not well founded. Ofgem cannot lawfully take into account the wholesale costs suppliers incurred for supply in Q4 2018, when determining the relevant costs suppliers incurred for supply in Q1 2019.

### *The Subsequent Caps Period Proposal*

12. It appears that Ofgem is also considering whether to reassess suppliers' costs not only for the first cap period but also for subsequent cap periods. The Consultation Paper notes that: '*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>20</sup> Ofgem states that '*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*'<sup>21</sup> and also indicates that cap period three would be subject to the same 'transition problem'.<sup>22</sup>
13. Any such approach would be erroneous for two reasons:
- First, Ofgem's approach misunderstands or mischaracterises its original decision in November 2018.

<sup>17</sup> *British Gas Trading Limited v GEMA* [2019] EWHC 3048 (Admin) para 29.

<sup>18</sup> Decision, Appendix 4, para 3.157, emphasis added.

<sup>19</sup> For the avoidance of doubt, this should not be understood as an argument that Ofgem must guarantee cost recovery to all suppliers, or even to the hypothetical efficient supplier. The point is that the Administrative Court accepted, in effect, that it was a mandatory relevant consideration for Ofgem whether the allowance allowed for cost recovery.

<sup>20</sup> Para 2.20.

<sup>21</sup> Para 2.22.

<sup>22</sup> Para 2.21.

- Secondly, there is no basis now to reopen the assessment of the allowance for any subsequent period.
14. As to the first of those reasons, Ofgem's approach either misunderstands or wilfully mischaracterises its original decision about the methodology that Ofgem would use to set the level of the cap in cap period two. On a correct reading of the decision, the transition issue played no role whatsoever in justifying Ofgem's approach to cap period two.
15. The paragraph of the original decision to which Ofgem refers is as follows:
- 'We also take the view that any residual impact on particular suppliers has to be considered in context. First, the first cap period is short – only three months long. We consider it in the context of a two to five year cap period. Second, if a supplier had less favourable costs in the first cap period than one using a typical approach, then we should consider how the second cap period might mitigate this. The second default tariff cap period will start in April 2019. Our May and statutory consultations proposed that we would set the allowance for the second cap period using an observation period between August 2018 and January 2019. That allowance will be higher than the costs of any supplier that used a typical 18-month observation period before we published our consultation in May 2018, as they would have already purchased some the energy in advance.'*<sup>23</sup>
16. In this paragraph, Ofgem uses the approach taken in cap period two to support its view that any 'residual loss' on suppliers in the first tariff cap period was acceptable. In other words, Ofgem's approach to the second cap period provides support for its approach to the first cap period.
17. Two points emerge from this aspect of the Decision.
18. First, Ofgem did not accept that there was any 'residual loss' suffered by suppliers. Ofgem in fact decided that, at worst, 'our allowance would slightly *overcompensate* a supplier' who followed the hedging approach<sup>24</sup> - indeed it required Centrica to take this matter to the High Court before Ofgem was forced to acknowledge that this conclusion could be wrong. Therefore, Ofgem must have accepted that the second cap period had been set at the correct level, even if the first cap period did not create a 'loss' for suppliers.
19. Secondly, this paragraph takes the approach in the second (and later) cap periods as a given. It does not justify, or qualify the basis of, the approach taken in the second cap period. Ofgem's approach to the second and subsequent cap periods was made independently of, and was not in any way justified by, the approach to the first cap period. As Ofgem explained, only the first cap period took account of suppliers' actual costs:

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<sup>23</sup> Decision, Appendix 4, para 3.166.

<sup>24</sup> Decision, Appendix 4, para 3.162.

*We expect suppliers will adapt their previous approach to fit within the cap. For the six largest suppliers that means changing to a shorter strategy that passes through costs into retail prices more quickly than they previously did. In that context, we do not need to request data on their actual costs (whereas we needed detailed information on operating costs). However, for the first cap period, we do need to consider actual costs because suppliers have already purchased a significant proportion of their energy. (Decision Appendix 4, para 3.150).*

20. It follows that, in the Decision:

- Ofgem did not have regard to suppliers' actual costs for the second (and subsequent) cap periods;
- Ofgem decided that the level of such costs would not have impacted its decision; and
- The wholesale allowance was determined for the second (and subsequent) cap periods in a manner independent of the approach taken for the first cap period.

21. As to the second reason identified at paragraph 13 above, there can be no justification for re-opening subsequent price cap periods, which have now elapsed.

22. The Administrative Court's judgment provides no such justification: it requires Ofgem only to 'reconsider the allowance for Q1 2019'.<sup>25</sup>

23. Any wider re-opening would constitute:

- a proposal to make an un-signalled and wholly retrospective regulatory change; and
- would run directly contrary to Ofgem's statement in the consultation paper that '*For the avoidance of doubt, the ongoing wholesale methodology was not challenged and shall apply in future cap periods*'.<sup>26</sup>

24. Such an un-signalled retrospective change to a price cap is a startling proposition – one which appears to opportunistically abandon standards of good regulation which have long been respected in the UK. The reasons why UK regulators have always avoided un-signalled retrospective adjustments will be well known to Ofgem and do not need to be rehearsed in full here – un-signalled retrospective adjustments raise the regulatory risks associated with investing in the sector, undermining investment, innovation and competition, and raising the required levels of returns for those that do invest. They undermine the acceptance by investors that regulation is transparent, and that their business decisions can be made on the basis of a 'fair bet' – without profits which comply with the regulatory framework being subjected to unexpected *ex post* expropriation. The long-term impacts for consumers of undermining the regulatory bargain are well understood. Ofgem itself has recognised that retrospective adjustments to price caps 'undermine [the] regulatory commitment'.<sup>27</sup>

25. Taking these factors into account, there appears to be no reasonable basis on which Ofgem could rationally and lawfully decide to reopen the second (and potentially subsequent) cap periods.

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<sup>25</sup> *British Gas Trading Limited v GEMA* [2019] EWHC 3048 (Admin) para 90. Furthermore, in relation to the first cap period, it was clear immediately after Ofgem made the decision that major suppliers did not accept the decision and that it was under challenge. Numerous major suppliers wrote to Ofgem setting out their concerns.

<sup>26</sup> Consultation Paper, para 4.4.

<sup>27</sup> Ofgem, Handbook for Implementing the RIIO Model, para 5.6.