Anna Rossington
Deputy Director, Retail Price Regulation
Consumers & Markets
Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

26th Jun 2020

Dear Anna

Retail Price Cap – Compliance with terms of Judicial Review - Period 1 correction made in period 5

The saga of the setting of period 1 of the price cap enters its third year and is not rehearsed here. We stand by points that we have made before today and confine this response only to remedy of the wholesale re-indexation unlawfully made. Npower is now fully owned by E.ON. We have read the E.ON response and support it in all respects.

Ofgem's correction, at around £11 (annualised dual fuel bill) is approximately half the proper amount.

Our view remains that the situation is, and always has been, simple. Ofgem must simply reverse the re-indexation, unlawfully made, and overturned in court. The point is conceded in the consultation (5.19 to 5.24, excepting the volume attrition effect), but not executed as stated. We do not attend in this response to the large amount of information in the consultation that is irrelevant to executing the terms of the judgment.

Further, the volume attrition effect over approximately two years between periods 1 and 5 was caused by the long delay between first challenges to the decision and its overturning in court, and further long delay between the judgment and addressing its terms. The very long overall delay must be given sufficient weight in the balance when applying corrections to period 5, beginning October 2020.

All other points are ancillary but must be taken into account if the re-indexation is not simply reversed and the attrition effect not corrected for. We have enclosed further detail below.

This letter is not confidential

Yours sincerely

Chris Harris
Head of Regulation
07989 493912

npower

Npower Group Ltd
Trigonos
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

T +44(0)1793/87 7 77
F +44(0)1793/89 25 25
I www.npower.com

Registered office:
Npower Group Ltd
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

Registered in England
and Wales no. 8241182

Reversing the offending re-indexation or applying a new method

Ofgem's analysis *indicates* that, *on average*, on a *modelled* basis, suppliers outperformed the original indexation method by an annualised dual fuel amount of around £6. The new method proposed has had the effect of clawing this back and depressing the cap by this £6 (reducing the correction from about £17 to about £11, before volume attrition).

On the basis of wholesale costs, this compromises the financeability of half of the suppliers. Using Ofgem's calculations, if we take the second most expensive gas and electricity hedge (figures 4.1 and 4.2), we can see that the effect of the range is about the same again as Ofgem's correction, i.e. we can simply double the correction made. If suppliers have very different gas and power hedging strategies (there is no obvious reason for this), then the effect of range is slightly lessened.

The range of efficient hedge costs is actually somewhat wider. There are n*on speculative* efficient deviations from the core strategies, such as year end close outs. Ofgem concedes this point at 3.80 but does not take it into account when making the correction. We agree with Ofgem that speculative gains and losses have no place in the cap.

We recognise that risk diversifies and that this must be taken into account when considering cost ranges. However, in addition to all factors noted below; i) wholesale cost represents suppliers' largest cost, ii) unless otherwise asserted, *all* suppliers must be assumed to hedge efficiently so there is a case to use the highest not second highest cost, iii) the extra cost was caused by Ofgem. Therefore, most of the £11 must be recognised, fully nullifying Ofgem's £6 clawback and making it unjustified.

We do recognise Ofgem's argument that if execution of the strategies arrived at an ex post average cost to suppliers lower than Ofgem had intended, then a*ll other things being equal*, there may be a case to claw back *some* of the range of costs in order to balance the effect on consumers.

However;

i) Either Ofgem had all relevant information when setting the index initially but either did not use it properly, or the £6 resulted from market movements afterwards

ii) If the former, then the resulting instability that the regulator may claw back the effect of its errors, *made in one direction only*, causes a deadweight cost of uncertainty to the market that flows in future to consumers in the form of increased financing costs, *larger than the £6 clawed back*

iii) If the latter, then it is extremely unlikely that Ofgem would have increased the cap if the £6 had been increased rather than decreased cost. There is clear precedent that Ofgem would simply have assigned the increased cost to headroom, as it did for other factors such as unidentified gas. Ofgem has therefore flowed a *one way market risk* to suppliers. This adds to the moral hazard and associated increase in financing costs that flow to consumers. *In addition* to the deadweight cost of risk, there is a *bias* to be taken into account if

Ofgem corrects in one direction only. Uncertainty makes this bias indeterminate but it is probably of the order of several £ per year.

iv) The *irrationality* of the re-indexation, requiring efficient suppliers to act in the past, adds further to the moral hazard cost that flows to future consumers.

v) All other things were *not* equal. Suppliers were put to loss by Ofgem, the 1.9% ex ante margin was proven ex post to be incorrect, headroom was exhausted, the volume attrition effect was significant, the two year delay of the correction had a capital cost, the range of efficient supplier costs is ignored, the period 5 cap is likely to fall in line with the fall in wholesale prices. These all weigh on the other side of the balance. When Ofgem has regard to all factors when making the correction. Ofgem must either "turn the handle" by simply reversing the unlawful re-indexation and correcting for volume attrition, or add in *all* relevant factors, that it must in law have regard for, but not pick and mix the factors as it has done.

Clearly, the degree of scrutiny applied to the £6 clawback falls significantly short of that that may justify this.

Requirements of the Act

Ofgem in the consultation repeats its position on the relative importance of enabling suppliers to finance their businesses. The position was stated in court but was not substantively addressed in judgment. Not least because Ofgem did not prevail in court overall, Ofgem may *not* rest on its position as if it were settled in Ofgem's favour (and, we recognise, not against Ofgem either).

Our position on this is expanded on below in the Annexe. In summary, the degree of importance, and scrutiny, of each factor to be taken into account is context specific. The specific context of supplier financials *does* demand high importance since the financial viability of the whole energy supply complex has been placed at risk by Ofgem, with concomitant risk to consumers. Both the risk and the impact on consumers of supplier defaults was recently acknowledged by Ofgem in endorsing/requiring[1] loans (in the form of payment deferrals) from network companies to suppliers of lesser creditworthiness. Further, since defaults on these loans are underwritten by consumers (via the network price controls), Ofgem implicitly asserts that payments by consumers are necessary to underpin financeability (in the case of financing by networks, not the sector overall, but selected suppliers). This precedent is directly relevant to the volume attrition effect.

Ofgem having been found at fault in the judgment for inadequate scrutiny and failure to consult properly, the error should not be repeated. In particular, assertions of supplier inefficiency, in this case with regard to hedging, may not properly be made *and acted on* without adequate scrutiny. No further citation is needed than the judgment itself, at 14 "It

[1] https://www.energynetworks.org/electricity/regulation/supplier-credit.html. We note all the responses to Uniform Network Code Modification 726 and Ofgem's overturning on June 23rd the recommendation of the Panel https://www.ofgem.gov.uk/system/files/docs/2020/06/20200623_unc726_decision_letter_0.pdf

was obliged to have due regard to the 4 "needs", but that is not the same thing as achieving them. So long as those matters were *properly and conscientiously* taken into account, and *weighed in the balance*, GEMA would have complied with its obligations under that subsection" (emphases added).

Effect of customer number attrition

The total number of customers on default tariffs has been falling on a continuous basis. Ofgem rightly recognises that correcting period 5, by an amount that ignores this effect, would leave suppliers harmed financially by the offending re-indexation, as there are less customers to recover costs from. Adding the 18% cited by Ofgem (at 5.21) to the £17 proper correction brings the total proper correction to around £20.

We recognise that Ofgem's powers were enacted under public law and that suppliers may therefore not claim in the manner of *contract* law against Ofgem for unlawful breach of the Act. Ofgem had nevertheless had a *duty of care* to suppliers, firstly to set the cap correctly (and indeed not to make a specific intervention to the contrary), secondly to give reasons and address challenges conscientiously, and thirdly to act promptly on the terms of the judgment.

We say that the *requirement* from the judgment is clear - to reverse the offending re-indexation. We recognise that the judgment was not so specific because; i) since period 1 actions cannot be undone in the past, the period 5 remedy is complex ii) Judicial Review generally, and here, focus on process and not merit, and so do not go into details on complex remedies iii) failure to consult must be followed by consultation. *The consultation revealed that the re-indexation should never have been done*. Hence it should be reversed and remedied in period 5 as best as possible.

The two year delay to resolve the issue has caused extra harm to suppliers and is a factor that must be "weighed in the balance" (Judgment at 14). The cost of capital over the two years has a similar and additive effect (two years at 10% cost of capital on £17, then correcting by 18% for volume attrition is around £4).

Ofgem notes in the consultation that "For this reason, we cannot reverse the impact of our 2018 decision for both suppliers and customers. We consider that it would not protect customers to charge suppliers' remaining default tariff customers an 18% surcharge [to the correction] to account for suppliers' customer losses." Naturally we recognise the difficulty of the situation here, and, in the absence of effective remedy in contract law, the effect of correcting Ofgem's unlawful action currently only lies between consumers and suppliers. Nevertheless, the consultation is seriously inadequate in analysis. Given that the case turned on failure properly to consult, and thence making wrong conclusions, this is troubling.

For example; i) most (but, we recognise, not all), consumers directly impacted by the cap in period 5 benefitted in period 1, ii) the correction might cause bill shock in period 5 *if the cap rises* via other factors but not if the cap falls, and it is *expected* to fall, iii) that the target margin of 1.9% was *proven* ex post to have been incorrectly calculated ex ante, iv) that headroom has already been more than completely exhausted, v) Ofgem's chosen method fell short of the proper correction to be made by reversing the re-indexation. These factors are relevant and material but not, or inadequately, cited in the consultation. The right to declaratory relief in the form of remedy of harm may therefore not be rejected *out of hand* as it is here. The factors *must* be weighed.

In the consultation at 5.38 Ofgem notes that declaratory relief was not prescriptive to hold British Gas harmless to the re-indexation unlawfully made. We *do* recognise that Ofgem is not directed by the judgment to make the volume correction. The judgment did indeed say "make such adjustments as it considers appropriate". However, this does *not* exempt Ofgem from the duty to consult properly and to disclose reasons. In the absence of reasons to deviate from the spirit of the judgment, the default action *must* be *fully* to reverse the *effect* of the re-indexation unlawfully made, and therefore to make the volume correction. The correction is around 0.3% of consumer cost but about 15% of ex ante supplier margin at 1.9%. *Proportionality* therefore weighs in favour of making the correction.

Inconsistency of approach in passing through past cost changes

Ofgem's initial position with regard to the cap was that ex post differences to ex ante forecasts would *not* flow into cap corrections in the next period. This is despite the fact that the correction method, called "Recovery" and sometimes simply "k", is standard in supply price controls internationally and in Great Britain in network charging. Whilst recovery does have minor issues, for example in a slight distortion of competition and a slight difference in the consumer cohorts between the corrected period and the recovery period, this is clearly overwhelmed by the deadweight cost of risk that flows to consumers in the form of increased cost of capital, by not applying recovery.

It was inevitable that Ofgem would reverse the decision of not applying recovery, and this was indeed done, firstly in relation to its view of the costs of the smart meter rollout. Ofgem has now implicitly *confirmed* this reversal in its approach in period 5 to bad debt. The confluence of the Covid 19 economic crisis and the softening of debt collection pathways in response, means that it is inevitable that the payments for energy consumed in periods 3 to 5 (the big change beginning March 2020) will fall further short of normal bad debt run rates. Ofgem has implicitly confirmed[2] (albeit embedded in a letter about financial support for selected suppliers, rather than by open consultation), that Ofgem will not change the bad debt rate in the cap ex ante in period 5 but will instead *recover* the inevitable increase in bad debt losses in period 6 and beyond (if the cap continues – otherwise Ofgem's error[3] may not be resolved). In the face of this implicit *confirmation* of reversal of policy, it is not *rational* or *reasonable* for Ofgem to take a different approach to the volume attrition correction. Again there is a pick and mix being applied, which is at variance to the requirements in the Act to give all factors due regard.

Supplier archetype

At various points throughout the whole process of consulting on the cap, Ofgem has used, to describe suppliers and their hedges, the terms "hypothetical", "typical", "notional", "average"

[2] https://www.ofgem.gov.uk/system/files/docs/2020/06/open_letter_on_relaxing_network_charge_payment_terms_1.pdf page 5

[3] The correct approach is to uplift the cap to reflect expectation of bad debt losses, and correct to actuals, upwards or downwards, in the recovery period. This is recognised by Ofgem in its approach to defaults to the network companies

(various types), “median”, “actual”, “rateable” and “comparable”. Various combinations of these terms have been used. The terminology has not been used consistently. We recognise the challenges but the inconsistency has made navigation through the consultations difficult. The judgment at 29 refers to “hypothetical “typical” efficient”. If the re-indexation is simply not to be reversed as it should be, this makes sense to us as a second best solution, and it appears that Ofgem has conformed to this in the narrative. The execution approximates the narrative reasonably well. In fact when the range of efficient supplier costs is taken into account using Ofgem’s method[4] the Ofgem method and the reversal of the re-indexation come to approximately the same figure for the cap (on the annualised dual fuel basis).

Efficiency

Efficiency in wholesale market transaction , as a standalone exercise, is different to efficiency in operations, since, on an ex ante basis, all market transactions have an expectation profit of zero (other than small corrections for bid/offer and cost-of-risk bias[5]).

In the consultation, Ofgem has correctly expounded on the practice of *hedging,* for example at paragraph 2.10. As Ofgem correctly infers, and is clear in hedge theory, a supplier hedge strategy that differs from a market reference, is inefficient at the level of the corporate enterprise. As the judgment notes at 21 “A failure to align would be tantamount to gambling” (which is inefficient and quite rightly is not asserted by Ofgem). For present purposes, “average supplier” is a good enough market reference. Under relatively stable conditions (that existed before party political statements about price interventions), the Ofgem 18 month reference hedge was a reasonable approximation of the average hedge and in turn became self-fulfilling by creating the average hedge that suppliers tended to align to. When the *Ofgem* reference hedge became unsuitable, the *market* reference remained the efficient hedge, and average was the best proxy. Clearly, suppliers do not know one another’s hedge positions and hence the estimation of average has a *range*. Hence the range of hedge profiles, and therefore hedge costs for suppliers, *all* of whom hedge efficiently, and are therefore *to be regarded as efficient,* must be used. i.e. the supplier with the hedge costs upper bound in the range is efficient. To have due regard for the ability of (efficient) suppliers to finance themselves, the width of the range *must*, in *law* (Gas Act 1986 s4AA(2)(b) and Electricity Act 1989 s3A(2)(b)), be *applied* to the cap and in any event otherwise, under the Tariff Cap Act and the associated case law relating to “have regard”, be given sufficient weight in the balance. A weight of zero is prima facie inadequate.

Construction of hypothetical typical efficient supplier hedge

In practice, the bottom up construction of the actual Q1 hedge cost from transactions is complex because there are several assumptions to be made (for example ex post allocation of hedges to different supplier tariffs, when such allocation was never needed by the supplier) and thence corrections to weighted average price of all allocated transactions (such

[4] See figures 3.1 and 3.2 in the consultation
[5] In power, this is approximately neutral over the relevant period. In gas it is probably so.

as tactical deviations from efficient hedge policy, inter-seasonal effects, year end close outs, etc.). The degree of discretion and complexity makes an accounting reconciliation to an imputed price somewhat impossible.

The Ofgem team did a good job in getting to grips with an expedient method for calculating a *proxy* for the *approximate* effects of *actual* hedge strategy. This was essentially reconstruct the hedge, not from the transaction forensics but from the *narrative* description that we (and we assume other suppliers) provided of what we did and why and when. Although this work was unnecessarily made more complex, to the detriment of addressing relevant matters, by the insistence of Ofgem to include information irrelevant to the terms of the judgment, the final hedge path simulation was, in our case, a good enough approximation.

Forgetting for a moment whether the average should be weighted or unweighted, or whether median is best, and whether outliers should be discarded, the method does, in our view arrive at a good enough proxy for the middle of the range of hypothetical typical efficient. As Ofgem stated in court, and as the judgment notes at 65 "“typical” in this context really meant average". If the modelling of other supplier pathways was as accurate as it was for ours, then the method also arrived at a good enough proxy for the range of efficient costs.

<u>The winter period</u>

The winter period 1 was Jan-Mar 2019. Figures 2.3 and 2.4, showing the winter period as Oct-Mar, is misleading and obscures the relevant period by including an irrelevant period. We have previously explained to Ofgem that if period 1 is treated as the first of a *contiguous series*, that the "calendar spread" position is net "short" (on a "delta" weighted basis), and the cost of a short position in a market rise would increase the cap. Ofgem has in the calculation (but not the narrative) treated the period as standalone. This point is not specific to the judgment and hence is not expanded on here (and, being irrelevant to the terms of the judgment, had no cause for consultation).

<u>What is relevant</u>

At 3.37 Ofgem asserts that in making the correction required in the terms of the judgment that it does not confine itself to the judgment but may make wider revisitations of the cap. This may or not be a proper approach but where Ofgem makes decisions (following necessary consultation) on further retrospective corrections irrelevant to the judgment, they should be separated clearly and not conflated. The attention given, in the consultation and the enquiry process, to matters irrelevant to the terms of the judgment, has had the practical impact of obfuscation of the simple and narrow point of re-indexation of period 1, and has diluted the attention that should properly have been made on relevant matters, such as the range of efficient hedges.

<u>Conclusion</u>

The judgment stated that "GEMA will have to reconsider the allowance for Q1 2019 in the light of the information that it now has, and make such adjustments as it considers appropriate in the light of that reconsideration"

The reasons given for the re-indexation have been rejected in court. The re-indexation, as Ofgem concedes at 5.20 in the consultation, but does not execute, must simply be reversed.

We recognise that in the absence of litigation against Ofgem, the harm to suppliers caused by Ofgem can only be remedied in the form of consumer tariffs. Whilst the *default* action must be *fully* to restore the harm, including from the volume attrition and cost of capital, we do recognise the requirement of the Act to weigh everything in the balance. Therefore we recognise that *full* restoration cannot be done. Equally the volume attrition and capital cost effects may not be weighed too lightly, or indeed at *nothing*, as is currently the case. Two years on, no further delay can be brooked, and hence passing through half the cap correction from volume attrition and cost of capital seems the most expedient course of action.

The range of efficiency of suppliers is set too narrowly, in violation of the Act (and the Electricity and Gas Acts).

The necessary actions to execute the terms of the judgment are therefore straightforward;

i) Reverse the re-indexation, or in any event use the analysis that Ofgem did for hypothetical efficient supplier, necessarily using an adequate range of efficiency. Both methods yield similar results.

ii) Weigh in the balance how much of the volume attrition and capital cost effect to pass through. In the absence of proper analysis then passing through half would be the most compliant (or least non compliant) action with respect to the Act.

Annexe - The legal basis – Electricity Act 1989 and Domestic Gas and Electricity (Tariff Cap) Act 2018

Electricity and Gas are similar, so we just cover electricity.

Electricity Act 1989 (as amended) (EA89) states at 3A(2) "the Secretary of State or the Authority shall have regard to…..(b) the *need* to secure that licence holders are able to finance the activities which are……" (emphasis added)

We understand that it is common ground with Ofgem that everything hinges on the interpretation of "regard". Note that there is no rider in EA89 (or GA86) of "efficiency", as in "efficient supplier". This Acts is unqualified in this regard. The requirement for efficiency is captured by the absence of "all" as in "all licence holders" and the competitive market, since the least efficient supplier will lose market share and not be able to secure finance. Similarly, "licence holders" is in the plural and any efficiency threshold imputed in EA89 cannot be at the level of the most efficient supplier (in the singular). A natural reading of EA89 is that in the absence of demonstrated profligacy that the sector as a whole needs to be sufficiently financeable to serve the customer base of Great Britain. Therefore the efficiency threshold is at the level where most (but not necessarily all) suppliers surpass it.

EA89 gives further information at 3A(3) "..the Secretary of State or the Authority shall have regard to the interests of… [vulnerable consumers]…but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer."

There is then, at this point, a clear hierarchy in the consideration of "regard", being, in order, (i) vulnerable consumers, (ii) suppliers' ability to finance their regulatory requirements (including SLC22 duty to offer terms), (iii) other consumers. We see below how actually the ability to finance the sector takes primacy.

(i) and (ii) are placed in balance by; 3A(1) "The principal objective of the Secretary of State and the …. Authority ….. … under this Part is to protect the interests of existing and future consumers …" *and* 3A(2)(a) "the need to secure that all reasonable demands for electricity are met….". Note the term "need". This is an absolute and not relative term. The dictionary definition of "need" is require something because it is essential or very important, rather than just be desirable. I need food because it is *essential* to survive. Children need love and not to be beaten because it is *important* even if survival is possible otherwise. EA89 was drafted before the Utilities Act 2000 but we can be reasonably confident that solvency of enough of the supply sector is covered by 3A(2) because; (i) suppliers collect money for transportation and generation, and mutualised insurance of payments to these are not secure if the supply sector cannot secure funds to pay, (ii) the act of supply, being conveying through a meter[6],

[6] This definition of the active verb "supply" is to be found implicitly in UA00, with its origin in EA89. UA00 separated the conveyance roles of distributor (to the meter) and supplier (through the meter).

requires financing of everything relating to metering (in addition to remitting the direct costs such as wholesale costs, network costs, and obligations costs), is required to "keep the lights on". Without these two, then reasonable demands cannot be met.

Putting these together, we do have a clear logical flow;

i) The Principal Objective of the Authority is to protect the interests of current *and future* consumers.
ii) Primacy here is awarded to financial and physical integrity of the Electricity Supply Industry so that electricity can flow *physically*. In practice this means to all consumers and it includes metering.
iii) Noting the term "need" in 3A(2), it is a *requirement* of the Authority to *ensure* (in affect this is "*achieve*") the financial integrity of the supply *sector*. This integrity includes the ability to secure finance. The Principal Objective cannot be achieved without this. The Authority need not necessarily achieve financeability of every single supplier.
iv) *Conditional on* the requirement to achieve financial integrity of the supply sector, the Authority must have regard to the interest of consumers, for example in the level of bills, with very clear precedence of vulnerable consumers.

So we have a clear ranking for the consideration of "regard", being; i) financial integrity of the supply sector to enable it to sustain, otherwise vulnerable and other consumers cannot be served ii) the level of bills for vulnerable consumers and iii) the level of bills for other consumers.

Ofgem's principal objective does not include the interests of suppliers (or shippers). The need for financial integrity of suppliers (and shippers) is to protect the interests of consumers. In the recent decision, overturning the majority recommendation on consultation, not to proceed with the loans from networks to suppliers without investment grade ratings, Ofgem notes[7] ".our duties to licence holders to *secure* that they can finance their licensed activities". (emphasis added). There is no mention of have regard. Ofgem's approach is inconsistent and not rational.

The drafting of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (TCA18) in relation to EA89 is unfortunate; At 6 it states "The Authority …..must have regard to the following matters—....(d)….the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence". The interpretation of "efficiency" between the three Acts must be resolved.

In UK law, there is no formal precedence of recent over older acts. Where they interact, the new act should amend (or repeal) the older one and if this is not done, then they have equal status.

[7] Page 8
https://www.ofgem.gov.uk/system/files/docs/2020/06/20200623_unc726_decision_letter_0.pdf

Whatever anyone may think about the quality of the drafting or the politicisation of the debate is of no consequence. We have to address it as it is. Ofgem must do the same. The law is the will of Parliament. Hence, the rider of efficiency, but with no amendment of EA89, must be addressed.

EA89 states "the *need* to secure that licence holders are able to finance the activities which are subject to" (emphases added) and TCA18 states "the *need* to ensure that holders of supply licences who operate efficiently are *able to finance* activities authorised by the licence" (emphases added).

Taking the differences between the acts one by one;

On efficiency, EA89 has no voice. However, as we note above, it does play a silent role.

The interpretation of TCA18 in "operate efficiently" may be taken from the Competition and Markets Authority (CMA) Energy Market Investigation (EMI) 2014-16 examination of efficiency. This must stand until there is consensus in further studies and/or in peer reviewed journals that it was seriously inadequate, flawed and proven incorrect ex post. Nevertheless, the *CMA arguments on efficiency may only be taken in their own context and period of time* (pre 2016, before further extensive cost cutting by suppliers). They may not be extended to other contexts without adequate care. CMA cited incumbent inefficiency in relation to non incumbents. Not least because the sector must be financeable, the *CMA* citations cannot be transposed by *Ofgem* to use to impute an efficiency threshold for use in TCA18. The set of suppliers used for the efficiency threshold is the set of incumbents and the only efficiency at stake in complying with the terms of the judgment is efficiency in hedging.

In the absence of conflict, Ofgem *may* in its interpretation of efficiency in the drafting of TCA18 place higher weight to its drafting than the drafting in EA89 because TCA18 has a specific context. However, where this interpretation creates *conflict* in its reference to higher principles and broader context, then Ofgem *must* apply greater weight to the drafting of EA89 in setting the cap. The higher principles are the Principal Objective and the *needs* specified in EA89.

Parliament had the opportunity to, *but did not take*, the opportunity in TCA18 to amend the Principal Objective and the needs in EA89. Various Energy Acts have refined the needs and the elements of regard in EA89. As in all legal drafting, we must assume it to reflect the will of Parliament (subject on occasion to Hansard on interpretive detail), and may not cite neglect in drafting. The absence of amendment of EA89 on this point must be viewed as *deliberate*.

We may not however take "who operate efficiently" in TCA18 as nugatory. The best we can do to marry both of the Acts is something like; i) the *sector* must be financeable whether efficient or not, ii) profligate suppliers deserve no *individual* protection, iii) further, financeability is *not* protected for the *least efficient* supplier, iv) it is a *requirement* for Ofgem to set the level of the cap such that most suppliers can finance themselves. Here, most suppliers means all but the least efficient supplier/s.

Ofgem made further, and different, errors to the CMA in their calculation of efficient benchmarks[8]. Where not backed up by CMA analysis and/or commentary, they do *not* enjoy the legal status of the CMA EMI, which preceded the legal drafting of TCA18.

On the second difference, on the supplier activities *required* and *authorised*, these are different. Suppliers have numerous "relevant requirements", as bound by EA89, such as the Renewables Obligation and the Energy Company Obligation. The RO is not subject to supplier efficiency or inefficiency and must be fully factored into the cap, including the expectation value of mutualisation of defaults, mutualisation of defaults of mutualisation, and a spiral of mutualisation of defaults. Not that since it is not known *which* suppliers would survive a default spiral, the cap must be uplifted for *all* suppliers to contend with the spiral, otherwise demands for electricity may not be met as required in EA89. The default spiral has the effect of requiring more suppliers to be financeable. Depending on the likelihood of such a spiral, this may raise the cap to highest rather than second highest realised hedge cost.

We have read the human rights case law cited by Ofgem. Ofgem's arguments on "achieve" as distinct to "have regard" fall when we consider context (for example Ofgem has far greater control on the ability to achieve supplier financeability than the home office has to achieve the end of discrimination in society). The case law demonstrates the need for "anxious scrutiny" as the context requires. Sector financeability is required to "keep the lights on" and hence adequate scrutiny is required. Ofgem need look no further than the 2019 Consolidated Segmental Statements to demonstrate that what was obvious *and stated* ex ante, was proven ex post regarding financeabiltiy.

Ongoing financeability can be determined using standard financial tools. In the November 2018 price cap decision document, at 2.74 Ofgem "set a profit allowance at 1.9% before interest and tax", noting an "efficient supplier should make a normal level of profit to finance its activities". The 1.9% must be accepted on all sides as it is rooted in statements by the CMA in the EMI. The market cost of risk capital is exogenous and cannot be determined by suppliers or Ofgem. The standard Capital Asset Pricing Model is good enough here. From this can be determined the maximum risk for a supplier to be financeable at a given margin. Retrospective actions by the regulator create uncertainties that flow through to significant increases in financing costs (by modelling them as risks). It therefore falls within the Principal Objective for Ofgem to minimise both risk and uncertainty, especially at the very low ex ante margin of 1.9%.

To conclude, Ofgem *must*, *in law*, set the cap at a level at which most suppliers can be financed. Wholesale costs are a very significant source of risk. On a single fuel basis, the wholesale cost benchmark to be used for the cap is at least the second highest of suppliers' costs. For dual fuel suppliers, as all of the significantly affected suppliers are, this depends somewhat on the relative ranking of realised gas and power costs. If they are very different, then this slightly reduces the benchmark.

[8] These are explained in npower responses. The most significant errors are in the form of selection biases in factor costs through the use of lower quartile factor costs, as distinct to lowest quartile total cost over a representative period