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**2 March 2020**

Dear Anna

We are writing in response to your consultation on reassessing the wholesale allowance in the first default tariff cap period. This submission is entirely non-confidential and may be published on your website.

We are surprised that the consultation makes no reference to headroom as a relevant factor in reassessing the wholesale allowance. We think it should be taken into account if you are to avoid double-counting.

The headroom built into the cap is intended to absorb unexpected costs that a supplier may face in addition to those already included in the efficient benchmark. As Ofgem put it when deciding to include headroom,

'This allowance is one of the ways in which we recognise the net cost of uncertain pressures that are not already captured in other areas of our methodology for setting and updating the cap.'<sup>1</sup>

It was clear that headroom was expected to help cover unexpected and unforeseen cost pressures as well as those that could be guessed at:

'We arrived at the headroom allowance by considering [...] scope for any remaining unidentified errors and uncertainties.'<sup>2</sup>

The situation Ofgem is now in is one of having to reassess the wholesale allowance in order to address the High Court's conclusion that it contained unidentified errors.

In effect, headroom is designed for precisely this situation - to mop up limited errors and inaccuracies in the calculation of the efficient benchmark.

We therefore think that any correction in the wholesale allowance must take into account the headroom that has already been given to suppliers in the relevant price cap period. If the value of the headroom exceeds the value of the estimated uplift needed to the wholesale allowance, no correction should be made - as suppliers have already been compensated for the error. If the value of the estimated uplift

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<sup>1</sup> Paragraph 2.3, 'Default Tariff Cap: Decision. Appendix 2 - Cap level analysis and headroom,' Ofgem, 6 November 2018.

<sup>2</sup> Paragraph 2.14, Ibid

needed to the wholesale allowance exceeds the value of headroom, the correction should be the net of the two (i.e. the excess), rather than the gross.

In a range of other areas there is significant ambiguity on the potential implications of decisions that makes it hard to reach an informed position as a stakeholder.

To give an example of this, although the High Court judgement only relates to how the wholesale allowance was set for the first cap period, you signal that you may consider whether to assess the impact of what you term the transition challenge across multiple cap periods as a possible alternative to only considering its impact in the first cap period. It is not clear to us what the financial impact of this would be - whether it would increase or decrease consumer costs, and if so, whether it would do so by a nugatory or a material amount.

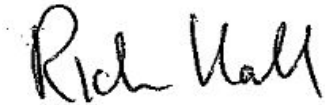
More broadly, the confidentiality constraints surrounding the High Court case make it very difficult for third parties to understand the likely materiality of any correction. This has knock-on implications for reaching a view on what time period any correction should be made over. So, eg, we would have different views on an appropriate correction window for a low materiality correction of a few pounds per customer, where it might be appropriate to recover monies in a single price cap period, than we would on a high materiality correction of tens of pounds per customer, where it might be more appropriate to recover monies over several price cap periods.

On the specific question of whether Bulb should be included among the suppliers whose wholesale costs you seek, we think this would be appropriate. As you highlight, they now serve more gas customers than several members of what used to be referred to as the Big 6. While you suggest they may differ from those suppliers in that their single tariff serves both acquisition customers and default ones, this does not alter the fact that it is, under the definitions contained in legislation, a default tariff. Excluding Bulb from the reference pool when suppliers that are smaller than it are included would not appear to have a reasonable objective basis. There may be arguments for widening the pool further, though we recognise that there are administrative implications in so doing that would need to be weighted against the incremental insight that could be offered.

We are, in principle, supportive of your proposal to base any revision on the average wholesale costs of the reference supplier pool. Legislation does not allow you to set an individual cap for each supplier and it would not be appropriate to price above

the average as the intention of the exercise (at aggregate level) must be to correct the overall effect of the error and not to reward suppliers.

Yours sincerely

A handwritten signature in black ink that reads "Rich Hall". The signature is written in a cursive, slightly slanted style.

Richard Hall  
Chief Energy Economist