



Reassessing the wholesale allowance in the first default tariff cap period – E.ON response

Executive Summary

Thank you for the opportunity to comment on Ofgem’s proposals for reassessing the wholesale allowance following the High Court conclusion that Ofgem would have to reconsider the wholesale allowance for the first cap period of the default tariff cap (“DTC”) (Q1 2019) and make appropriate adjustments, as a result of the inadequacies of its consulting process and its failure to recognise the implications of the announcement of the price cap on suppliers’ hedging strategies.

We are disappointed that Ofgem has taken three months to consult on this issue and would now urge it to continue without delay to ensure it can issue its statutory consultation by mid-April, with a Decision before the end of June 2020 and preferably before 12 June, 2020 (the last date at which, under current licence conditions, a Decision could be taken account of for the fifth cap period).

We have carefully considered Ofgem’s proposals in this consultation and, whilst we are supportive of its minded-to position to only include the largest six suppliers in its assessment and to set a 12-month assessment period, we have two significant areas that we urge Ofgem to re-consider.

Firstly, our view is that it should not have been necessary for Ofgem to obtain actual information about each of the largest six suppliers’ hedging strategies. In the judgement in the Judicial Review, the Honourable Mrs Justice Andrews DBE notes that Ofgem had *“failed to appreciate that there had been a development in the market [the announcement of the price cap] that was not only likely to, but did cause a change in hedging strategies”*. To rectify this, Ofgem could have revisited the analysis it carried out as stated in paragraph 48 of the Judicial Review, adding in different approaches/combinations of approaches based on the changes a reasonable supplier might have made to its hedging strategy in the light of the announcement that the Government intended to introduce a price cap. Ofgem appears, however, to have ignored such an approach. Now that it has details of the hedging strategies of the six largest suppliers, it will be difficult to take this approach without the risk of being influenced by the information it has obtained: if its decision resulted in a lesser detriment to consumers than would have been the case for Ofgem’s minded-to approach, and thus resulted in suppliers under-recovering, Ofgem could be accused of ‘fixing’. Yet again, Ofgem has failed in its consultation process, by not considering and consulting on all possible options.

Secondly, we believe it would be unreasonable and unfair for Ofgem to retrospectively consider the impact of suppliers’ hedging strategies in any period other than Q1 2019. Throughout its consultation with stakeholders on its methodology for the DTC, Ofgem refused to consider any form of correction mechanism for forecasting errors or additional, unexpected costs such as mutualisations; it should not reverse its position in respect of this single issue.

We discuss these issues in more detail below, along with our thoughts on Ofgem’s other stated challenges.

Challenge 1: suppliers in scope

1. Under the methodology for reassessing the wholesale allowance in the first cap period, Ofgem has chosen to review the market shares of suppliers as they were in Q1 2019. We do not

believe this is appropriate; Ofgem's Decision was published 6 November 2018 and it would therefore not have had this information. This reassessment should be based on the information available to Ofgem at the time of the Decision.

2. In its Decision, Ofgem considered only the costs of larger suppliers; any reassessment of the methodology should be limited to these same suppliers. Ofgem acknowledges in paras. 2.12 and 2.13 of the consultation that the finances of the six largest suppliers were more exposed to the level of the DTC, and that they served nearly 90% of customers on standard variable tariffs at the time of the Decision. We do not therefore believe it is relevant to include any supplier other than the largest six suppliers in its scope for this reassessment.
3. In respect of the addition of Bulb within Ofgem's scope, there are three additional considerations:
 - Bulb has only a single tariff, a variable tariff. Customers who have defaulted onto the tariff are therefore limited to those who have become responsible for their energy supply due to the original contracting party no longer occupying the premises. We agree that Bulb's tariff is therefore more likely to be priced competitively to attract new business and thus was not comparable to the default tariffs of the largest six suppliers.
 - For the period to March 2019 Bulb posted a loss of £130m in the annual accounts it recently published. We believe this is an indication that Bulb was therefore not acting in a sustainable way; it was pricing its tariff to grow, not to make a reasonable return.
 - Another consideration is that it is probable that Bulb's hedging strategy was much shorter than that of the largest six suppliers. According to its annual report for March 2019¹, it hedged "on a rolling four month forward basis". Thus, it is likely to have been impacted differently by Ofgem's change to the observation window.
4. We therefore agree with Ofgem's minded-to position that Bulb is not relevant to its considerations.

Challenge 2: relevant cap periods

5. We see no relevance for including anything other than the first cap period within the scope of this reassessment.
6. In *The Queen (on behalf of British Gas Trading Limited) and the Gas and Electricity Markets Authority and Interested Parties ("the Judicial Review")*, the Honourable Mrs Justice Andrews DBE concludes: "*GEMA will have to reconsider the allowance for Q1 2019 in the light of information it now has, and make such adjustments as it considers appropriate in the light of that reconsideration.*" The Judicial Review does not concern itself with any other cap period.
7. There was no change in Ofgem's proposals concerning the second or subsequent cap periods between the publication of the Default Tariff Cap: Policy Consultation, 25 May 2018 (the "May Consultation") the Decision – Default Tariff Cap, 6 November 2018 (the "Decision"). There was no challenge to Ofgem's Decision in respect of the second or subsequent cap periods in the

courts and thus no judgement. Therefore, we do not believe it would be fair for Ofgem to reassess the wholesale allowance for the second or any subsequent cap periods. To do so would be tantamount to a correction mechanism: something Ofgem consistently ruled out during the entire consultation period.

Challenge 3: estimating comparable costs

8. In the Conclusion in the Judicial Review, the Honourable Mrs Justice Andrews DBE stated that *“For the avoidance of doubt, if on reflection GEMA decides that it should seek further information from the suppliers before it reconsiders the allowance, there is nothing to prevent it from doing so.”* This does not necessarily mean it needs to use *actual* supplier hedging strategies as opposed to *assumed* strategies.
9. In its analysis of what action suppliers may have taken in respect of their hedging strategies on receipt of the May Consultation, Ofgem used assumptions; it did not consider it was necessary at that point to obtain actual information from suppliers. We maintain that, for the purposes of reassessing the wholesale allowance in the first cap period, Ofgem should take a similar approach.
10. Any further information requested from suppliers should be sufficient only to allow Ofgem to apprise itself of what action a “typical” (or average) supplier would have taken in relation to its hedging strategy subsequent to Ofgem’s request for information in March 2017, which enquired about suppliers’ hedging strategies, and before its May Consultation, during which time draft legislation relating to the introduction of the DTC was published. Indeed, it is probable that no additional information would be required; Ofgem could make assumptions similar to those it made about how suppliers may have changed their hedging strategies following the publication of its May Consultation.
11. Analysis of any information provided should relate to whether the average supplier changed its hedging policy in the light of developments in the market, and to what extent. The exact values are irrelevant for modelling purposes; they were not used in modelling the potential impact of Ofgem’s proposal in its May Consultation concerning the observation window; they should not be used for this reassessment.
12. However, given that Ofgem has already obtained details of suppliers’ hedging strategies in respect of the first cap period, any change in its approach at this stage could lead to accusations of ‘fixing’; i.e. that the results of analysis of suppliers actual hedges delivered a higher detriment for consumers than Ofgem was prepared to accept and thus it had chosen to make assumptions that would lower that impact, resulting in suppliers under-recovering. Therefore, Ofgem must be as transparent as possible in its decision-making.
13. Whether suppliers benefited by their hedging strategies or lost out because of them is irrelevant. The outcome of any hedging decision has always been, and should always be, part of the competitive process within the energy supply market. Had Ofgem stuck to the observation window it had originally proposed and that suppliers had a legitimate expectation of, there would still have been instances where suppliers gained or lost from any action they took in respect of their hedging strategies.

Challenge 4: variation in costs

14. Assuming that Ofgem persists in using actual hedging strategies to analyse the differential between the wholesale allowance it set and the wholesale allowance it would have set had it taken into account supplier's actual behaviour, we have considered below Ofgem's proposals regarding variation in costs.
15. We agree with Ofgem's proposal to have regard to average costs; however, there is a lack of clarity on which type of average Ofgem proposes to use. We believe it should be the mean average.
16. In a sample of just six, it would be difficult to prove that any individual supplier was an outlier, rather than that five are clumped together leaving the sixth isolated. Removing the 'outlier' could introduce bias.
17. As we have stated above, we agree with Ofgem's minded-to position to include in its analysis only the largest six suppliers and specifically not to include Bulb (whose market shares in January 2019 were the next greatest after the largest six suppliers). To include any other supplier, it would be necessary to prove they were equivalent to the six large suppliers in terms of their tariffs, hedging strategies and operating in a steady state.

Challenge 5: setting an adjustment charge

18. It is obvious that it would be impossible to put customers back in the situation they would have been had Ofgem not changed the observation window. As is pointed out in the consultation, customers will have switched supplier or tariff and consumption levels may have changed.
19. Indeed, the effect of the introduction of the DTC appears to have resulted in an increase in switching amongst customers on default tariffs. It is likely, therefore, that more customers will have benefited from lower prices in Q1 2019 than will be detrimented by higher prices during the adjustment period. Suppliers, particularly the largest six, have lost considerable numbers of customers over recent months, and are likely to under-recover during the adjustment period.

Challenge 6: setting an adjustment period

20. We agree that there are risks of further uncertainty if the adjustment period is longer than 12 months, and any shorter period could have a significant impact on customers' prices.
21. A 12-month period would therefore be the most ideal, but presents potential difficulties should the Secretary of State decide to end the DTC on 31 December 2020. In accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018, Ofgem can make its decision on whether to recommend to the Secretary of State whether the cap should remain in place for 2021 any time up until 31 August 2020, and the Secretary of State does not have to publish his/her decision until 31 October 2020. Thus it will be unclear what the future of the cap will be at the time the cap prices are published for the fifth cap period.



22. Under current regulations, Decisions relating to changes that impact prices for the fifth cap period must be made by 12 June 2020: even under Ofgem's proposed rule changes, Decisions would have to be made by 6 August 2020, at which time it is unlikely that the Secretary State will have made a decision on whether to extend the cap. Indeed, it is even probable that Ofgem will not have made a recommendation to the Secretary of State.
23. We therefore urge Ofgem to adopt a three-month adjustment period. Any longer adjustment period would result in suppliers under-recovering, which is completely unacceptable.
24. The only other alternative is for Ofgem to consider and consult on how suppliers would be fully compensated for the under-recovery should the DTC end or be significantly altered beyond 31 December 2020.