

Decision

Reassessing the wholesale allowance in the first default cap period: August 2020 decision

Publication date: Wednesday 5 August

Contact: Anna Rossington

Team: Retail price regulation

Email: retailpriceregulation@ofgem.gov.uk

We have consulted on proposals to adjust the default tariff cap in order to retrospectively correct the wholesale allowance in the first cap period. This follows the Judicial Review of our decision on the wholesale allowance in the first cap period.

This document sets out our decision.

© Crown copyright 2020

The text of this document may be reproduced (excluding logos) under and in accordance with the terms of the [Open Government Licence](#).

Without prejudice to the generality of the terms of the Open Government Licence the material that is reproduced must be acknowledged as Crown copyright and the document title of this document must be specified in that acknowledgement.

Any enquiries related to the text of this publication should be sent to Ofgem at:
10 South Colonnade, Canary Wharf, London, E14 4PU. Alternatively, please call Ofgem on 0207 901 7000.

This publication is available at www.ofgem.gov.uk. Any enquiries regarding the use and re-use of this information resource should be sent to: psi@nationalarchives.gsi.gov.uk

Contents

Executive summary	4
1. Introduction	6
2. Assessing suppliers' comparable wholesale costs	11
Summary of our decision.....	11
Our reassessment of suppliers' comparable wholesale costs.....	12
Challenge 1: suppliers in scope	15
Challenge 2: relevant cap periods.....	18
Challenge 3: comparable wholesale costs	22
3. Reconsidering the wholesale allowance in the first cap period	28
Summary of decision	28
Reassessing the allowance in the first cap period.....	29
Challenge 4: variation in costs	30
4. Adjusting future allowances.....	34
Summary of our decision.....	34
The structure of the adjustment allowance	35
Challenge 5: setting an adjustment charge.....	38
Challenge 6: Adjustment period	42

Executive summary

Reviewing our decision

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.¹

We have concluded that the wholesale allowance in the first cap period was too low. Following consultation on our proposals, we have decided to include an adjustment allowance in the fifth cap period (between 1 October 2020 and 31 March 2021). That will allow suppliers, in the fifth cap period, to charge an additional £7.98 per gas customer with benchmark consumption and £2.64 per electricity customer with benchmark consumption.² In annualised terms, our proposed adjustment will increase the published cap levels for gas and electricity by £10.71 and £4.56 respectively.³

Reassessment of suppliers’ comparable costs

In our 2018 decision to implement the default tariff cap we considered suppliers’ wholesale costs, based on an assumption about how a typical supplier’s historical hedging strategy up to May 2018 would affect their wholesale costs.⁴ The High Court found that we had not sufficiently tested that assumption. It ruled that we must reassess our decision, and make such adjustments as we consider appropriate in the light of that reassessment.

We have assessed the historical hedging strategies and comparable wholesale costs of the large energy suppliers (British Gas, EDF, Eon, Npower, Scottish Power, and SSE).⁵ The impact on each supplier varied, but on average, suppliers’ comparable costs exceeded the wholesale allowance in the first cap period.

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

² See paragraphs 1.4 to 1.8 for an explanation of benchmark consumption.

³ Before Payment Method Uplifts, EBIT, VAT, and headroom, which are percentage figures that we apply to all allowances.

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

⁵ We discuss suppliers as they were during the first cap period. Since the first cap period, suppliers have consolidated.

An appropriate allowance

In our 2018 decision, we set the allowance in the first cap period using the standard approach for a winter cap period. In other words, we chose not to include a transitional arrangement in the first cap period.⁶

In the light of the evidence provided, we consider that we should have used a transitional arrangement to set the wholesale allowance in the first cap period. We have decided that we should have set an allowance in line with the weighted average comparable wholesale costs of the six large suppliers in the first cap period.

An appropriate adjustment

We have decided to introduce a new allowance in the default tariff cap methodology: an adjustment allowance. This allowance will increase the level of default tariff cap for a limited time.

To adjust for the wholesale allowance in the first cap period, we will set the adjustment allowance for one cap period (1 October 2020 to 31 March 2021). That allowance will enable suppliers, on average, to recover the revenue they would have been able to charge in the first cap period, had we set the wholesale allowance in line with their weighted average comparable wholesale costs.

In contrast to our May 2020 proposal, we have decided to set the adjustment allowance in respect of the wholesale allowance in the first cap period on a collective basis, adjusting for the fact that suppliers will have fewer default tariff customers in the adjustment period than they had in the first cap period.

⁶ In our September 2018 consultation we stated “In our May 2018 consultation we proposed a transitional arrangement, where we could set the direct fuel allowance for the first cap period using a different observation window from the one we would normally use to analyse forward contracts. We now propose to use our standard approach for a winter cap period”

1. Introduction

What did we consult on?

This document

- 1.1. 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.
- 1.2. In May 2020, we consulted on our reassessment of the wholesale allowance in the first period of the cap.⁷ We concluded that we should have set the allowance higher to reflect the impact suppliers’ historical hedging strategies had on their comparable wholesale costs. We proposed to include an adjustment allowance in the fifth cap period to reverse the impact of our 2018 decision.
- 1.3. This document sets out our decision to include an adjustment allowance in the fifth cap period (1 October 2020 to 31 March 2021), which adjusts for a shortfall in the wholesale allowance in the first cap period. The adjustment will increase the maximum variable charge that suppliers will be allowed to charge their default tariff customers – for customers with benchmark consumption, this will increase gas bills by £7.98 and electricity bills by £2.64 (or £10.71 and £4.56 expressed in annualised terms). We set the adjustment allowance in ‘Annex 8 – adjustment allowance’ of standard condition 28AD of the electricity and gas supply licences.

Benchmark consumption

- 1.4. The wholesale allowance scales with consumption. Customers that consume more, pay more. The wholesale allowance is a cap on the price suppliers can charge per unit of energy. In this document we discuss the unit of cost of energy in £ per MWh. For illustrative purposes, we also discuss the wholesale allowance at “benchmark

⁷ Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: May 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-protecting-energy-consumers-prepayment-meters>

consumption”, which expresses the impact on customers with certain level of consumption (12,000 kWh for gas and 3,100 kWh for electricity).

- 1.5. We designed the default tariff cap using the Typical Domestic Consumption Values (TDCVs) in use at the time (2018) and set the values in the licence condition to a Benchmark Annual Consumption Level which matched the 2018 TDCVs.⁸ The TDCVs have since been updated to reflect changing consumption patterns.⁹
- 1.6. All values presented in this decision are stated in terms of the 2018 TDCVs, as are the values used in the modifications to the licence conditions. This is because it would make it difficult for stakeholders to follow the actual changes in methodology and values resulting from our decisions if we simultaneously changed the way we present results in our detailed publications. The changes to the TDCV do not affect the calculation of the maximum charges.
- 1.7. For the press release accompanying the cap updates (published each August and February) we state the cap level using the latest TDCVs for presentational purposes.¹⁰ To avoid confusion, we refer to old TDCVs as “benchmark consumption” in this decision document, which is 3,100 kWh for electricity and 12,000 kWh for gas.

Context

The cap

- 1.8. 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 tariff customers”). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.

⁸ Medium consumption values of 3,100KWh per annum for electricity profile class 1 and 12,000 kWh for gas.

⁹ 12,000 kWh gas medium consumption and 2,900 KWh electricity profile class 1 medium consumption, set out in Decision for Typical Domestic Consumption Values, January 2020
<https://www.ofgem.gov.uk/publications-and-updates/decision-typical-domestic-consumption-values-2020>

¹⁰ We will announce the cap level for the fifth cap period on Friday 7 August 2020, effective on 1 October.

- 1.9. 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.¹¹
- 1.10. The cap comprises several allowances, each relating to different cost 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.¹²

The wholesale allowance in the first cap period

- 1.11. To ensure a common understanding of the issues, in Chapter 2 of our May 2020 consultation we described the important points regarding wholesale costs, the wholesale allowance in the default tariff cap, the transition problem, our 2018 decision on the wholesale allowance in the first cap period, and the judicial review of that decision. We have not repeated that chapter in this document, but refer to it where necessary.
- 1.12. In this document we explain how we have reassessed suppliers’ comparable wholesale costs in the relevant cap periods (Chapter 2), reassessed the allowance in the first cap period (Chapter 3), and will adjust the fifth cap period to correct for the error in the first cap period (Chapter 4). In Chapters 2-4, we explain and respond to stakeholders’ views on our proposals.

Decision process and related publications

- 1.13. We published our decision on the first wholesale allowance in November 2018. The High Court published its judgment in November 2019. We consulted stakeholders on the issues and our proposals in January and May 2020. We also conducted bilateral discussions with the six largest suppliers to discuss their hedging strategies and our assessment of their comparable wholesale costs.

¹¹ Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6).
<http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>

¹² Domestic Gas and Electricity (Tariff Cap) Act 2018; section 2(2).
<http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

1.14. The relevant publications are:

- An overview of our 2018 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
- 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>
- Our January 2020 consultation on our reassessment of the wholesale allowance in the first cap period: Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation>
- Our May 2020 consultation on our reassessment of the wholesale allowance in the first cap period: Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: May 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-protecting-energy-consumers-prepayment-meters>

Your feedback

General feedback

1.15. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

Please send any general feedback comments to retailpriceregulation@ofgem.gov.uk.

2. Assessing suppliers' comparable wholesale costs

In this chapter, we analyse the impact of each relevant supplier's historical hedging strategies on its comparable wholesale costs.

Summary of our decision

- 2.1. We conclude that we should have used a transitional arrangement to set a wholesale allowance in the first cap period that was higher than the wholesale allowance we chose in our 2018 decision. In addition, we conclude that the April-September observation window that we proposed in our May 2018 consultation would have set the wholesale allowance too high, and that we were right not to adopt that approach. In Chapter 3 we explain at what level we should have set the wholesale allowance in the first cap period.
- 2.2. In this chapter we explain how we have assessed suppliers' comparable wholesale costs, and why. For each supplier, we have calculated comparable wholesale costs using their historical hedging strategies. We did so using data from each supplier on their hedging strategies and the actual volumes of energy they accumulated over time. Suppliers' comparable wholesale costs varied extensively. Due to the historical contracts they purchased before May 2018, each supplier was unable to align to the observation window for the first cap period, and half were unable to align to the observation window in the second cap period.
- 2.3. In our assessment of suppliers' comparable costs we have:
 - restricted our analysis to large domestic energy suppliers that seek to follow the observation windows in the wholesale allowance (in practice, this means the 'six large suppliers' only);
 - analysed the impact that these suppliers' historical hedging strategies (that were in place up to May 2018) had on their comparable wholesale costs in the first two cap periods, but not subsequent cap periods; and
 - analysed these suppliers' wholesale costs in comparable terms to the wholesale allowance, not their accounting costs.

- 2.4. In response to one supplier’s representations we have adjusted our assessment of its comparable wholesale costs, increasing our estimate of its comparable wholesale costs. We have made no other changes to our assessment of suppliers’ comparable costs.
- 2.5. Below, we explain our assessment of the suppliers’ comparable costs, and how they compare to the wholesale allowances in the cap. We also consider stakeholders’ views on the three analytical challenges set out in our January and May 2020 consultations.¹³ Below we discuss:
- our assessment of suppliers’ comparable wholesale costs;
 - which suppliers we include in the scope of our analysis (challenge 1);
 - which cap periods we consider when reassessing the allowance in the first cap period (challenge 2); and
 - how we ensure that our cost estimates are comparable with the wholesale allowance (challenge 3).

Our reassessment of suppliers’ comparable wholesale costs

Overview

- 2.6. For each supplier, we have calculated comparable wholesale costs using their historical hedging strategies. We have collected data from each supplier on their hedging strategies and the actual volumes of energy they accumulated over time.
- 2.7. Suppliers’ comparable wholesale costs varied extensively. Due to the historical contracts they purchased before May 2018, each supplier was unable to align to the

¹³ Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation>. Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: May 2020 consultation <https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-reassessing-wholesale-allowance-first-default-tariff-cap-period>

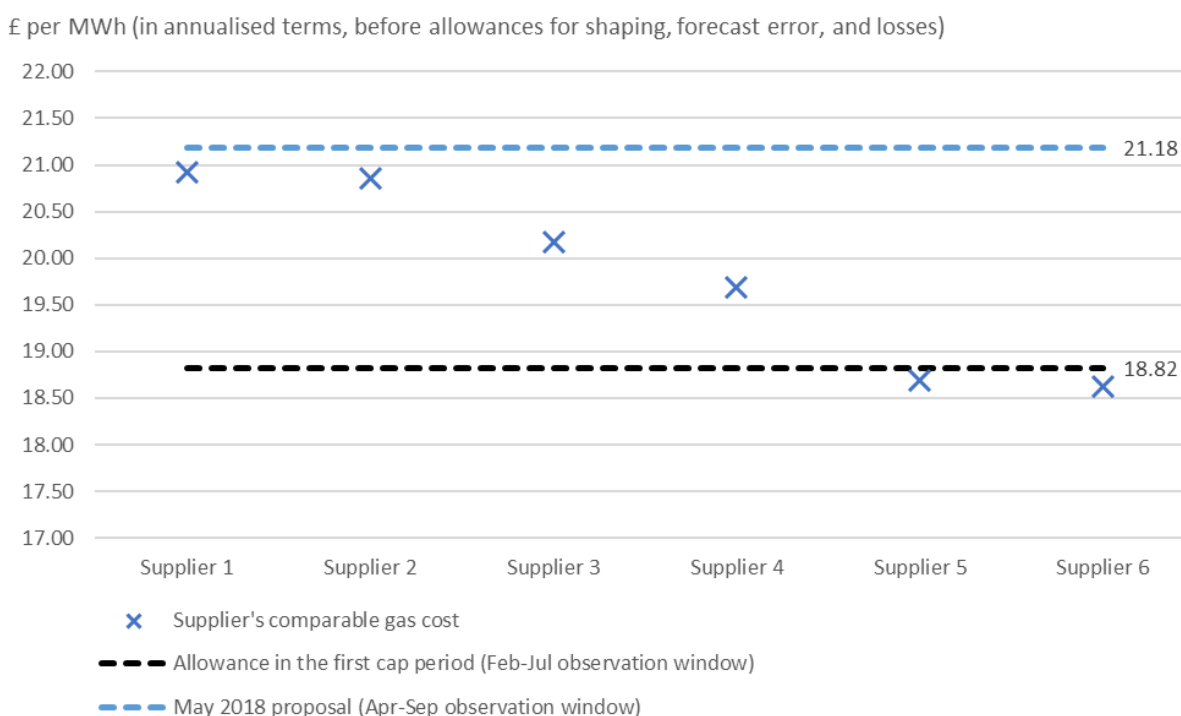
observation window for the first cap period, and half were unable to align to the observation window in the second cap period.

Suppliers' comparable costs in the first cap period

2.8. Figures 2.1 and 2.2 show each supplier's comparable wholesale costs in the first cap period per unit of gas and electricity compared with the comparable wholesale price in the wholesale allowance (stated in annualised cost per MWh before applying the standardised uplifts for shaping costs, forecast error, and other factors such as transmission losses).

2.9. Four of the six suppliers had comparable gas costs above the allowance. Five of the six suppliers had comparable electricity costs above the allowance.¹⁴ The extent of the variation depends on each supplier's historical hedging strategy. Those who purchased the most energy before May 2018 have the lowest costs. Those who purchased the least energy before May 2018 have the highest costs.

Figure 2.1: Suppliers' comparable gas costs in the first cap period

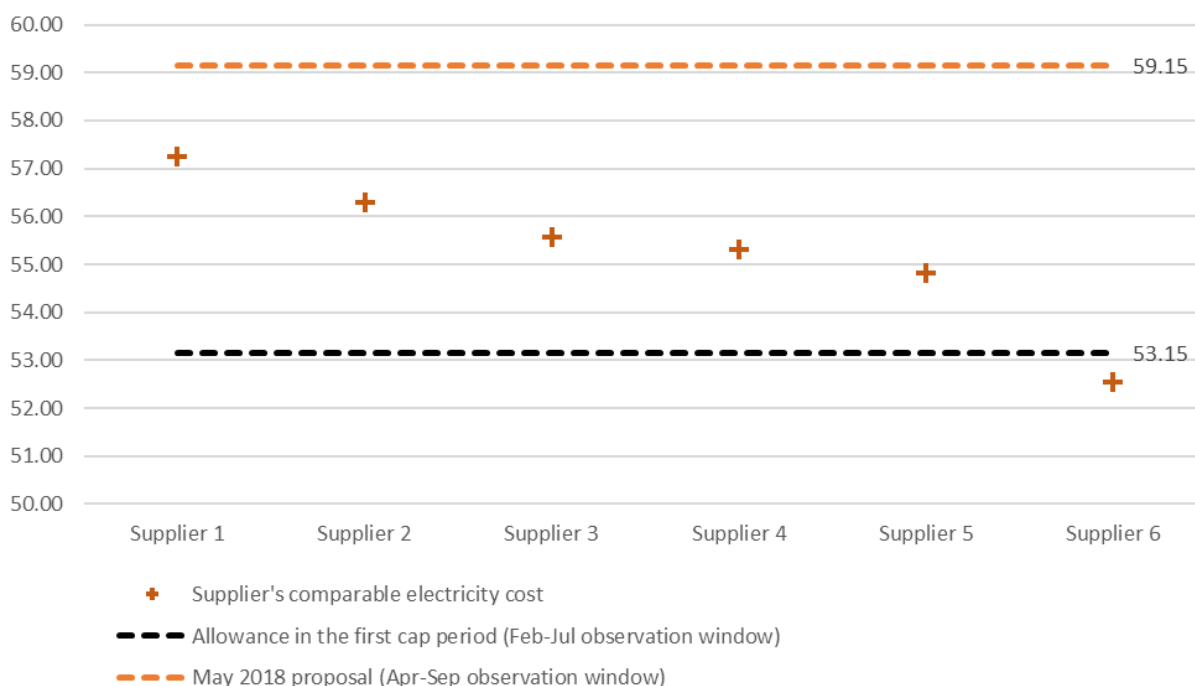


Note: We order suppliers' costs by size for each fuel separately. "Supplier 1" for gas costs is not necessarily the same supplier as "Supplier 1" for electricity costs.

¹⁴ Note that these are not necessarily the same four suppliers in each case.

Figure 2.2: Supplier’s comparable electricity costs in the first cap period

£ per MWh (in annualised terms, before allowances for shaping, forecast error, and losses)



Note: We order suppliers’ costs by size for each fuel separately. “Supplier 1” for electricity costs is not necessarily the same supplier as “Supplier 1” for gas costs.

Suppliers’ comparable costs in the second cap period

2.10. Three of the six suppliers were aligned with the observation window (Aug-Jan) for the second cap period. They had not purchased energy for summer 2019 before May 2018. The other suppliers had purchased energy for summer 2019 using their historical hedging strategies up to May 2018. Their costs were below the allowance in the second cap period, but one supplier was only marginally so. The amount of the energy these suppliers purchased before May 2018 was much less than they purchased for the first cap period, so the extent of the difference between their comparable costs and the allowance in that period is less.

The total impact of the transition problem

2.11. In our 2018 decision we considered whether to set the allowance in the first cap period using the standard observation window, or a transitional observation window. In either case we did not consider that suppliers would have purchased energy in line with the relevant observation window. We considered whether the allowance set using either window would approximate suppliers’ comparable costs, taking into account the impact of the transition problem (in total).

- 2.12. In light of the evidence provided, neither of the policy options we considered in our 2018 decision (the February-July observation window and the April-September observation window) reflected suppliers' comparable wholesale costs. Most suppliers had comparable costs above the first cap period wholesale allowance due to their historical hedging strategies. All suppliers had comparable costs substantially below the transitional arrangement we had proposed in our May 2018 consultation.
- 2.13. We conclude that we should have set a new transitional allowance in the first cap period to account for the impact of the transition problem. In Chapter 4 we consider at what level we should have set the allowance in the first cap period in the light of evidence on how suppliers' historical hedging strategies affected their comparable wholesale costs.

Challenge 1: suppliers in scope

Our decision

- 2.14. We have decided to restrict our analysis to large domestic energy suppliers that aim to follow the observation windows in the wholesale allowance. In practice, this means we assess the costs of six large suppliers only (British Gas, EDF, Eon, Npower, Scottish Power, and SSE).¹⁵ We exclude Bulb and small suppliers from our analysis.
- 2.15. This decision maintains the proposal in our May 2020 consultation.

Options

- 2.16. In our 2018 decision we considered the likely impact of our decision on the six largest standard variable tariff (SVT) suppliers at that time, who we believed would serve 90% of all default tariff customers in the first cap period. We considered that smaller suppliers' costs would not affect our decision.
- 2.17. By the definition of "large suppliers" we used in our 2018 decision, Bulb was a large supplier of customers with SVTs in the first cap period. In our January 2020

¹⁵ Since the first cap period, suppliers have consolidated. Eon purchased Npower. OVO Energy purchased SSE. For this assessment we analyse each supplier as they were during the first cap period.

consultation, we consulted stakeholders on whether or not we should include Bulb in our assessment of costs.

2.18. In our May 2020 consultation we proposed to exclude Bulb and small suppliers from our assessment.

Our rationale for excluding small suppliers

2.19. In our 2018 decision, we concluded that we would not increase the wholesale allowance to reflect small suppliers' wholesale costs, even if they had very high comparable costs. We did not estimate their comparable wholesale costs.¹⁶

2.20. In response to our January and May 2020 consultations, suppliers agreed with our proposal.

2.21. We have excluded small suppliers for two reasons:

- 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 default tariff cap; and
- few default tariff customers were served by small suppliers in the relevant cap periods, so small suppliers' comparable wholesale costs should have limited impact on the level of protection default tariff customers required (on average). We consider that the additional value to our analysis of each small supplier is increasingly limited, yet the time and resources required to analyse each additional supplier's comparable wholesale costs is similar.

Our rationale for analysing six large suppliers only

2.22. We have analysed the costs of the six large suppliers because:

- collectively, these suppliers served a high proportion of default tariff customers during the first cap period, so the costs they incurred serving those customers

¹⁶ 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>

are relevant considerations when reassessing the wholesale allowance of the first cap period; and

- default tariff customers are a significant proportion of each supplier's business, so they are exposed to the level of the cap.

2.23. We have excluded Bulb from our assessment because unlike the other large suppliers, it did not attempt to align its hedging strategy with the observation window in the wholesale allowance, nor did it attempt to manage its hedging strategy in a similar way to the six large suppliers before we introduced the cap. On that basis, we do not need to consider how much the transition problem (its historical hedging strategies before May 2018) constrained Bulb's ability to align with the observation windows. Bulb chose not to align. As such, its costs are not relevant when considering the wholesale costs of a typical supplier serving default tariff customers.

2.24. As we discussed in Chapter 2 of our May 2020 consultation (2.9-2.11), the other large suppliers have different specific hedging strategies, but they share an overarching objective. The transition problem is relevant for these suppliers because each supplier was affected by the transition from one regime to the other, being unable to align their costs.

Considering stakeholders' views

Summary

2.25. In response to our May 2020 consultation, all suppliers that considered this issue (which included Bulb) agreed that we should restrict our analysis to the six large suppliers only.

2.26. One consumer group considered that we should include Bulb in our assessment. It reasoned that Bulb's strategy shows that the suppliers could have taken other approaches and should not be compensated for the choices they made. As explained below, we do not consider that to be the case.

Bulb's hedging strategy and pricing of competitive tariffs

2.27. Before and after the introduction of the cap, Bulb had a shorter hedging strategy than the six largest suppliers. This means it purchased energy closer to the point of

delivery, passing through wholesale price changes onto customers much sooner than the other suppliers of default tariff customers. This approach meant that its wholesale costs were more volatile, increasing more and faster when wholesale prices rise, and falling lower and quicker when wholesale prices decline. At the time of the first cap period, wholesale prices were rising, so Bulb will have had higher than average wholesale costs (taking those costs in isolation). If Bulb's wholesale costs were representative of costs for default tariff customers, it would *increase* our assessment of wholesale costs.

2.28. Bulb's short strategy (and in this period, its high wholesale costs) are not relevant when considering the costs of serving default tariff customers. Its variable tariff is competitively set. As such, it has different incentives to the incumbent large suppliers and, for that reason, it manages its hedging strategy differently to the other large suppliers. For suppliers serving default tariff customers it was rational to purchase energy so that they would align with the costs of other suppliers of default tariffs (before we introduced the cap) or the observation window in the wholesale allowance (after we introduced the cap). That does not apply for suppliers pricing tariffs to attract engaged customers. On that basis, the transition problem did not apply to Bulb, so we exclude its costs from our assessment.

2.29. For the avoidance of doubt, for the remainder of this decision we use "suppliers" to refer to the six large energy suppliers in our analysis.

Challenge 2: relevant cap periods

Our decision

2.30. We have decided to assess the impact suppliers' historical hedging strategies had on their comparable wholesale costs in the first cap period only. We have ignored the impact those historical strategies had on suppliers' costs in subsequent cap periods.

2.31. This decision maintains our proposal in the May 2020 consultation.

Options

2.32. In our January 2020 consultation we explained that we intended to assess how suppliers' historical hedging strategies before May 2018 affected their comparable hedging costs in each of the first three cap periods. We expected that the impact on the third cap period would have been minor, and that we might not analyse costs in

that period on that basis. We noted that British Gas successfully challenged our assumption that suppliers would have maintained typical historical hedging strategies until 23 May 2018 (when we published the observation window in our May 2018 consultation) and so we saw no principled reason to restrict our analysis to consider the impact of those historical strategies on the first cap period only, and not consider their impact on the second cap period.

Our rationale

2.33. We consider that, on average, suppliers' historical hedging strategies prevented them from aligning with the observation windows for the first two or three cap periods. In principle, we are content to disregard suppliers' comparable costs in cap periods where the impact of their historical hedging strategies was minor. We consider that the impact was only material in the first cap period. On that basis, we limit our considerations to that period only.

Summary of stakeholders' views

2.34. In response to our May 2020 consultation, all of the large suppliers agreed that we should assess the impact that their historical hedging strategies had on their costs in the first cap period only, and not consider their strategies' impact on costs in subsequent periods. They considered that British Gas had not challenged our decision on the wholesale allowance in the second cap period, so regardless of whether or not their historical hedging strategies before May 2018 gave them lower costs than were allowed for, it would be unlawful for us to review and correct for those costs.

2.35. One consumer group disagreed with our proposal. It stated that although the impact was minor (around £2), the order of magnitude was the same as in the first cap period, so we would turn a net shortfall into a net windfall.

2.36. Below we consider suppliers' views in detail, addressing four themes:

- our decision on the wholesale allowance in the second cap period;
- the relevance of comparable costs in the second cap period;
- suppliers' entitlement to their benefits in the second cap period; and

- the materiality of suppliers’ benefit in the second cap period.

Considering the relevance of costs in the second cap period

2.37. Some suppliers maintained their views that our decision on the *allowance* for the second cap period had not been challenged and had nothing to do with actual costs or the transition problem.

2.38. That is correct, but irrelevant to this decision. As we explained in our May 2020 consultation, suppliers’ comparable costs in the second cap period are relevant to our decision on the wholesale allowance in the first cap period because:

- our 2018 decision sought to set the wholesale allowance in the first cap period *in order to address the impact of the transition problem*, and that decision was challenged;
- our 2018 decision clearly stated that costs in the second cap period were relevant to the transition period, as we concluded “that [the second wholesale] 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 of the energy in advance”;¹⁷ and
- the transition problem (and specifically our hedging assumption that suppliers would have maintained a typical historical hedging strategy up to May 2018 which British Gas challenged) logically and empirically applies to the second cap period (see Figure 2.7 in Chapter 2 of the May 2020 consultation).

2.39. Some suppliers considered that the High Court had only instructed us to reassess the first cap period, and therefore we could not reconsider costs in the second cap period regardless of whether it was relevant to the issue or not. In the Judicial Review, British Gas had challenged the adequacy of the wholesale allowance on the basis that our assumption about suppliers’ historical hedging strategies up to May 2018 was not consulted on and likely incorrect. The High Court agreed and instructed us to reconsider the allowance in light of the evidence available. While it is possible that

¹⁷ Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.166.
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

British Gas did not challenge the correction of that assumption in principle, but in narrower circumstances that favoured it, the impact of historical hedging strategies on suppliers' costs in the first two cap periods feature in our decision on the allowance for the first cap period, as discussed above.

- 2.40. One supplier argued that we had assumed the allowance in the first cap period was higher than suppliers' costs on average in the first cap period, in effect leaving the benefit we recognised that suppliers would receive in the second cap period in place. On that basis, their view was that we should not now remove the benefit.
- 2.41. We consider that this is true to an extent, and we factor it into our decision. We considered that the benefit would cover uncertainty in our estimate of costs in the first cap period and mitigate losses for those with above average costs in the first cap period. The uncertainty is no longer relevant, as the High Court required us to calculate the average based on relevant evidence. However, considering the benefit in full, would reduce the mitigation afforded to suppliers with above average costs.
- 2.42. The data we now hold shows that four of the six suppliers were aligned, or almost aligned with the allowance in the second cap period, so the mitigation afforded by the second cap period is slight. On that basis, we do not consider it necessary to apply our reassessment of our assumption about suppliers' historical hedging strategies in full to all cap periods.

Considering the materiality of suppliers' benefits in the second cap period

- 2.43. On our May 2020 consultation we stated that, in principle, we were content to disregard suppliers' comparable costs in cap periods where the impact of their historical hedging strategies was minor. The scale of the impact is an empirical question so we gathered data and analysed suppliers' comparable costs.
- 2.44. For the first cap period, the impact is material (about £9). So, we consider these costs in our reassessment of the wholesale allowance in the first cap period.
- 2.45. For the second cap period, the impact is much less. On average the impact is about £2 per dual fuel customer with benchmark consumption in the first cap period. As a non-recurring financial impact, this is not a significant variance over the life of the cap.

- 2.46. We accept the view that the impact, although minor, is a similar order of magnitude to the impact in the first cap period. However, it as we stated in our May 2020 consultation, the impact is small and unevenly distributed. Half of the suppliers had short historical hedging strategies and were aligned with the observation window for the second cap period, and another supplier was more or less aligned. These suppliers received very little or no financial benefit. We are prepared to exclude suppliers' benefits in the second cap period, on the grounds that the impact is minor and the majority of suppliers were aligned, so they would have received no benefit to mitigate higher than average costs in the first cap period.
- 2.47. We exclude the third cap period (and subsequent cap periods) on the grounds that the impact would be negligible.

Challenge 3: comparable wholesale costs

Our decision

- 2.48. We analyse suppliers' comparable wholesale costs, not their accounting costs. By 'comparable wholesale costs' we mean that each supplier's wholesale costs are stated in comparable terms to the wholesale allowance (for example, accounting for annualised prices). The wholesale allowance never matches a supplier's accounting cost in an isolated cap period.
- 2.49. In practice we have estimated suppliers' comparable costs in each cap period by using the wholesale allowance methodology (as described in our 2018 decision), except that we replace the observation window with a supplier's actual profile of the energy volumes it purchased using its historical hedging strategy. In effect, we have calculated a personalised wholesale allowance for each supplier.
- 2.50. Before our May 2020 consultation, we had bilateral discussions with the six large suppliers, making refinements to how we calculate suppliers' comparable costs based on their hedging strategies.

Rationale

- 2.51. Assessing suppliers' comparable wholesale costs, not their accounting costs, ensures that the wholesale allowance protects customer in the way we intended it to.¹⁸
- 2.52. The distinction between accounting costs and comparable costs is important because the wholesale allowances work in series, not in isolation – they reflect accounting costs across multiple periods, not in each period. For that reason, every wholesale allowance must be set on the same basis. If the first allowance or allowances reflected accounting costs, and subsequent allowances used our standard methodology, then customers may pay for the same costs twice (for example, paying the accounting costs of winter in the winter cap period and then also paying for a portion of those winter costs again in the summer cap period which we set using annualised prices, not low summer prices).
- 2.53. Using the comparable costs approach maintains the principle behind the approach we took in our 2018 decision. We replace the observation window with a supplier's hedging profile and keep all other aspects of the methodology the same. The difference with our 2018 decision is that we now use evidence on each supplier's actual hedging profile, rather than an estimate of the average hedging strategy based on historical practice (the medley approach) (see paragraphs 2.54 to 2.57 in our May 2020 consultation). We do so to provide greater transparency to each supplier on how their hedging profile and comparable costs compare to the average costs, to which we have regard when setting the allowance.
- 2.54. This approach focusses on the differences between the observation window and when suppliers actually purchased energy and in what proportions. That assumption was the focus of the Judicial Review and the only aspect of our 2018 decision that was challenged. The way our methodology treats other aspects of wholesale costs should stay the same as these were not challenged. Our treatment of all other aspects of

¹⁸ In Chapter 2 of our May 2020 consultation (2.26 to 2.33), we explained the difference between suppliers' comparable wholesale costs and their accounting costs. For example, suppliers' accounting costs are seasonal, and include the specific impact of shaping and changes in demand that may have been more favourable or less favourable than average. The wholesale allowance smooths the peaks and troughs in suppliers' accounting costs across multiple cap periods.

suppliers' wholesale costs is, and must be, the same as our standard methodology (2.58 to 2.62 in our May 2020 consultation).

Considering stakeholders' views on our methodology

2.55. In our January and May 2020 consultations, we explained that we need to assess wholesale costs in a comparable way to the allowance. We said that we cannot assess suppliers' costs by looking at the accounting cost they incurred in the first quarter of 2019. If we did so, then the wholesale allowance would not protect default tariff customers in the manner we intended. Customers could be overcharged, for example by paying for high seasonal winter prices twice.

Considering suppliers' accounting costs

2.56. In response to our May 2020 consultation, no suppliers argued that we should consider their accounting costs.

2.57. In response to our January 2020 consultation, some suppliers considered that we should use suppliers' accounting costs to reassess the wholesale allowance in the first cap period. In our May 2020 consultation we discussed in detail (see paragraphs 2.26 to 2.33) why we needed to ensure that our assessment of wholesale costs treats seasonal prices, shaping costs, and forecast error in the same way as the wholesale allowance because the allowance under-recovers costs in some periods and over-recovers them in others (see Figure 2.5 in our May 2020 consultation). If we set the wholesale allowance on a different basis in different periods then customers may be overcharged, or suppliers may under-recover.

Considering hedging strategies for winter 2018

2.58. In response to our May 2020 consultation, suppliers agreed that we should exclude the impact of contracts for energy delivered in Q4 2018 (i.e. the first three months of winter 2018-19 contracts). We explained the reasons for this in the May 2020 consultation.

Considering deviations from suppliers' baseline hedging strategies

2.59. In response to our January 2020 consultation, some suppliers enquired how we would treat their historical hedging strategy if their evidence on how they accumulated

energy for Q1 2019 (and other cap periods) showed they did not actually follow their baseline strategy in practice.

- 2.60. In our May 2020 consultation, we explained that we calculated suppliers' comparable costs using data on the actual volume of energy suppliers held for delivery in Q1 2019. We used hypothetical examples as we could not discuss specific suppliers' strategies. We explained that there are two principal reasons for this.
- 2.61. Firstly, a baseline hedging strategy is an idealised model. In practice, a supplier may not be able to follow its baseline hedging approach precisely. Fidelity will depend on the availability and liquidity of specific contracts at specific times. This issue affects all suppliers in our analysis. Where this is the main cause of deviation, the relationship between the modelled baseline strategy and the actual profile of purchased energy is a close one.
- 2.62. Secondly, some suppliers have the latitude to deviate from their baseline strategy (usually within agreed parameters) in order to achieve lower average costs. This was the case for some of the suppliers in our analysis, but not all. As an illustrative example, in 2019 the wholesale price was falling. If a supplier thought the costs would continue to fall, it might purchase less energy at that time, compared with if it continued to follow its baseline strategy precisely. The supplier would do this in the hope that it could purchase a higher proportion of its energy later on, when prices would be lower. Alternatively, if it thought energy prices would increase, then it may 'accelerate' its purchasing strategy. On that basis, it would purchase a higher proportion of its energy at that time than if it followed its baseline strategy precisely. It would do so in the hope that it would purchase a lower proportion of its energy in the future, when prices would be higher. Depending on wholesale prices and the individual supplier's agreed parameters and practices, deviation between the baseline strategy and supplier's actual profile of energy purchases can be relatively wide, depending on the latitude provided and choices made.
- 2.63. Three suppliers commented on this approach.
- One noted that it was impossible to be accurate with any approach; that in their case the approach was "good enough", but it had the potential to misstate costs for *other suppliers*.

- One supplier considered that actual volumes would be distorted by various issues including liquidity tradeable products, proxy hedging, forecast change, and the impact of hedging for other periods.
- One wanted to know the cause of variances between baseline strategies and actual volumes *for other suppliers*.
- One supplier noted an error in the calculations estimating the comparable cost of the energy volumes it held for Q1 2019.

2.64. We recognise that no approach to estimating comparable costs will be accurate. We have discussed our approach with each supplier specifically, ensuring that the approach is reasonable for that supplier.

2.65. We cannot share the specific circumstances of a supplier with its competitors. However, suppliers should not expect the baseline strategies and actual volumes to closely align in each circumstance. As we explained on our May 2020 consultation, in each case we have discussed the extent of deviation and the reasons for it with each supplier. Our principle is that where the impact of these deviations directly affected the wholesale costs of the retail energy supplier¹⁹ then we use the actual profile of the energy volumes the supplier purchased, not the baseline strategy that it deviated from (i.e. the supplier's change in approach is relevant because it affected the cost to serve its customers. The deviations were not profits or losses attributed to trading activities outside the retail business). In practice, some suppliers have a very close relationship between their actual profile and baseline strategy (as the main cause of deviation was practical constraints). Others do not have a close relationship if they accelerated or decelerated their purchases within agreed parameters.

2.66. One supplier asked if the selection of actual volumes revealed bias. It does not. As we explained in our May 2020 consultation, we do not consider whether deviations from baseline strategies were efficient or not. We take them at face value. For some suppliers, the baseline strategy would have incurred lower costs (with the benefit of hindsight). For other suppliers, following the baseline strategy would have incurred higher costs. Ultimately we set the allowance having regard to suppliers' costs on

¹⁹ As opposed to representing the gain or losses of a speculative trading activity.

average. So the extent to which suppliers were lucky or unlucky has a diluted impact on the final result.

- 2.67. We recognise the difficulty of using actual volumes. However, we consider the estimates are robust, or “good enough” as one supplier put it. Firstly, in our 2018 decision we were concerned about the impact on costs of the volumes of energy that suppliers had already purchased. Suppliers may alter their purchasing due to liquidity or the tradeable products available and in doing so, they affect the volumes they hold. For suppliers that attempt to closely follow their baseline approach, the deviation is relatively minor.
- 2.68. Secondly, for most suppliers, we consider that the impact of deviating from one’s baseline approach has a much bigger impact than the factors affecting actual volumes. Where a supplier substantially deviates from its baseline strategy it has, in effect, changed its hedging strategy so that the baseline is irrelevant, or only tangentially relevant. As one supplier recognised, no approach is completely precise. However, if we ignored *all* deviations from the baseline strategy we would abandon any attempt to understand suppliers’ actual costs.
- 2.69. For one supplier we have not been able to satisfy ourselves that data on their actual volumes produces a more reliable estimate of their comparable wholesale costs than if we used their baseline strategy. On that basis, we have used their baseline strategy to estimate their costs. This increases our estimate of its comparable gas and electricity costs.

Considering suppliers’ gains or losses selling historical contracts

- 2.70. In response to our January 2020 consultation, two suppliers questioned how we would treat the gains (or “windfalls”) suppliers made on excess contracts they purchased under their historical hedging strategies. In our May 2020 consultation, we explained that we include suppliers’ gains and losses in our assessment of their comparable wholesale costs, providing hypothetical examples to explain the rationale.
- 2.71. In response to our May 2020 consultation, suppliers did not comment on how we treat gains and losses when suppliers sold historical contracts.

3. Reconsidering the wholesale allowance in the first cap period

In this chapter we reassess the wholesale allowance in the first cap period, and consider what transitional arrangement we should have included to account for the impact of suppliers' historical hedging strategies on their comparable costs.

Summary of decision

- 3.1. We consider that we should have set a transitional wholesale allowance in the first cap period to account for the impact suppliers' historical hedging strategies before May 2018 had on their comparable costs in the first cap period. In light of the evidence provided, suppliers' historical hedging strategies meant that their comparable costs were higher than we had allowed for.
- 3.2. We have concluded that we should have included a transitional arrangement in the first cap period, setting the allowance in line with the weighted average impact suppliers' historical hedging strategies had on their comparable costs. On that basis, the allowance in the first cap period should have allowed suppliers to recover an additional £6.78 from each default gas tariff customer with benchmark consumption in the first cap period and £2.24 from each default electricity tariff customer with benchmark consumption.²⁰ That would have allowed the six large suppliers to charge an additional £101m in the first cap period.
- 3.3. Below, we explain our reconsideration of the wholesale allowance in the first cap period. We also respond to stakeholders' views on the analytical challenge we explained in our January and May 2020 consultations: that we must set a single cap and suppliers' comparable wholesale costs vary.

²⁰ These figures is expressed as an average across Great Britain. In practice, we calculate the weighted average £ per MWh before applying other allowances including transmission and distribution losses, which are different in each of the 14 regions. These figure do not reconcile to the figures in the executive summary. We increase the cost by 18% to adjust for the fact suppliers will have fewer customers in the adjustment period than they did in the first cap period. We explain this decision in Chapter 4.

Reassessing the allowance in the first cap period

Considering suppliers' weighted average comparable costs

- 3.4. Figures 3.1 and 3.2 show how suppliers' comparable costs in the first cap period varied from the wholesale allowance (in £ per MWh before applying other multipliers for shaping costs, forecast error, and losses). Taking a weighted average of suppliers' comparable costs, their gas costs were £1.24 per MWh above the level they were allowed to charge (before applying other wholesale allowances), and their electricity costs were £2.07 per MWh above the level they were allowed to charge (before applying other wholesale allowances).
- 3.5. In the first cap period, a customer with benchmark consumption would have consumed 5.03 MWh of gas and 0.88 MWh of electricity. After applying other wholesale costs, suppliers were able to charge such a gas customer £6.78 less than they would have charged if we had set the allowance in line with suppliers' weighted average gas costs. The would have been allowed to charge such an electricity customer £2.24 less than they would have charged if we had set the allowance in line with suppliers' weighted average electricity costs.

Figure 3.1: Difference between comparable gas costs and the allowance in Q1 2019

Difference with allowance (in £ per MWh before multipliers)

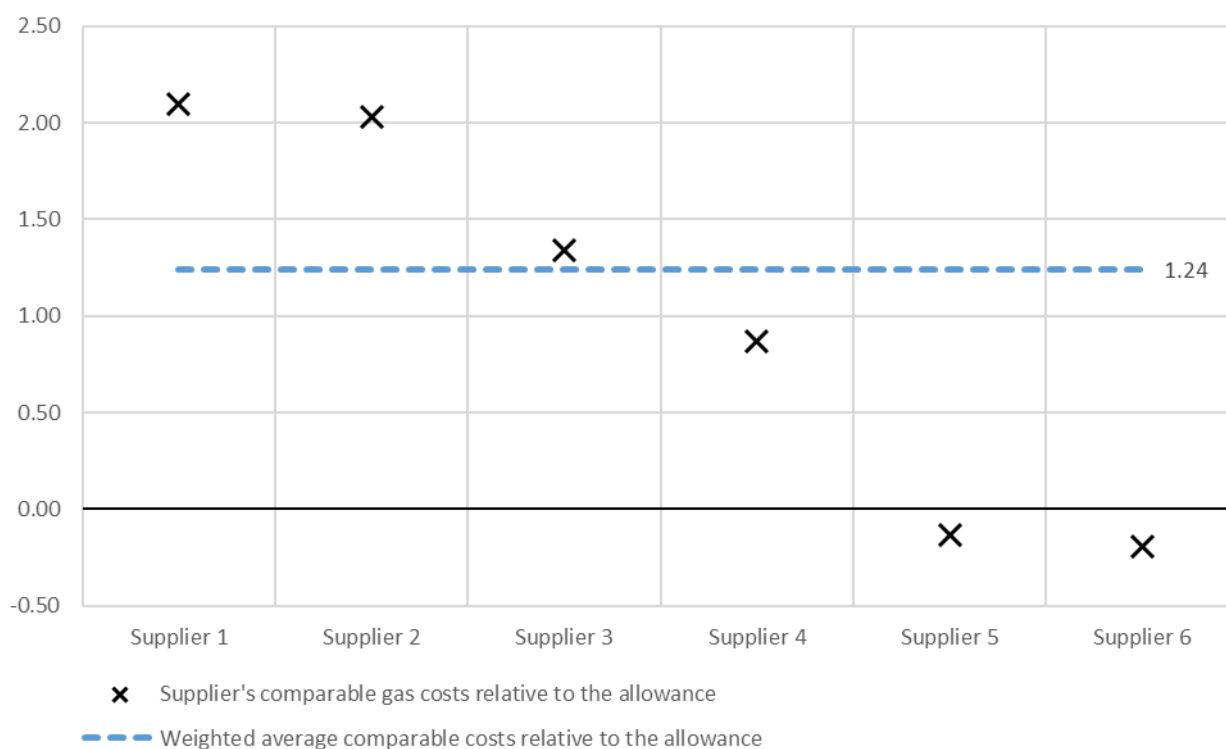
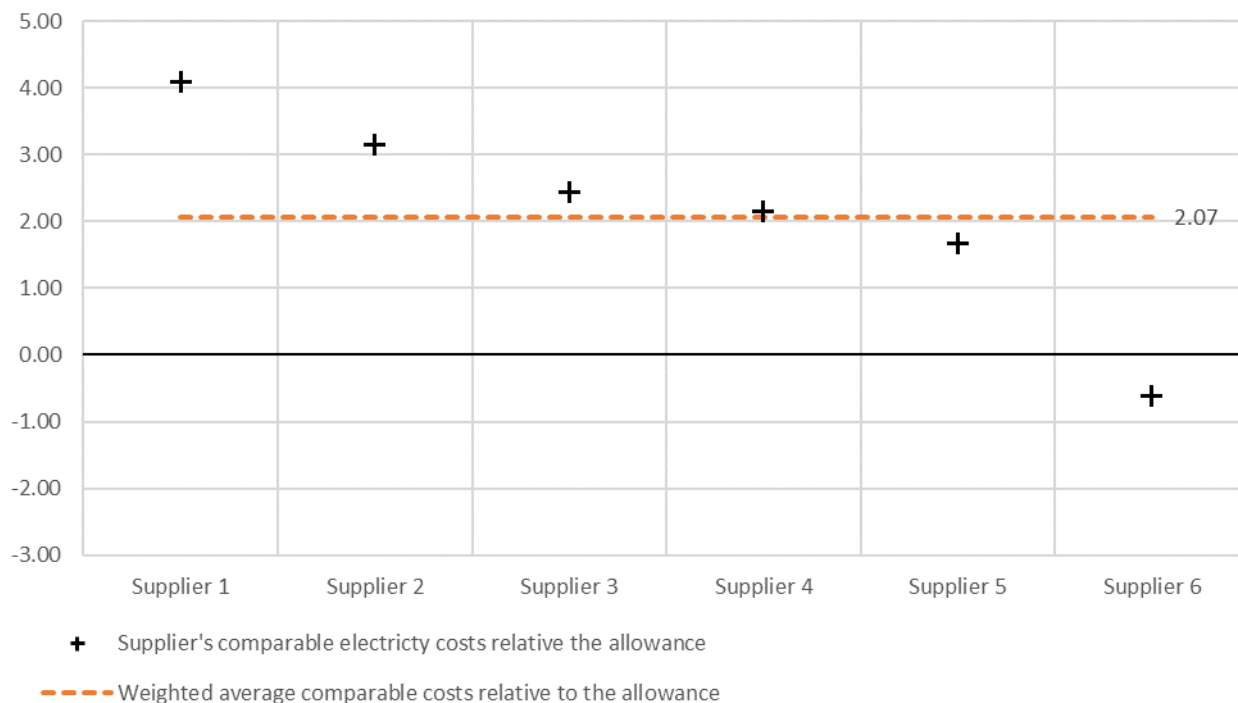


Figure 3.2: Difference between comparable electricity costs and the allowance in Q1 2019

Difference with allowance (in £ per MWh before multipliers)



Challenge 4: variation in costs

Options

3.6. Suppliers' costs vary. The Act states that the cap may not make different provision for different holders of supply licences.²¹ Therefore, no level of wholesale allowance could reflect *each* supplier's comparable wholesale costs. At whatever level we set the allowance, some suppliers will be at a disadvantage compared to others.

3.7. In our January 2020 consultation we considered how we might set the single wholesale allowance. We could set it in line with:

- the highest costs, ensuring that all suppliers could recover their costs;

²¹ Domestic Gas and Electricity (Tariff Cap) Act 2018. Section 2(2). <http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

- the lowest costs, ensuring that no default tariff customer paid more than the cost of supplying them energy; or
- the average costs, ensuring that customers were not charged more than the average cost of supplying them energy.²²

3.8. In our May 2020 consultation we proposed to set the allowance in line with the weighted average of suppliers' comparable costs.

Our decision

3.9. We have decided that we should have set the wholesale allowance in the first cap period in line with the weighted average of suppliers' comparable wholesale costs. Using a weighted average means that the allowance in the first cap period would have been higher than some suppliers' comparable wholesale costs, and lower than others'.

3.10. This decision maintains our proposal in the May 2020 consultation.

Rationale

3.11. In our January 2020 consultation we explained that we would consider the appropriateness of the wholesale allowance in the first cap period with reference to the customer protection it affords to customers and the statutory "needs" set out in section 1(6) of the Act.²³

3.12. In seeking to protect customers, we consider that tariffs should not exceed underlying efficient 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, in this specific context, it cannot be achieved for each supplier at the same time.

²² Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation>

²³ Domestic Gas and Electricity (Tariff Cap) Act 2018. Section 1(6). <http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>

- 3.13. The weighted average of suppliers' comparable costs best describes the underlying comparable costs of serving default customers as a group. The weighted average multiplied by the total number of customers should reflect suppliers' aggregate comparable costs. In effect, it is the simple mean of the costs associated with each customer.
- 3.14. The weighted average gives more prominence to suppliers with a lot of customers, which (strictly speaking) is not relevant when regarding wholesale costs. The simple mean better reflects the comparable cost around which we would expect suppliers' wholesale costs to vary. In this case, suppliers with the most customers happened to have higher costs, so the weighted average is higher than the simple mean, but the difference is marginal.

Considering stakeholders' views

- 3.15. In response to our May 2020 consultation, most suppliers agreed with our proposal to use a weighted average of suppliers' comparable costs.
- 3.16. Two suppliers said we should use the transitional allowance we had proposed in our May 2018 consultation, set using an observation window of prices between April and September 2018. In addition, one supplier said that we should not set the allowance lower than the comparable costs of the suppliers with higher than average costs.

Considering our May 2018 consultation proposal

- 3.17. The transitional arrangement we proposed in our May 2018 consultation would set an allowance higher than any suppliers' comparable costs. For the reason we stated in our September 2018 consultation and 2018 decision, that would not protect customers and is inappropriate.

Considering the supplier with the lowest costs

- 3.18. Setting the allowance at the level of the supplier with the lowest costs would protect customers – no customer would have paid more than the underlying efficient costs of serving them. However, the other suppliers would only partially recover their costs. The customers of those suppliers would all pay less than the underlying cost of supplying them with energy.

Considering the supplier with the highest costs

- 3.19. Setting the allowance at the level of the supplier with the highest costs would protect the customers *of that supplier*. They would not have paid more than the underlying cost of supplying them energy. All other suppliers could over-recover their costs. That would not protect their customers, all of whom would pay more than their underlying costs.
- 3.20. We do not consider that Section 1(6) of the Act requires that we set the wholesale allowance above the costs of the majority of default tariff customers. That would not protect those customers. We must have regard to an efficient supplier's ability to finance its activities, but that is not the same thing as achieving that. In this case, where efficient comparable wholesale costs vary, we have considered each suppliers' costs and consider that the average level protects default tariff customers.

Considering how to measure average costs

- 3.21. In our May 2020 consultation, we considered the relative merits of characterising typical costs as median costs, weighted average costs, or simple mean costs. We have decided to use weighted average costs for the reasons stated in the consultation.

4. Adjusting future allowances

In this chapter, we consider how to adjust future allowances to account for the transitional allowance that we would have set in the first cap period.

Summary of our decision

- 4.1. We are introducing a new allowance in the default tariff cap methodology: an “adjustment allowance”. This allowance can adjust the level of the cap for a limited number of cap periods. In this case, it will increase the cap level between 1 October 2020 and 31 March 2021.²⁴
- 4.2. To correct for our decision on the wholesale allowance in the first cap period, we will set the adjustment allowance so that it:
 - increases the cap’s maximum variable charge and not the standing charge;
 - adjusts for the error in the first cap period on a collective basis (adjusting for suppliers’ loss of default tariff customers); and
 - adjusts the cap for the fifth cap period only, starting on 1 October 2020.
- 4.3. On that basis, the adjustment allowance will be:
 - £10.71 for a gas customer with benchmark consumption (stated in annualised terms), allowing suppliers to recover £7.98 per customer (76% of gas annual consumption is in winter), and about £71m in aggregate during the fifth cap period.

²⁴ This allowance will remain part of the licence and be set a £0 once we have made the adjustment relating to the wholesale allowance in the first cap period. At present we have no plans to use the adjustment allowance for any other adjustment. If, in future, we consider that some other adjustment is necessary then any proposal to use the adjustment allowance for that purpose would be subject to consultation.

- £4.56 for an electricity customer with benchmark consumption (stated in annualised terms), allowing suppliers to recover £2.64 per customer (57% of electricity annual consumption is in winter), and about £29m in aggregate during the fifth cap period.
- 4.4. For the avoidance of doubt, the ongoing wholesale methodology as set out in Annex 2 to SLC 28AD (electricity and gas) shall apply in future cap periods as normal.
- 4.5. Below, we explain our decision on the adjustment allowance in detail. We also respond to stakeholders' views on the two challenges we set out in our January and May 2020 consultations. We explain:
- the structure of the adjustment allowance;
 - setting an appropriate adjustment charge (challenge 5); and
 - setting an appropriate adjustment period (challenge 6).

The structure of the adjustment allowance

Our decision

- 4.6. We are modifying the default tariff cap methodology, introducing an "adjustment allowance", independent of the wholesale allowance. Alongside this decision, we have published the modifications to standard licence condition (SLC) 28AD, and a new annex (Annex 8) to SLC.28AD, which calculates the value of the adjustment allowance in each period.
- 4.7. The adjustment allowance changes the maximum variable charge in the default tariff cap. It does not affect the standing charge. In practice, that means the adjustment allowance is zero when we calculate the cap level at nil consumption. Below, we consider the level we would set the adjustment allowance at when calculating the cap at benchmark consumption.
- 4.8. To calculate the adjustment charge, we calculate the incremental £ per MWh that suppliers should have been able to charge in the first cap period (the weighted average comparable £ per MWh minus the allowed £ per MWh). We then apply:

- a consumption volume adjustment factor: to reflect that customers will consume more energy in the adjustment period than they consumed in the first cap period, so we need to adjust the unit charge per MWh to ensure the total amounts match;²⁵ and
- a customer attrition adjustment factor: to reflect that suppliers will have 15% fewer default tariff customers than they had in the first cap period, so we increase the charge for *remaining* customers to account for the shortfall in aggregate.

Rationale

The licence

- 4.9. We consider it more transparent to show the adjustment allowance separately from the wholesale allowance, which is an allowance for wholesale costs in the current cap period.
- 4.10. The adjustment allowance will remain part of the licence and be set at £0 once we have made the adjustment relating to the wholesale allowance in the first cap period. If, in future, we considered that some other adjustment was necessary, then any proposal to use the adjustment allowance (as we propose it here, or in some amended form) would be subject to consultation.

PPM customers

- 4.11. Alongside this decision we have published our decision to protect default tariff customers with prepayment meters (PPM) under the cap. The adjustment allowance will not apply to PPM customers. They were not in scope of the cap during the first cap period.

²⁵ See Annex 8 to the licence, published alongside this decision.

Variable charges

- 4.12. We consider it appropriate to set the adjustment allowance so that it recovers money through the variable charge, as customers incur wholesale costs in proportion to the amount of energy they consume.
- 4.13. A customer's consumption changes with the weather (among other factors), so it is unlikely that the amount suppliers recover from a customer over the period that the adjustment allowance is in place will match the under-allowance that customer benefited from in the first cap period. Depending on their consumption in each period, a customer may pay back more or less than they would have done in the first cap period.
- 4.14. We are not recovering money through the standing charge because it would not adequately protect customers. In the first cap period the size of the benefit each customer received due to the wholesale allowance being too low was in proportion to their consumption, with those consuming the most energy receiving the largest benefit. If we adjusted the standing charge, each customer would pay the same adjustment in absolute terms, disproportionately over-charging customers with low consumption and under-charging customers with high consumption.

Adjusting the charge for differences in the period length (the consumption volume factor)

- 4.15. In Chapter 3 we conclude that the wholesale allowance in the first cap period was too low in £ per MWh. This cap period was only three months long. The adjustment period, when the correction will be charged, is six months long. Customers will consume more energy in that adjustment period than they did in the first cap period. If we set the adjustment charge so that it matched the original error (in £ per MWh), then suppliers would be able to charge customers more than they require.
- 4.16. We calculate a volume adjustment factor, which recognises that suppliers will apply the adjustment charge for six months. For gas, we multiply the adjustment charge by 55%, as customers use 42% of their annual energy in Q1 and 76% in the cap five

adjustment period.²⁶ For electricity, we halve the adjustment charge, as customer consume 27.5% of their annual energy in Q1, and 55% in the adjustment period.

Challenge 5: setting an adjustment charge

Our decision

4.17. We seek to reverse the impact (as much as is possible) of setting the wholesale allowance in the first cap period too low.

4.18. In our January 2020 consultation we considered two options for setting the adjustment charge (the amount we seek to recover from each customer with benchmark consumption). We could reverse the impact of our 2018 decision:

- On a per customer basis: in the first cap period, a typical dual fuel default tariff customer paid £9.03 less than we should have allowed for (£6.78 for their gas supply and £2.24 for their electricity supply). This option would offset that benefit for each customer.
- On a collective basis, accounting for suppliers having fewer customers with default tariffs in the adjustment period: in the first cap period, the six large suppliers would have charged default tariff customers £101m (£71m for gas and £29m for electricity) more than we allowed them to. This option seeks to offset that amount in full.

4.19. Collectively, the six energy suppliers expect to serve 15% fewer default tariff customers in the fifth cap period (1 October 2020 to 1 April 2021) than they served in the first cap period. On that basis, setting the adjustment allowance on a per customer basis would mean that suppliers would collect 85% of the revenue that they would have collected from their customers in the first cap period. Setting the cap on a collective basis would mean that default tariff customers pay 18% more than the benefit they originally received in the first cap period.

²⁶ See Annex 8 to the licence, published alongside this decision.

- 4.20. In our May 2020 consultation, we proposed to set the adjustment charge on a per customer basis, not increasing the charge to account for the reduction in suppliers' customer numbers. We proposed to update the £ per MWh adjustment by CPIH.
- 4.21. In contrast to our May 2020 consultation, and for the reasons explained below, we have decided to set the adjustment charge on a collective basis, increasing the amount recovered from each customer by 18%.

Rationale

- 4.22. In our January 2020 consultation, we explained that we could not reverse the impact of our 2018 decision for both customers and suppliers. Either customers would pay more than the benefit they originally received, or suppliers would recover only part of the money they would have charged.
- 4.23. We noted that, under section 1(6) of the Act, we must protect customers on default tariffs and – amongst other things – have regard to an efficient supplier's ability to finance its licensed activities. On that basis, we stated that our starting point was that the combined impact of the under-allowance in the first cap period and the adjustment allowance should net out from an individual customer's perspective. A customer should not pay more than the benefit they received.²⁷

An overview of stakeholders' views

- 4.24. In their responses to our May 2020 consultation, suppliers supported setting the charge on a collective basis accounting for their customer losses. Most suppliers recognised that there was no perfect outcome.
- 4.25. One consumer group agreed that we should recover costs on a per customer basis, as protecting customer must be our primary focus.

²⁷ Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation, paragraph 4.23. <https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation>

Our considerations

Fewer default tariff customers

4.26. In the first cap period, the large suppliers served about 10.5 million gas default tariff customers and 13.1 million electricity default tariff customers. In the fifth cap period, the same suppliers (collectively) expect to have 15% fewer default tariff customers, although the expected losses for each supplier vary around that average.

Protecting default tariff customers

4.27. If we set the adjustment allowance on a per customer basis, then the impact on a customer that had a default tariff in the first cap period and the adjustment period would net out. They would pay back in the adjustment period an amount that offset the benefits they received in the first. New default tariff customers that were not default customers in the first cap period would incur additional costs that did not reflect their costs. Customers that had default tariffs in the first cap period, but no longer do, would not pay back the benefit they received. These two circumstances are unavoidable, if regrettable.

4.28. If we set the adjustment allowance on a collective basis, then default tariff customers would pay back 18% more in the adjustment period than the benefit they received in the first cap period. New default tariff customers would have paid that additional amount, having received no benefit in the first place. Customers that are no longer default tariff customers would not pay back the benefit they received.

4.29. Since our May 2020 consultation, we have considered that there may be other adjustments in the future that we would want to assess ex post. A retrospective approach can protect customers and allows suppliers to recover their costs in circumstances where it is uncertain what level of costs we should allow for in advance. Retrospective allowances can guard against overestimating the impact and overcharging customers.

4.30. However, it is likely that suppliers will continue to lose default tariff customers. If we set all retrospective corrections on a per customer basis, suppliers would systematically under-recover their costs. That would undermine retrospective cost recovery as an approach, which would likely undermine customer protection in the long run, as we would rely on uncertain estimates in advance.

4.31. This decision does not mean that we consider that all retrospective adjustments *must* be increased to reflect customer losses. There may be other factors or circumstances that require us to take a different approach in different circumstances.

Considering the impact on suppliers

4.32. In protecting customers on default tariffs, we must have regard to an efficient supplier's ability to finance its licensed activities.²⁸ In this specific context, we consider each supplier's wholesale costs were efficiently incurred. We consider it desirable that suppliers can recover the money they would have charged in the first cap period, but we do not consider this an absolute constraint on our decision. The primary focus of the Act is to protect customers.²⁹

4.33. The impact of any adjustment will differ for each supplier. The Act requires that the cap is a single level for all suppliers.³⁰ We cannot provide each supplier with the money that they would have recovered in the first cap period, had the allowance been higher. For the reasons stated in Chapter 3, we consider the aggregate (average) impact on suppliers.

4.34. Had we set the wholesale allowance in the first cap period in line with suppliers' weighted average comparable wholesale costs, then suppliers would have charged customers about £101m more (£29m for electricity and £71m for gas). By setting the adjustment allowance on a collective basis, the customer attrition adjustment factor should enable suppliers to recover that amount in full.

²⁸ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6).
<http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>

²⁹ [2019] EWHC 3048 (Admin), paragraph 14.
<https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html>

³⁰ Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2).
<http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted>

Challenge 6: Adjustment period

Our decision

- 4.35. We have decided to include the adjustment allowance for one cap period (the first cap period), beginning from October 1 2020.
- 4.36. This maintains our May 2020 consultation proposal.

Rationale

- 4.37. We consider that the impact on default tariff customers is similar whether we spread the adjustment over two cap periods or one. Customers pay the same amount, whether we recover the adjustment allowance over one cap period or two cap periods.
- 4.38. In principle, it is preferable for customers that we minimise the size of the adjustment allowance in each cap period. A longer adjustment period spreads the impact out over time. In addition, price comparison websites and suppliers state tariffs in annualised terms. Using a short (less than 12 month) adjustment period would make the adjustment seem larger than is actually the case, which should increase switching (theoretically). In practice, the difference between the annualised amount and the actual amount to be recovered is not large, so we do not weigh this consideration heavily.
- 4.39. In our January 2020 consultation we set out two factors we would consider when setting the adjustment period. First, the potential expiry of the cap. We did not consider this a significant issue when choosing between the two options.
- 4.40. Second, that default tariff customers may continue to switch to cheaper tariffs and competitor suppliers. A shorter adjustment period reduces the uncertainty about what losses suppliers might incur. A shorter adjustment period also reduces the period of time in which each supplier might lose more customers.

Considering stakeholders' views

- 4.41. Most suppliers' supported a six-month adjustment period (i.e. one cap period).

- 4.42. One supplier noted that if the Secretary of State chose not to extend the cap, then suppliers would not recover fully the amounts intended. In that event, it stated that we should set out proposals ensuring that suppliers would recover the shortfall.
- 4.43. We will consider if additional proposals are necessary once the Secretary of State has published his decision.