

**In re: The change in Ofgem's proposed treatment of wholesale costs  
in setting the default tariff cap**

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**JOINT OPINION**

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1. In this Joint Opinion we will first set out a summary of what we consider to be a legally correct analysis (Part I), to which we will then add some key points of elaboration (Part II).

**PART I : SUMMARY OF ANALYSIS**

2. Ofgem is setting a price cap designed and intended to reflect suppliers' true wholesale energy costs.
  - a. Wholesale energy has an objectively identifiable market price. Ofgem is able to take a market price on a given day, for the purchase of a particular volume of energy deliverable on a particular date. There is in principle no problem of measurement.
  - b. Assessing the cost of this market wholesale price of energy for supply is a function of (a) the date on which the contract is entered into (b) the dates and period for which the energy will be delivered and (c) other contract features such as contracted volume.
3. For good and sensible reason, Ofgem favours evaluation of these costs in the following way, as part of what is known as an index:
  - a. Ofgem identifies standard contract features which it will use in the evaluation exercise.
  - b. Ofgem takes an observation period, within whose dates suppliers enter into contracts for energy (with relevant contract features), to be delivered on future dates and periods.

4. For later periods under the cap the position is straightforward, in the following sense:
  - a. Suppliers know what the standard features are, and what the observation periods are.
  - b. Suppliers can act by contracting in line with the standard features, by contracts entered into within the observation periods – that means their costs fall within the evaluated index including the observation period.
  - c. Action of that kind is very familiar to the industry and to Ofgem – it is called matching.
  - d. Suppliers who choose to gamble and enter into contracts with different features, or on dates outside the observation period, do so at their own risk. That is knowingly risky action which may lead to being under or over-compensated.
5. For the initial period (Q1 2019) there is a question as to how to undertake an evaluation which is accurate, evidence-based and fair.
  - a. Ofgem does not deny the need to undertake an accurate, evidence-based and fair evaluation.
  - b. It is right not to do so. Applicable legal standards, and so the rule of law, require no less.
6. What Ofgem did, when consulting in May 2018, was as follows:
  - a. Ofgem identified standard features for an index.
  - b. Ofgem also identified an observation period covering the 6 months April 2018 to September 2018, which would be a basis of evaluation of the wholesale energy costs of delivering energy for Q1 2019.
7. By doing so Ofgem was able to give a signal and, provided that it later chose to act consistently with that signal, it would be able to say that suppliers had fair warning. The practical consequence of this was that suppliers could see what was coming and could react to it.

8. Nearly all the signalled 6-month observation period lay ahead. There was a practical choice that suppliers could take.
9. What happened next is (a) what Ofgem expected (b) what Ofgem has acknowledged and (c) what the industry has told it. It is that suppliers were able to and did undertake matching. They were able to choose to match the standard features of the index; choosing to enter contracts for delivery in Q1 2019 within the observation period April 2018 through to September 2018. Contracts entered into in August 2018 and September 2018 were at the wholesale prices applicable in those months.
10. In September 2018 Ofgem announced that its final proposals involved keeping standard features previously signalled.
11. However, Ofgem announced a proposed position which would involve changing the observation period, to take it back in time:
  - a. Ofgem would replace August and September 2018 as observation months with February and March 2018.
  - b. Ofgem's reason was that this change was justified in order better to reflect the costs actually incurred by suppliers.
12. The problem with this is that Ofgem has to show how a February 2018 to July 2018 observation period is a better reflection of actual wholesale energy costs for Q1 2019 than an observation period April 2018 to September 2018.
13. That is a straightforward challenge. But Ofgem has not met it. On examination, the changed observation period lacks justification. No reasoning or evidence supports it. Nothing shows that this alternative period would be a suitable means for achieving the cost-reflection objective.
14. In short:
  - a. Ofgem needs to show how it is that February and March 2018 are better reflections of the actual costs of suppliers in the delivery of energy in Q1 2019 than are August and September 2018. Ofgem has, and has pointed to, no evidence to support that proposition.

- b. Ofgem's changed observation period now abandons – and cannot replicate – what would be the virtue of being a period to which it could point, having been clearly signalled, to which suppliers could react.
  - c. August and September 2018, by design, were the subject of that virtue.
  - d. February and March 2018, by design, cannot be the subject of that virtue.
  - e. Moreover, August and September 2018 reflect the reality of what suppliers have actually done.
  - f. That reality is what Ofgem envisaged, is what Ofgem has been told, and is what Ofgem has expressly acknowledged.
  - g. Ofgem needs to explain, but cannot explain, how it can be justifiable to take a supplier who has contracted within the standard index features for Q1 2019, by a contract entered into in August 2018 or September 2018, and ignore the costs of it doing so.
15. Without any supporting justification, a decision by Ofgem to progress as now proposed would not be a lawful one.
16. It is not difficult to see what has happened and what has led Ofgem astray. What has happened is that wholesale fuel costs have risen. They are higher in August and September 2018 than before. Specifically, they are higher for forward Q1 2019 contracts entered into in August 2018 and September 2018 than they would be for forward Q1 2019 contracts entered into in February and March 2018.
17. This increase in actual wholesale costs means that, by taking the observation period signalled in May 2018 the cap will be higher than it would be by taking the observation period now described in September 2018. But the answer to that is:
- a. The cap would be higher because the actual costs that are the suppliers' reality for delivery in Q1 2019, which costs need to be covered by the cap, are higher.
  - b. Ofgem rightly says that its aim must be to cover the reality of the costs actually incurred for Q1 2019.

- c. Changing the observation period to get to lower costs is only justifiable if February and March 2018 better reflect the reality for suppliers, compared with August 2018 and September 2018.
  - d. Ofgem has pointed to no evidence-based or reasoned justification to support that conclusion.
- 18. Ofgem has canvassed the idea that some unspecified suppliers may have entered into cheaper historic contracts prior to April 2018, meaning that for them a cap based on an observation period April 2018 to September 2018 could be overcompensation. As to that:
  - a. If this were a good point, Ofgem would have said it in May 2018.
  - b. If it were a good point, Ofgem would have evidence of it.
  - c. Ofgem identifies no such evidence. It has not even asked the question, for its May document or its September document.
  - d. For there to be an overcompensated supplier, it would be necessary for that supplier not to have adjusted its position in response to the May consultation, or for savings from earlier forward contracts to outweigh price increases on later ones and for the supplier to have held on to any gains rather than to have passed them on to consumers.
  - e. Even if there were evidence that some suppliers were in this position, that still would not justify Ofgem adopting what is necessarily a generalisation, to arrive at a general outcome through a single cap.
  - f. That is because of the suppliers for whom that generalisation is unevidenced and unjustified. Such a response in such circumstances has a penalising consequence and is classically disproportionate, unreasonable and unjustified.
  - g. It is also deeply ironic. The suppliers whose wholesale energy costs are not now to be covered are those who followed the signal and acted within the period signalled, as Ofgem expected they would, was told that they have and confirmed that it knows that they have.

19. The idea of a public authority, in the context of justification and transition, being able to point to the virtue of a signal within a consultation document is familiar. A classic example is where a public authority is considering transitional arrangements and lead times for new changes. In such situations, it is economically literate and relevant in public law terms for the public authority to be able to say that a relevant time-frame includes a clear signal which it gave in a consultation, provided that (a) it later chooses to follow from and act consistently with that signal; and provided that (b) in the context, those affected could be expected – as in this case – to receive the signal as a warning. That is also why a ‘change in law’ can be described as “foreseeable” as at a particular date, when by that date it had been published in a consultation document of a competent authority.
20. This really matters.
  - a. There is no reason, efficiency or otherwise, for failing to cover the actual costs of a supplier who has acted in the way Ofgem anticipates and expects.
  - b. The fact that – in doing so – the costs rose is a reason to cover those costs.
  - c. ✗
  - d. Moreover, this is the single largest component in all the costs needing to be covered by the cap.

## PART II : ELABORATION

### (1) Relevant context

21. Ofgem discussed the cap in a “Working Paper #1”, dated 12 March 2018.
  - a. In relation to wholesale costs, Ofgem’s said it was proposing to use an index-based approach. Ofgem explained that this would be “*transparent and not overly complex*”; and that, “by matching the hedging profile implied by the index, companies are able to reduce the risk that they incur wholesale costs above those allowed under the cap” (Working Paper #1, §5.32)<sup>1</sup>.

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<sup>1</sup> Underlining in quotations connotes emphasis added.

- b. Ofgem recognised, however, that this justification would not apply when determining the wholesale allowance for the initial cap period if suppliers did not have sufficient notice of the index to allow them to match the "*hedging profile implied by the index*", and that this might have implications for the design of the cap (Working Paper #1, §5.33).
- 22. Ofgem's consultation paper was published on 25 May 2018 ("**the May Consultation**"). Ofgem proposed to introduce the cap with effect from January 2019 at an opening level that would apply for Q1 of 2019; and would then be updated twice a year in April and October. Given the limited time remaining before the introduction of the cap, Ofgem set out different proposals as to (i) the index it would generally use to measure wholesale costs for subsequent periods; and (ii) the index that it would use for the initial cap period.
  - a. For periods from April 2019, Ofgem proposed to use the so-called semi-annual "**6-2-12 model**" designed by the CMA for use in setting the prepayment cap. Under that model, (1) the cost allowance is determined twice-yearly (in April / October); (2) the measurement is done by averaging the daily prices of a specified basket of forward contracts observed over a 6 month observation period, ending 2 months prior to the date when the cap is set; and (3) the relevant forward contracts are for delivery over a 12 month period from that date. Thus, an April cap would ordinarily be set on the basis of prices observed in August to January; and an October cap would be set on the basis of prices observed in February to July.
  - b. For the initial period from January to March 2019, Ofgem proposed to use an observation period running from April to September 2018,. The forward contracts considered would cover a 12-month period from October 2018. This index therefore involved a **6-3-12 model**: May Consultation, Appendix 6, §5.45. Ofgem has confirmed in its current consultation dated 6 September 2018 ("**the September Consultation**") that the May Consultation proposed was identified "*in response to comments on our early working papers that suppliers were worried they would have already started hedging for the first default tariff cap period, potentially on a different hedging strategy, and wanted as much advance notice as possible*" (Appendix 4, §1.21). Under the proposal, more than two-thirds of the observation period applicable to the initial cap was still unelapsing at the

time of the May Consultation. That meant suppliers could match their forward purchasing behaviour to the index during the period until the end of September 2018.

23. In their responses to the May Consultation, suppliers responded to Ofgem's proposed index for the initial cap period. Most agreed with it. There was strong recognition of the matching which Ofgem had described and was envisaging.
24. The second largest supplier, SSE,<sup>2</sup> observed that:

"The proposed indexation approach for the initial period is appropriate. We would suggest not changing this approach now as some suppliers may have already started hedging following this indexation."

25. The fourth largest supplier, EDF,<sup>3</sup> stated that:

"We acknowledge the challenges in how to update the benchmark for the first cap period. No method will be perfect. However, it is imperative that you now follow your proposed method, as it has provided a signal to suppliers on which they are likely to act; any subsequent change will expose them to unnecessary market price risk, to the ultimate detriment of consumers."

26. The need for transparency and predictability, to facilitate matching, was a constant theme in what Ofgem was told:
  - a. Scottish Power, the fifth largest supplier, observed: "*It is important that the cost allowance for the forward purchase element of direct fuel costs is based on a well-defined and transparent hedging strategy*" (at p.8). Scottish Power agreed that Ofgem's proposed transitional approach for the initial cap period was "*appropriate*" (at p.37).
  - b. Centrica (owner of the largest supplier, British Gas) emphasised that "*[t]he commodity index that is used to set and update the cap should be replicable by suppliers*"; and that the observation period used should

<sup>2</sup> See SSE's consultation response dated 25 June 2018 (available at [https://www.ofgem.gov.uk/system/files/docs/2018/09/sse\\_response\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/09/sse_response_0.pdf)), at p.38.

<sup>3</sup> See EDF's consultation response dated 25 June 2018 (available at [https://www.ofgem.gov.uk/system/files/docs/2018/09/edf\\_response\\_0.pdf](https://www.ofgem.gov.uk/system/files/docs/2018/09/edf_response_0.pdf)), at p.19.

therefore be in the future, or at least should “minimise the extent to which the decision is retrospective” and thereby “maximise the opportunity for suppliers to replicate the assumed hedging strategy” (see main Centrica response, p.128).

- c. Npower, the third largest supplier, “broadly agree[d]” with Ofgem’s transitional approach to setting the wholesale allowance for the initial cap. Its parent, RWE, agreed with Ofgem that “suppliers will have a strong incentive to follow a hedging strategy that matches the chosen index”: see RWE response, §14.
  - d. Engie, the electricity producer and supplier, observed that “Under a price cap environment, [it] is expected that energy suppliers will try to mitigate the risk of losses arising from higher costs from those calculated in the price cap methodology. The largest controllable cost component is the wholesale cost and to mitigate risk it is likely that suppliers will try to adopt a hedging strategy that mimics the wholesale reference price method used for the cap”: Engie response, pp.4-5.
27. Ofgem would have been, and was, aware of the implications of what it has signalled, and acknowledged those implications. Centrica met with Ofgem on 12 July 2018 to discuss the approach to wholesale costs. ✗

## (2) The September Consultation

- 28. The September Consultation, published on 6 September 2018, contains Ofgem’s final proposals for the design of the cap.
- 29. For subsequent periods, Ofgem confirms its position to assess allowable wholesale costs after the initial period on the basis of the “6-2-12” index approach used to set the prepayment cap. In support of this approach, Ofgem again emphasises the phenomenon of matching:
  - a. Ofgem reiterates its view that, under this approach, suppliers will have “strong incentives” to follow “*a buying strategy that matches the valuation given by the way we assess wholesale costs*”; and can thereby “reduce the risk that they incur costs that exceed the allowance” included in the cap (September Consultation, Appendix 4, §1.5).

- b. Ofgem recognises that its approach to setting the allowance “*may not match the way all suppliers currently manage their wholesale costs*” (September Consultation, §2.24), but states that the index specifies “*a realistic allowance within which suppliers can manage their wholesale costs*” going forward (§2.41). Ofgem explains that, “*as the cap progresses, we expect suppliers to change their historic purchasing strategies to ones that more closely reflect the costs set by our allowance*” (September Consultation, Overview document, §2.23).
  - c. Ofgem accepts that suppliers who “*follow a buying strategy that matches the valuation given by the way we assess wholesale costs*” would “*still face risks*” of incurring costs in excess of the index, by reason of shaping, forecast error and imbalance costs. It proposes to address those risks by way of additional allowances to reflect the expected costs. It models the costs “*from a starting position that takes into account our method for buying forward wholesale energy contracts*” (September Consultation, Appendix 4, §3.7), i.e. the forward contracts observed in the index “*as per 6-2-12 model*” (Table A4.3).
30. As to the initial period, Ofgem notes that the majority of suppliers supported Ofgem’s proposal in the May Consultation to use April to September 2018 as the observation period.
- a. In its summary of responses received, Ofgem notes that the arrangement was supported (by the two suppliers who gave reasons) “*on the basis that our May consultation provided a signal to suppliers*”; and that “*any deviation from these proposals represented more uncertainty and potentially increased costs to suppliers*” (September Consultation, Appendix 4, §4.7). Ofgem nowhere says it rejects this; still less does it give reasons or evidence on which basis it could justify doing so.
  - b. Ofgem now proposes, however, to abandon this proposal and to use February to July 2018 as the observation period instead.
  - c. Ofgem says there is justification for this reversal in order to “*ensure the wholesale allowance better reflects the underlying costs that suppliers are likely to have incurred*” when purchasing energy during the first cap period (September Consultation, overview document, §2.21). That logic lacks reasoning or evidential support.

- d. Ofgem emphasises that there have been “*increases in wholesale costs since April*”, such that the wholesale costs allowance in Q1 of 2019 would be £7 higher per dual fuel customer if estimated using the April - September observation period (September Consultation, Appendix 4, §§1.22-1.23). That reasoning is revealing and reinforces the need for increased costs to be recovered.
- e. Finally, Ofgem asserts that “*large suppliers have most likely already bought much of the energy SVT customers will use in early 2019*” (September consultation, overview document, §2.21). But there is no evidential basis for this assertion; still less any analysis as to how it outweighs the actual and increased costs; nor how any such evidence in relation to any supplier could be applied to suppliers in general.

### **(3) Relevant legal obligations**

- 31. As a matter of public law, the duties to which Ofgem is subject include the following:
  - a. Need to act reasonably. Ofgem must act reasonably. It must be able to offer some meaningful justification for its decision; it must take account of all relevant considerations; and it must omit irrelevant matters from its consideration.
  - b. Need to act proportionately. Ofgem must act proportionately in designing retail price regulation, by virtue of applicable EU law (see Case C-265/08, *Federutility*, EU:C:2010:205, §33) and Article 1 of Protocol 1 of the ECHR. Its decision must pursue a clearly defined objective; must be appropriate for achieving that objective; and must go no further than is necessary to achieve that objective.
  - c. Need for supporting evidence. Ofgem must have “*adequate material to support [its] conclusion*” as to the appropriate observation period: *Office of Fair Trading v IBA Health Ltd* [2004] EWCA Civ 142 [2004] 4 All ER 1103 at §93 (*per* Carnwath LJ). For Ofgem to reach a decision without supporting evidence would amount to an error of law: see e.g. *Din (Taj) v Wandsworth London Borough Council* [1983] 1 AC 657, 664H (*per* Lord Wilberforce).

- d. Need to undertake reasonable enquiries. Ofgem is required to “*take reasonable steps to acquaint [it]self of the information relevant to [its] decision*” on the appropriate observation period: *Secretary of State for Education and Science v Tameside Metropolitan Borough Council* [1977] AC 1014, 1065B (*per Lord Diplock*).
- e. Need for financeability. The Act requires that, in designing and setting the cap, Ofgem must have regard to what Parliament identifies as “*the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence*”: see s.1(6)(d). That means suppliers being able to cover their efficiently incurred costs and to earn a normal rate of return.

#### **(4) Critical analysis of Ofgem’s reasoning in the September Consultation**

- 32. The correct analysis in law, as we see it, is explained in summary in Part I above. In our opinion, a decision based on Ofgem’s current proposals for measuring wholesale costs in the initial period of the cap would be inconsistent with each of the legal obligations identified above. Ofgem’s proposal to abandon the observation period signalled in the May Consultation, in favour of the alternative and earlier period, lacks justification and to adopt it would not be a lawful course for Ofgem to pursue. In elaborating on this, we emphasise the following points.
- 33. The wholesale allowance is meant to be a realistic estimate of the actual costs that suppliers incur in purchasing fuel to supply customers who are subject to the cap (see e.g. September Consultation, Appendix 4, §2.24).
- 34. Ofgem justifies the use of an index to measure wholesale costs on the basis that suppliers can “*follow a buying strategy that matches the valuation given by the way we assess wholesale costs*” and thereby minimise the risk of incurring wholesale costs above the cap (*Id.*, §1.5). This justification works, and only works, if suppliers have sufficient advance notice so that they can “*manage their wholesale costs*” (*Id.*, §2.41) by applying Ofgem’s “*method for buying forward wholesale energy contracts*” during that period (*Id.*, 3.7).
- 35. This is why, in its May Consultation, Ofgem proposed to use an observation period, from April to September 2018, which lay mainly in the future. As Ofgem subsequently explained, the proposal aimed to give suppliers “*as much notice as possible*” of the index (*Id.*, §15).

36. The proposal only made sense on the assumption that suppliers would use the available time to match the index. Several large suppliers confirmed in their consultation responses that they were matching the index. Ofgem itself acknowledged in a meeting with Centrica that it was aware that suppliers would have moved to match the index.
37. There was nothing inefficient in the wholesale procurement of suppliers who followed Ofgem's signal by purchasing fuel in August and September. It was, on the contrary, a rational course, which Ofgem expected them to take.
38. Ofgem's change of approach, to adopt instead an observation period from February to July 2018, lacks coherent justification.
  - a. Suppliers cannot now match a February to July observation period.
  - b. Those suppliers who, as Ofgem expected, have matched the April to September period are now exposed to the higher prices that have since eventuated.
39. ✗ .
40. As has been explained, Ofgem defended its change of approach on the basis that a February to July index period "*reflects underlying costs more closely*". Ofgem believes that "*large suppliers have most likely already bought much of the energy SVT customers will use in early 2019*" and will therefore have secured forward contracts at better rates than those which have since eventuated in August and September.
  - a. Ofgem has not, however, undertaken the basic enquiries that would be needed to support its belief as to the hedging position of "*large suppliers*", and has no evidence to justify it.
  - b. Although Ofgem is understood to have data for the purposes of calculating additional cost allowances, we understand from Centrica that it has not been asked to provide any data on its forward purchasing or the composition of its current hedging position for 2019.
  - c. ✗.

41. Then, as explained above, §4.16 of the September Consultation contains the assertion that large suppliers will “*have most likely already bought much of the energy SVT customers will use in early 2019*”. Nothing is said or shown in support of this. It appears by nature to be guesswork, with no evidenced-basis, still less any balancing or analysis of (a) the who (b) the when (c) at what prices and (d) counterbalancing in what way what later contracts. Ofgem refers to two matters, but neither is of any assistance.
  - a. First, Ofgem cites “*data we have on suppliers' strategies in 2016*”. Such data relates, however, to purchasing in an unregulated market in which suppliers are not subject to a cap. It cannot be relied upon as a reliable guide to the way in which suppliers will purchase forward contracts for supply during a price cap period, when suppliers are seeking to ensure that they match an index which Ofgem has indicated that it is minded to use in setting a wholesale costs allowance.
  - b. Second, Ofgem relies on unspecified “*submissions in response to our consultation*”. It is unclear what submissions Ofgem is referring to. The consultation responses of SSE and EDF suggest, on the contrary, that suppliers are likely to have aligned their forward purchases with the adjusted index proposed in the May Consultation. In any event, given that each supplier can only speak for itself, consultation responses plainly cannot provide a reliable industry-wide perspective on whether or not the unadjusted index “*reflects underlying costs more closely*” than the adjusted index.
42. There can be little doubt that Ofgem has been galvanised by increased wholesale costs, and no doubt Ofgem’s internal documentation will reinforce this. But that is not a reason to backdate an observation period and fail to cover actual costs. Quite the contrary.
43. Finally, the effect of Ofgem’s proposed abandonment of the April to September observation period would be as follows:
  - a. It would penalise suppliers who have matched their purchases during the period. It would be disproportionate and unreasonable. It would also run counter to the statutorily-prescribed need to ensure that efficient suppliers are able to finance their activities. Suppliers who followed Ofgem’s signal to the market will have waited to purchase fuel

in August and in September at prices which – as matters have turned out – are higher than those to which Ofgem now proposes to have regard.

- b. Ofgem's reasoning in support of its proposal does not address and accommodate this aspect, borne out of action which cannot be – and is not – condemned as irrational or inefficient; but which is known and acknowledged and was expected. By setting the wholesale costs allowance in Q1 2019 at a level insufficient to enable such suppliers to cover their actually incurred costs, Ofgem sets the cap in a way which does not meet the need to ensure that efficient suppliers are able to finance their activities. Ofgem does not even acknowledge this, does not identify what would meet the need, and does not purport to give any cogent reason – there is none – for deciding not to meet it.
- c. As to Ofgem's assertion that suppliers had already purchased forward contracts for the initial cap period in early 2018, this stands as an assertion and in the language of unevidenced guesswork. It is unsupported by evidence, still less direct and reliable evidence. It has been asserted without undertaking, demonstrating and then consulting upon enquiries of suppliers, to establish the correct position in fact.
- d. Ofgem has therefore failed to identify any legitimate basis that could justify as proportionate its decision to deprive suppliers who followed its earlier signal of the ability to recover their wholesale costs in Q1 2019.

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8 October 2018