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Sent by email to: retailpriceregulation@ofgem.gov.uk

Price cap - Call for Input on Additional Wholesale Allowances Review: NON-CONFIDENTIAL VERSION

Dear Dan,

We welcome the opportunity to respond to this Call for Input and share our views on whether a review of the additional wholesale allowances is appropriate and if so, what form it should take.

You have asked for comments on both a possible short-term review and an enduring review, so we comment separately on each.

Short term review

We support a short-term review of the Additional Wholesale Allowances (AWAs).

Ofgem previously made an ex-post adjustment for shaping and imbalance costs in period 7 of the price cap¹ and is now considering whether a further adjustment might be necessary, specifically with respect to period 9a and 9b of the price cap. The underlying cause of the review of period 7, in November 2021, was the 'scale and pace of wholesale price increases over recent months (and the increased associated uncertainty around future prices)'² Our view is that this issue remains relevant.

In carrying out its second review, considering both period 8 and 9, Ofgem had difficulty obtaining information on shaping and imbalance costs due to data and methodological issues. This was given as a reason for not adjusting period 9 allowances:

¹ [Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem](#)

² [Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem, Paragraph 1.11.](#)

'We consider there is too much uncertainty around market conditions and suppliers' estimates to justify an adjustment.'³

Given historic data is now available our view is that Ofgem should review cap period 9 to ensure that suppliers are able to recover efficient costs. Furthermore, given that Ofgem's proposed enduring review is not scheduled to complete until Summer 2024 it should also consider whether a review will be required for the interim periods i.e. Winter 2023/24.

Ofgem also did not include transaction costs in previous AWA reviews. Given changes to the cap methodology⁴, our view is that a review of transaction costs is required both in the short term and as an enduring issue.

Enduring review

We support an enduring review of the AWA including a review of the methodology for calculating the allowances as well as a review of the input data.

In addition to the issues that Ofgem has identified we note the following points which should be considered in an enduring review:

- We believe that a more fundamental review of the purpose and nature of price regulation is needed to consider the appropriate balance between competing objectives, to ensure the best protection for consumers over the longer term. Particularly in the context of the Energy Prices Act, we encourage DESNZ and Ofgem to engage with all relevant stakeholders to define the characteristics of the energy market that best protect current and future consumers, and then design price regulation to deliver those objectives. We would like to reiterate that we do support price regulation which has well thought through objectives and is both principles based and designed well enough to achieve those objectives.
- In particular, Ofgem has noted that it will consider 'a process for regular updates' as part of any enduring review. We agree that this should be included in any review. Ofgem has reviewed wholesale cost allowances twice now, covering three cap periods. A formal review process would reduce the need for ad-hoc reviews and increase predictability for stakeholders.

We would like Ofgem to improve disclosure to allow suppliers to review, in a constructive manner, its calculations related to price cap cost allowances. Ofgem has accepted the need for disclosure within an appropriate confidentiality ring in relation to COVID debt true-up models and the SMNCC models, and made material changes to correct errors identified as a result of external scrutiny. Such disclosure has to date not happened for shaping and imbalance costs and associated modelling. In the interests of transparency, we urge Ofgem to permit disclosure of models used to calculate shaping and imbalance costs and input data, using a confidentiality ring and/or publishing models with data redacted as required.

Yours sincerely,

Essie Barnett
Regulatory Manager

³ [Price Cap - Decision on possible wholesale cost adjustment | Ofgem, Paragraph 4.56.](#)

⁴ [Price cap - Statutory consultation on changes to the wholesale methodology \(ofgem.gov.uk\)](#)

Appendix – responses to consultation questions

1) Potential considerations for change

- a) Do you agree with the above outlined areas of consideration?

Ofgem has set out the following areas of consideration:

- Recent market trends;
- Enduring issues; and
- Impacts on different types of customers.

We agree with the outlined areas for consideration subject to our more detailed comments below.

- b) Are there any other areas we should consider?

We have previously recommended that Ofgem monitor specific metrics. In particular, we have suggested that Ofgem monitor the transaction costs incurred by suppliers on an ex-post basis (for example, by collecting data on bid offer spreads).

Our view is that where Ofgem has previously found that cap allowances are not covering suppliers' efficient costs, as was the case in period 7 for shaping and imbalance costs, it should take steps to ensure that under recovery is not recurring on an ongoing basis.

Furthermore, if an ex-post allowance is required this should be applied as close as possible to costs being incurred. This is particularly important where the unrecovered costs involved are of a sufficient magnitude to impact suppliers' ability to finance themselves. Recovering costs quickly is also important when wholesale prices are falling because customers who moved to default tariffs to take advantage of the lower prices under the cap will move back to FTCs. In this situation, timely recover of costs means that costs can be recovered from the customer base through which they were incurred.

- c) Are there sufficient reasons to indicate that it may be appropriate to carry out a review? If so, please support your view with evidence.

Shaping and imbalance costs are driven by unexpected variations in demand (mainly caused by the weather) and whether the price of buying and selling energy on the days these variations occur is above or below the price at which the energy was originally purchased.

This combination of the impact of volume and pricing means that shaping and imbalance costs can differ from direct fuel costs – against which their allowances are indexed.

We provide evidence on the need for a review in our response to question 2 (b) and 3 (b).

- d) Where would you see the additional wholesale allowance review sit in terms of priority alongside other workstreams set out in the Programme of Work?

We agree with Ofgem that the AWA review should take place during 2023/2024.

Ofgem cites the reasons for this review as ‘to ensure the allowances appropriately reflect efficient costs incurred by a nominal supplier, particularly given our changes to the wholesale methodology and that the methodology has not been reviewed since 2018.’⁵

We agree that the degree to which these allowances reflect efficient costs may have been affected both by changes to the wholesale methodology and other changes in the energy market since 2018. In order to ensure that suppliers are able to recover efficient costs it is right for Ofgem to review these allowances.

However, we note that Ofgem proposes to conclude its review of Additional wholesale allowances in the Summer of 2024, we assume this means that the current allowances would remain in place for cap periods 10, 11 and 12a at least. Should Ofgem find that allowances in previous cap period have not allowed suppliers to recover efficient costs any ex-post adjustments that are required should be completed through the adjustment allowance as soon as practicable.

- e) Are there any other key interactions which you consider could affect the scope of any review? Please explain your answer.

The AWAs are indexed as a fixed percentage of direct fuel costs, rather than calculated using a bottom-up approach. They will therefore interact with the wider wholesale costs allowance and will be affected by changes to the wholesale cost methodology. Ofgem should consider recent change to that methodology⁶ as part of its review of the AWAs to ensure that any interactions are considered.

For example, interactions include the move to quarterly cap updates and, more generally, changes that affect the hedging approach that suppliers need to take to hedge in line with the cap. As we set out in our response to question 2(a) below, Ofgem should mitigate the risk that an efficient supplier following Ofgem’s hedging guidance will incur costs that cannot be recovered under the cap including by monitoring transaction costs.

⁵ Price Cap Programme of Work, Annex 2, 25th November 2022.

⁶ [Price cap - Decision on changes to the wholesale methodology | Ofgem](#)

2) Considering a review for short-term issues:

Previous reviews indicate there is an issue with the AWA

Ofgem previously made an ex-post adjustment for shaping and imbalance costs in period 7 of the price cap and is now considering whether a further adjustment might be necessary, specifically with respect to period 9a and 9b of the price cap.

In its decision on the period 7 adjustment, Ofgem found that:

'industry faced considerable costs during cap period seven, from 1 October 2021 to 31 March 2022, that were not accounted for in the cap, and we must have regard to the need for suppliers to finance their efficient activities.'⁷

However, with respect to future cap periods, Ofgem found that an increase in the cap was not appropriate because:

'Doing so would risk consumers paying more from 1 April 2022 for costs where there is still considerable uncertainty whether costs related to wholesale market volatility will materialise, and where other interventions are being implemented to manage these risks.'⁸

Ofgem set out the interventions being implemented to manage these risks. These were:

- Measures on financial resilience monitoring and reporting
- Medium term changes to the price cap including an allowance for backwardation costs, a shortening of the implementation period and further consideration of a quarterly update
- Short term interventions to further stabilise the retail market including the Market Stabilisation Charge
- Further changes to the price cap including consultation on shaping and imbalance costs, CFD costs and a review of supplier financial resilience if necessary.⁹

These interventions were expected to mitigate the need for future adjustments. However, Ofgem did undertake a further adjustment review in May 2022¹⁰ considering cap periods 8 and 9. In that review Ofgem had difficulty obtaining information on shaping and imbalance costs due to data and methodological issues. This was given as a reason for not adjusting period 9 allowances:

'We consider there is too much uncertainty around market conditions and suppliers' estimates to justify an adjustment.'¹¹

⁷ [Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem](#), Executive Summary.

⁸ Ibid.

⁹ Ibid.

¹⁰ [Price Cap - Consultation on possible wholesale cost adjustment | Ofgem](#)

¹¹ [Price Cap - Decision on possible wholesale cost adjustment | Ofgem](#)

The underlying cause of the review of period 7, was described by Ofgem as the ‘scale and pace of wholesale price increases over recent months (and the increased associated uncertainty around future prices)’.¹² Our view is that this issue remains relevant. Whilst, Ofgem has made a number of changes to the price cap since its review of cap period 7. Our view is that Ofgem still needs to assess the degree to which these interventions have mitigated the need for a further cost review.

We do not agree with Ofgem’s position in the August decision that ‘it would be up to stakeholders to make the case for any future reviews’.¹³ Given Ofgem has previously identified an issue with the shaping and imbalance allowances which required an adjustment to the price control for period 7, Ofgem should be aware that the allowances as designed do not allow suppliers to recover efficiently incurred costs adequately. Furthermore, given Ofgem has previously reviewed the period 9 allowance and decided not to make an adjustment due to uncertainty it would be appropriate for Ofgem to reconsider this issue to the extent that this uncertainty can be resolved.

Ofgem propose to consult on AWAs from summer 2023. Given historic data will then be available our view is that Ofgem should be able to address previous uncertainties and review cap period 9 to ensure that suppliers are able to recover efficient costs.

Criteria for a review

Ofgem note that to consider that a review is appropriate they ‘would need evidence of a material and systematic issue’¹⁴. They also highlight that:

- evidence that ‘there is an issue in the round’ will receive more weight; and
- that they will ‘limit the scope of any review to differences that are unlikely to net out over time, and which may therefore lead to systematic impacts’.¹⁵

Our view is that Ofgem will need to proceed with a review to assess whether these conditions are met.

- a) Are there specific issues for this winter (2022-23) which mean that you consider a review is appropriate? If yes, please explain your understanding of the causes and potential actions required to address these issues.

Ofgem made a number of changes to the price cap in August 2022 including introducing quarterly updates to the price cap which came into effect in cap period 9a.¹⁶

Centrica had previously noted that quarterly updates to the price cap have a potential impact on shaping, imbalance and transaction costs because quarterly products had a lower level of liquidity.¹⁷ For example, on shaping costs, if suppliers are unable to purchase quarterly

¹² [Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem, Paragraph 1.11.](#)

¹³ [Price Cap - Decision on possible wholesale cost adjustment | Ofgem](#), Paragraph 5.92.

¹⁴ Price cap: Call for Input on Additional Wholesale Allowances Review, 3rd February 2023, Page 8.

¹⁵ Ibid.

¹⁶ [Price cap - Statutory consultation on changes to the wholesale methodology \(ofgem.gov.uk\)](#)

¹⁷ Centrica’s response to Consultation on Medium Term Changes to the Price Cap Methodology: non-confidential version, 4th March 2022.

products so that they need to purchase seasonal products and reshape closer to the time of delivery.¹⁸

We therefore suggested, in June 2022, that Ofgem mitigates this risk that an efficient supplier following Ofgem's hedging guidance will incur costs that cannot be recovered under the cap. as follows:

- 'For cap periods 9A, 9B, and 10A, Ofgem should monitor the transaction costs incurred by suppliers on an ex-post basis (for example, by collecting data on bid offer spreads). If these costs materially exceed the allowance in the cap, an ex-post adjustment will be required. Such an ex-post adjustment should be carried out through the adjustment allowance, together with an amendment to the MSC to ensure that suppliers can recover these costs even in the event of switching from SVTs to FTCs. It is important to recognise that a quarterly cap period has not been observed before, and the second quarter in a year is a challenging period to hedge.
- For subsequent cap periods, Ofgem should have sufficient information to determine whether the ex-ante allowance in the cap should be adjusted.¹⁹

Whilst we recognise that the transition to quarterly updates is proposed to be considered as an enduring issue – to the extent that it affected and affects suppliers' ability to recover efficient costs our view is that it should also be considered as a short-term issue.

- b) Please provide any evidence of whether costs this winter have materially and systematically diverged from the additional wholesale allowances



¹⁸ Ibid.

¹⁹ Centrica response, Price cap - Statutory consultation on changes to wholesale methodology, 14th June 2022.

- 3) Considering a review for enduring issues: Areas for feedback We particularly welcome feedback on the following issues:
- a) Are there additional general issues which mean that you consider a review is appropriate? If yes, please explain your understanding of the causes and potential actions required to address these issues.

As we noted in our response to Statutory Consultation on changes to wholesale methodology in June this year²⁰. We believe that a more fundamental review of the purpose and nature of price regulation is needed to consider the appropriate balance between competing objectives, to ensure the best protection for consumers over the longer term. Particularly in the context of the Energy Prices Act, we encourage DENZ and Ofgem to engage with all relevant stakeholders to define the characteristics of the energy market that best protect current and future consumers, and then design price regulation to deliver those objectives. We would like to reiterate that we do support price regulation which has well thought through objectives and is both principles based and designed well enough to achieve those objectives.

In the context of this review, we agree with the areas that Ofgem have highlighted to be included in an enduring review. We also consider that Ofgem's process for review is of particular importance.

Ofgem's process for review

Ofgem has noted that it will consider 'a process for regular updates' as part of any enduring review in the Call for Input. We agree that this is an important element of a review of the AWA.

Ofgem has reviewed wholesale cost allowances twice now, covering the last three cap periods. These reviews were triggered initially in Winter 2021 by the 'scale and pace of wholesale price increases over recent months (and the increased associated uncertainty around future prices)'.²¹ This shines a light on the fact that whilst the cap was designed to pass through specific exogenous costs, there was always the possibility that 'unforeseen trends in efficient costs' would need to be accounted for.²²

Given the end date from the price cap has been removed by the Energy Prices Act 2022, Ofgem now needs to consider how the cap will be reviewed on an ongoing basis. This should include how indexed allowances should be updated. A review should consider whether updating allowances more regularly would reduce variations between the allowance and out turn costs or alternative mechanisms to achieve this. A formal review process would also reduce the need for ad-hoc reviews and increase predictability for stakeholders.

²⁰ Centrica response, Price cap - Statutory consultation on changes to wholesale methodology, 14th June 2022.

²¹ [Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem, Paragraph 1.11.](#)

²² As noted in Appendix 3 of the Default Tariff Cap decision: [Default tariff cap: overview document | Ofgem.](#)

- b) Please provide any evidence of why you would expect costs to diverge from allowances on an enduring basis, including evidence of differences to date.



- c) Which of the two outlined approaches do you consider would be most appropriate for a review of enduring issues?

A review of input data

Ofgem set the AWAs in 2018 using historical data up to that date. In Approach 1 (a review of input data), they propose to update these models using more recent datasets.

Ofgem set out its approach to calculating the AWAs in its decision on the Default Tariff Cap.²³ However, we are not aware that Ofgem has shared the models used to calculate the AWAs and has not set out the data that would be updated in a potential review of input data. Given this, we cannot comment in detail on whether a review of input data would lead to the AWAs better reflecting costs, although we note that it seems likely, all else being equal. We therefore reserve the right to comment on an update of the input data when Ofgem sets this out in more detail.

Absent additional detail, we take 'a review of input data' to refer to input data on at least: forward contracts; seasonal normal demand;²⁴ historical imbalance volumes; and the average absolute price difference between system buy and day-ahead prices.

We agree that Ofgem should update this input data but do not think this would be sufficient to ensure that the allowances consider future market challenges. In particular, the indexation approach relies on there being a correlation between the indexed variables (shaping, imbalance and transaction costs) and the index (direct fuel costs). We would expect that there are a number of other factors, in addition to direct fuel costs, that drive shaping, imbalance and transaction costs over time. If this is the case, updating input data only may only be effective in the short term. As Ofgem suggests a review of enduring issues will mean it can consider other factors that affect these costs and how these might be accounted for.

However, we note Ofgem's point that a review of input data could be delivered more quickly. Based on Ofgem's forward work programme the delivery period for this review is Summer 2024. This would mean that existing allowances remain in place until at least price cap period 12b including winter 2023/24. Should Ofgem find, during the course of its review, that existing allowances have systematically and materially departed from an efficient level of costs Ofgem should not wait until Summer 2024 to correct this.

Full review of the methodology

We would support Ofgem undertaking a full review of the methodology including a review of the input data as well as: the key assumptions and methodology; separate calculations for Economy 7 and other Time of Use customers; and a process for regular updates.

²³ [Default tariff cap: decision - overview | Ofgem](#), Appendix 4; Wholesale.

²⁴ Which was previously based on 2017-18 provided by Elexon for electricity and for gas, annual load profiles for 2017-18 provided by Xoserve.

We agree in broad terms with the areas highlighted by Ofgem as a basis for an enduring review. We also note that Ofgem has highlighted issues with liquidity with reference to its proposed short-term review. Our view is that liquidity issues may be both a short term and enduring problem and should be considered as part of Ofgem’s enduring review.

d) What types of customers should we consider in any review (eg multi-register or PPM)? Please explain why.

We agree that Ofgem should consider different types of customers in a review of the AWAs including multi-register and PPM customers. We have particular comments on PPM customers which we set out below.

PPM customers

The cap methodology was updated in April 2022 to use different estimates of peak gas demand for PPM and non-PPM customers following the creation of a new End Use Category (EUC) specific to prepayment meter (PPM) customers.²⁵ This update also affected the Unidentified Gas (UIG) allowance which is now calculated separately for PPM and non-PPM customers.

Centrica has raised an urgent UNC modification on ‘Equalisation of prepayment and non-prepayment Allocation of Unidentified Gas (AUG) factors’²⁶. This modification seeks to mandate that there should be no differentiation in AUG weighting factors for prepayment and non-prepayment EUCs in the same sector and product class. The differential in the UIG allowance is expected to increase to almost six times higher in the latest proposed draft factors for gas year 2023/24. Table 1 shows the UIG allowance for price cap period 10a beginning in April 2023.

Table 1: UIG gas allowances for PPM and non-PPM, Period 10a.

	Gas Non-PPM	Gas PPM
Unidentified gas	1.83%	8.19%

Source: Annex 2 – wholesale_cost_allowance_methodology_v1.15

We consider that the differential in the weighting factors between domestic consumers creates an unnecessary level of risk and unpredictability and an increasing penalty on consumers with a prepayment meter. Our proposed modification corrects this, whilst the default tariff cap can continue to reflect the costs imposed on suppliers by using the industry allocations for UIG.

A modification panel decision is expected for this modification on 16 March 2023. We ask that Ofgem consider the outcome of this modification and consider including the impact of the PPM EUC on PPM customers in any enduring review.

²⁵ [Price Cap - Decision on reflecting prepayment End User Categories in the default tariff cap | Ofgem](#)

²⁶ [0838 \(Urgent\) - Equalisation of prepayment and non-prepayment AUG factors | Joint Office of Gas Transporters \(gasgovernance.co.uk\)](#)

4) Interactions with other workstreams

- a) Are there any other key interactions which you consider could affect the scope of any review? Please explain your answer.

We have reviewed the key interactions that Ofgem sets out in the Call for Input and discuss them in turn below.

Price cap extension

The price cap was set in 2018 for a maximum period of four years (2019 – 2023). The Energy Prices Act 2022 means that the cap will now continue after 2023 only ceasing to have effect following notice given by the Secretary of State.

The cap was designed to be updated every six months so that ‘exogenous’ cost indices, such as direct fuel costs, could be updated. This design meant that these exogenous cost indices, which were costs outside of suppliers control, were a direct pass-through.

However, the additional wholesale cost allowances are not a direct pass-through cost but are instead indexed to direct fuel costs. This indexation is based on assumptions about seasonal normal demand based on 2017/2018 data and a shaping approach which was related to the original cap indexation approach (6,2,12).

Ofgem note a number of reasons that this indexation may break down in their proposals for an enduring review. Ofgem should also consider that the cap was originally intended to operate for, at most, a four-year period. As a result, the indexation approach should be reviewed as a matter of course to ensure that it continues to meet the broader objectives of the price cap.

We also note that Ofgem issued a Call for Input on the update of Typical Domestic Consumption Values (TDCVs) including on whether to amend the benchmark annual consumption values in the price cap with updated TDCVs.²⁷ We note that, as is the case for additional wholesale allowances, the price cap data on TDCVs to estimate benchmark annual consumption has not been updated since the price cap was introduced and, in this case, relies on 2017 data. The point made in respect to AWAs also applies here. Given the end date from the price cap has been removed by the Energy Prices Act 2022, Ofgem now needs to consider how the cap will be reviewed on an ongoing basis including reviewing input data where this was not intended to be in use beyond 2023.

Operating costs

We understand that the review of transaction costs, which is included in this Call for Input, is distinct to any potential operating cost review. And that an operating costs review would include trading costs. In a review of operating costs, Ofgem will need to isolate the operating costs of trading energy from transaction costs and may therefore consider interactions with its review of the AWA.

²⁷ [Call for Input: Review of Typical Domestic Consumption Values 2023 | Ofgem](#)

Headroom

We do not consider there to be any key interactions between the headroom and additional wholesale costs allowances. The headroom allowance is designed to capture 'residual net uncertainty'. Any update to additional wholesale cost allowances would only be made according to Ofgem's criteria which is that 'it systematically and materially departed from an efficient level of costs'.²⁸

Furthermore, as noted in previous responses headroom has historically been insufficient and would therefore not soak up risks a supplier may incur as Ofgem implies. For example, in our December 2021 response to Ofgem's Consultation on the potential impact of increased wholesale volatility on the default tariff cap, we set out updated analysis originally submitted when the price control was set showing that headroom has continued to be insufficient.

²⁸ Ofgem, Decision – Default tariff cap – Overview document, 6 November 2018, Paragraph 3.14.