

Dan Norton
Deputy Director, Price Protection
Ofgem
10 South Colonnade
London
E14 4PU

1 March 2023

Dear Dan,

CALL FOR INPUT ON ADDITIONAL WHOLESAL ALLOWANCES REVIEW

We welcome the opportunity to respond to Ofgem's call for input on whether to launch a review of the shaping, imbalance and transaction cost allowances in the price cap. Ofgem intends to consider whether any review should address, either or both, short-term and enduring issues affecting these allowances. We have provided a detailed response in Annex 1 but summarise our position below.

We do need a review of ex ante shaping, imbalance and transaction costs allowances

We continue to think that the current ex ante additional wholesale allowances, including shaping and imbalance costs could be improved. This would require gathering sufficient market data on costs. This does not only need to be done on a retrospective basis, looking back at actual costs but could be done on a more prospective basis. Ofgem is in a position to use data available in the market to "operate" a shadow supplier. This could mean tracking market data from indexation to consumption to mimic baseload / peak purchases, shaping customer volumes and potentially calculate imbalance volumes. Bid offer spreads, and fees could be approximated to estimate transaction costs. Over a year, four cap periods, a reasonable amount of data could be analysed and indeed compared to supplier RFI responses on historical actual costs over the same period.

A review of the ex ante allowances is not urgent

Whilst we welcome a wide ranging review of the ex ante allowances, and think that data gathering as proposed above should begin after this winter period, we think the review itself could wait until Q2 2024, as proposed in Ofgem's November 2022 price cap programme of work. This is for several reasons:

- A review should only take place after a complete winter period so that the evidence for the period can be collected and assessed together. This is particularly the case in the current volatile market. We are seeing large swings in

costs due to volatility and its interaction with weather and these may change what we have seen in the first month of 2023.

- It could be premature to assess the impact of low liquidity, in particular of quarterly products, so early on in the implementation of the quarterly cap. We are currently only delivering the second quarterly cap and it is a transitional cap.

An ex-post assessment of costs may be needed

In addition, although there may be a case to consider whether the shaping and balancing allowances for winter 2022/2023 were sufficient, we do not have the data to fully assess this now. In Q4 2022 we observed material increases in costs relative to allowances which has been partially offset by lower costs so far in Q1 2023. However, one month of the quarter remains, much settlement data is outstanding and weather could either exacerbate or further mitigate costs. Were outturn costs to highlight material losses or gains after the winter period, we would seek an early review to consider ex post adjustments. We suggest that Ofgem issues its RFI in early May once the data relating to winter 2022/2023 is clearer.

Other areas also merit review

In addition to the areas raised by Ofgem in its call for input, we consider that the following two areas also merit review and this could be begun now:

1. **UIG:** We have consistently found that the UIG percentage in the cap is too low and suppliers have therefore under-recovered costs. Our demand weighted UIG volumes are greater than the allowance, and our current forward trading assumption is that UIG will continue to be above the cap allowances.
2. **Baseload/peak percentage split:** We have found that the peak percentage has been closer to [30%] since the inception of the cap as opposed to the 30% used by Ofgem. This should be assessed alongside shaping at the appropriate time.
3. **Wholesale risk allowance and headroom:** We propose these are considered from first principles.

Prepayment meter costs

We do not consider that there is a strong rationale for amending wholesale allowances such that they differ between payment methods.

Economy 7 costs

We do not believe that amending allowances for different meter types namely Economy 7 meters will future proof the cap for time of use tariffs but Ofgem could consider different shaping allowances for meter types taking into account the additional complexity.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

**CALL FOR INPUT ON ADDITIONAL WHOLESALE ALLOWANCES REVIEW
– SCOTTISHPOWER RESPONSE**

Question 1: Do you agree with the above outlined areas of consideration?

Yes, we agree that the areas outlined by Ofgem are elements of the wholesale allowances that should be considered (and in our response to Question 2 we identify three additional areas). We have provided a little more detail on these areas below:

Shaping and imbalance costs

We agree that shaping and imbalance costs should be considered for review, but suggest that Ofgem reverts to its original terminology and refers to 'shaping, forecast error and imbalance costs' to be clear about the scope. Ofgem has previously stated that its model for shaping reflects average long run costs of both shaping and forecast error,¹ and it is clear from Ofgem's November 2018 Decision² that it considered the relevant set of allowances (seasonal to monthly shaping, monthly peak/baseload to hourly shaping, re-hedging day ahead and imbalance) to include weather-related forecast errors,³ albeit with extreme weather events potentially covered by the additional risk and headroom allowances. Ofgem explained that it had grouped these elements together because they are different parts of the same broad objective, and the relative magnitudes may vary from one supplier to another.⁴ We agree that Ofgem should continue to consider shaping and imbalance costs together since they are so interlinked.

There has been one ex post adjustment allowed by Ofgem since the start of the energy crisis to account for exceptionally high shaping and imbalance costs. This was for cap period 7 and Ofgem allowed £12 per customer for electricity only, based on a volume weighted average of supplier cost submissions. There was no additional allowance for gas in period 7 and none for either fuel type in periods 8 or 9. We acknowledged in our responses to Ofgem's consultations that we had not seen exceptional costs for gas at that time. However, it was largely matter of chance that there have been no additional/excess costs incurred with large swings in the cost of shaping across cap periods especially over the course of the last year as a result of the combined effect of volatility and demand impacts. We are as yet unsure still whether winter 2022/23 will continue to show a material increase in costs due to lack of data until the end of the period and the settlement data is available.

As a result, we believe that a more suitable ex ante allowance should be set so that the allowance is more accurate by design rather than chance.

Transaction costs

Transaction costs include fees and charges from OTC and exchange trading. Transaction costs also include costs associated with bid offer spreads. Ofgem is correct to consider this element of the wholesale allowance and must consider all aspects of this, ie both fees and the impact of bid offer spreads. We note that the RFI did not ask for any specific data relating to bid/offer spreads. We propose that Ofgem request market wide data from Trayport and/or ICE

¹ https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_4_-_wholesale_costs.pdf para 3.5 to 3.17

² https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf, para 2.20

³ It is implied that weather-related forecast errors are covered by the 'rehedging day ahead' allowance, though the size of this allowance seems small if that is the case. Ofgem also considered that forecast errors relating to customer numbers are unlikely to be material.

⁴ Ibid para 2.18

and consider the trends in recent years in relation to both bid/offer spreads and even the general availability of price quotes. Ofgem must include bid/offer spreads in its assessment and tracking these over the next year would be appropriate prior to its assessment.

Economy 7 and other Time of Use Tariffs

Economy 7 customers typically have different usage patterns to those with single meters. By far the largest element of the wholesale cost stack, the direct fuel cost element, already differs between Economy 7 and single rate meters, reflecting the different mix of day and nighttime consumption. In its original price cap decision, Ofgem acknowledged that had based its analysis of the additional wholesale allowances on the single rate meter demand shape, which it justified on the basis that most (c.90%) domestic consumers fall into this category. This remains the case and we are doubtful whether more detailed analysis would reveal material differences between the additional wholesale allowances for single and multi-rate meters.

However, if Ofgem decides to consider this further, we would offer the following observations:

- We think the shaping and imbalance allowance is more likely to exhibit differences than transaction costs – and is much larger (6% vs 0.4%).
- We are unable to calculate the cost of trades associated with these customers specifically, but if required we could endeavour to provide some estimates.
- We would expect any differences in shaping and imbalance costs to be much smaller than the difference in direct fuel costs.
- Any differences observed today could reduce over time because shaping at nighttime, with an increasing number of wind generators on the system, can also lead to higher imbalance prices than used to be associated with the nighttime hours.
- Although Economy 7 meters have a profile class and long established consumption data, which might be sufficient to estimate differences in shaping and imbalance costs, there is unlikely to be sufficient data for other multi-rate and time of use tariffs – at least until there has been wider uptake and longer experience.

On balance we do not think that tailoring the allowances for multi-register meters will enable the cap to better reflect the costs associated with time of use tariffs or future proof the cap for market-wide half hourly settlement (MHHS) in late 2025.

Prepayment Meter Customers

We do not believe that there is currently any rationale to treat different payment methods differently with regards to shaping, forecast error, imbalance and transaction costs.

Following the changes to End User Categories (EUCs) in 2019 Ofgem updated the cap methodology in 2022 including how UIG costs were allocated in the cap. This led to PPM gas customers paying a much larger portion of UIG costs than non PPM customers. We are supportive of the recent urgent UNC modification (0838 - Equalisation of prepayment and non-prepayment AUG factors) which aims to remove the differential treatment of PPM and non PPM meters in the allocation of UIG to the extent that it does not impact different suppliers differently. As noted above, we believe that the UIG percentage in the cap under compensates suppliers.

Question 2: Are there any other areas we should consider?

We consider that there are three other areas that Ofgem should consider as part of its review:

- 1. UIG:** We believe the current UIG allowance of 2% is significantly too low and suppliers have therefore under-recovered costs. Ofgem decided not to address UIG in its consultations in 2021 (albeit it was amended indirectly via consultation on end user categories (EUCs) for PPM customers which is likely now being reversed). Ofgem should consider whether the current allowance remains appropriate.
- 2. Baseload versus peak load mix:** Suppliers operating under the default tariff cap commit to deliver energy to customers at a fixed forward price and are therefore exposed to the impact of price volatility on the final profiled cost of domestic supply, which cannot be realised until near delivery when demand levels become more certain and liquidity for suitable traded products materialises. Ofgem's assumption that only 30% of power consumption occurs in peak periods is inconsistent with our internal view which forecasts peak power consumption to [30-35]% on average. This forecast is the view we trade to and is informed by historically observed consumption. Having to buy greater volumes of the typically higher priced peak hours increases our cost of supply relative to the cap assumption. The cost of this dynamic has been exacerbated by growing price differences between peak and baseload hours since Q1 2020 due to a tightening of the UK power system following closures of coal and nuclear powered generation in addition to continued growth of renewable capacity.
- 3. The wholesale risk element** of the wholesale allowance as well as headroom. In our response to Ofgem's "Further consultation on amending the EBIT allowance" we stated that Ofgem should clarify the purpose and scope of both the headroom and wholesale risk allowances and provide a clear conceptual framework for them. These allowances should cover any cost item not already included in a specific cost allowance, but should not cover unforeseen increases in cost allowances already provided for (these are suited to ex post allowances). The wholesale risk and headroom allowances have also been referenced as covering weather related risks. Given climate change and its implications for extreme weather events, the increasing amount of renewables and the bigger impact weather related risk has on suppliers, a review and clarification of the wholesale risk allowance and headroom would enable suppliers to see if the cap adequately accounts for risks.

Question 3: Are there sufficient reasons to indicate that it may be appropriate to carry out a review? If so, please support your view with evidence

Table 1 shows the reasons that might contribute to the decision to carry out a review. In the notes section we give some thoughts as to appropriate timing.

Table 1: Drivers for a review

Driver	Description of impact	Recent / enduring market changes	Notes
Market tightness	Recent wholesale price volatility may reflect a tighter balance between available supply and demand, particularly at certain times (eg the winter peak) or for certain products	Recent (2021+)	Tighter markets increase power shaping and gas weather balancing risks

Liquidity	Low liquidity in quarterly products means we have to buy seasonal products, exposing us to some risk between quarterly price caps. This can also cause material and undesirable cashflow movements	Recent / enduring	It will be clearer the extent to which this is a temporary or enduring issue after the next winter period. A calmer market may bring an increase in liquidity
Liquidity	Due to low liquidity we cannot trade the correct baseload peak mix during the observation period	Recent / enduring	It will be clearer the extent to which this is a temporary or enduring issue after the next winter period
Demand profiles	Changes to working patterns in Covid may persist and affect demand profiles impacting the allowances. Demand reduction as a result of high prices and energy efficiency could also be enduring	Recent / enduring	After the next winter period we may see demand settling down a little or it may remain difficult to predict
Renewables increase	Increase in renewables means more shaping is required at different times of day and this increases cost	Enduring	
Renewables increase	Increase in renewables means imbalance volumes and cost increases	Enduring	
Economy 7 and other time of use tariffs	Demand profiles were based on single meter profile class 1	Enduring	As discussed above, there is plenty of data on Economy 7 but the impact of other time of use tariffs on demand will have to be learned over time
Increase in volatility	Volatility increases the risk that a fixed percentage allowance is not appropriate and should be replaced by a dynamic one. A lower wholesale price in a volatile market where prices could increase rapidly means the fixed percentage shaping allowance may not cover costs as was shown in period 7, 2021	Recent / enduring	
Increase in volatility	Bid offer spreads have been adversely impacted which drives up transaction costs	Recent could be enduring	

Question 4: 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 consider that the additional wholesale allowance could progress in different stages such that more pressing or complete elements are considered prior to others. The table below sets out a possible sequence with more detail provided in the commentary below.

Element of additional wholesale allowance	Month to begin assessment
UIG	April 2023
Baseload / peak	April 2023
Risk and headroom	April 2023
Data gathering "shadow supplier"	April 2023 to March 2024
Shaping and imbalance ex-post review (winter 2022/23)	RFI issued May 2023
Shaping and imbalance ex ante allowance review	March 2024
Transaction costs ex ante allowance, RFI to include bid offer spread assessment	March 2024

Shaping and imbalance

Were circumstances and outturn costs to highlight material losses or gains after the winter period, it would be appropriate to review shaping and imbalance costs relative to the allowances and consider ex post adjustments. Ofgem's RFI should cover January to March 2023 *in full* both from a cost and volume perspective, which would require the period to be complete and settlement data to be available. We suggest that Ofgem issues its RFI in early May once the data relating to winter 2022/2023 is clearer.

On a longer term basis, in relation to the suitability of the straight percentage ex-ante allowances, it may be premature to assess shaping and imbalance at this stage when there has not been time for the quarterly cap to be fully bedded in.

Ofgem should conduct a wide-ranging review of shaping and imbalance costs that includes collecting data, consideration of the issues and modelling during 2023, but does not need to start the analysis until after winter 2023/2024 when the impact of drivers of change can be assessed more clearly as transient or enduring, and requiring a similar or more sophisticated approach to calculating an allowance.

Transaction costs

Fees for exchanges and OTC trading are available for sharing transaction cost details, however, the impact of bid/offer spreads on costs cannot be estimated retrospectively because we do not retain the data this exercise would require. We suggest that Ofgem could request market wide data from the key trading platforms (Trayport and/or ICE) and consider the trends in recent years in relation to both bid/offer spreads and the availability of price quotes. Further, we believe it would be useful for Ofgem to collect data and assess liquidity/transaction costs for as many quarterly cap periods as possible and ideally include a full, non-transitional winter period e.g. Q4 2023 and Q1 2024.

Baseload / peak percentages

The assumed percentage baseload/peak split in the wholesale allowance has been wrong for many years and we believe is a priority to review. We trade forward for [x<] % peak vs the Ofgem 30% as a result of prior experience. We consider this can be done independently and prior to the consideration of the shaping and imbalance allowances in the cap.

UIG

On UIG, we consider that Ofgem should begin a review of this issue now since the allowance has been too low for a number of years.

Wholesale risk and headroom

In addition, a review of the wholesale risk allowance and headroom could begin now. Early clarity on these allowances would be valuable.

Question 5: 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.

As noted above, we are still in winter 2022-23 and we do not have the data yet to assess if there are any specific issues until the period is over this includes the month of March and also a large amount settlement data. In Q4 2022 we were adversely affected however and were

this position to remain we would welcome an ex-post assessment. We suggest that the RFI waits until after the period is over.

Question 6: Please provide any evidence of whether costs this winter have materially and systematically diverged from the additional wholesale allowances.

As noted above, we would prefer to wait until the winter is over to consider this. In Q4 2022 we did observe a material increase in costs relative to the allowance which so far in Q1 2023 has been partially offset by lower costs from a shaping perspective. However, one month of the quarter remains and weather has the potential to either exacerbate or further mitigate costs. Costs are expected to be lower than our forecast submitted to Ofgem last summer due to a welcome reduction in price volatility which followed a better-than-expected supply/demand balance in both the gas and power markets.

Question 7: 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.

We agree that after next winter, Ofgem should do a more thorough review of the shaping and imbalance allowance including more analytical work to attempt to model costs as a function of spreads and volatilities, with a view to developing more accurate ex ante allowances. As described above, this could mean a fixed percentage is no longer appropriate and a more dynamic allowance that varies with both wholesale price and volatility may be more suitable.

An ex post allowance will only be appropriate if costs have materially diverged from allowances and as we have explained it is too early to assess this.

Question 8: Please provide any evidence of why you would expect costs to diverge from allowances on an enduring basis, including evidence of differences to date

We believe there is a good rationale to consider the impact of the drivers listed in response to Question 3 above on the allowances. As discussed above, we think it would be premature to commence a full review now. However, we continue to believe that a review to develop a more dynamic ex ante allowance is needed. To this end we note that although we have not had excessive costs⁵ in shaping since winter 2021/22, we see quite significant swings between when the allowance is insufficient or over-compensates due to volatility in both price and weather and the interaction of these. This implies that a dynamic approach may be more appropriate than the straight percentage and it is more by chance that the shaping allowance has mostly been adequate. We consider that whilst Ofgem should begin now to collect and assess the costs, it should only consider recommendations after the quarterly cap has had more time to bed in including to see if liquidity in the market adjusts to the new approach to buying energy for most domestic customers.

Question 9: Which of the two outlined approaches do you consider would be most appropriate for a review of enduring issues?

As we have discussed above, we believe that a full scale review is more appropriate which appears to go beyond both Approaches 1 and 2. We consider that Ofgem should work with suppliers and expert advisors to develop an ex ante approach that more appropriately

⁵ As explained above, the outcome for this winter 2022/23 is as yet unknown

estimates shaping and imbalance costs this could mean an allowance that is not a fixed percentage but varies depending on price and volatility. Ofgem should begin to collect data to support a review including on an ongoing basis from now.

The review should include the current elements of Ofgem's model including:

- The cost of shaping peak/baseload seasons to seasonal normal demand and
- cost of adjusting from seasonal normal demand to monthly, then to hourly contracts then to actual demand (eg weather dependent).
- Transaction costs from collecting data on fees and bid/offer spreads
- analysis of actual costs reported by suppliers in response to the RFI; and
- more analytical work to attempt to model costs as a function of spreads and volatility⁶, with a view to developing more accurate ex ante allowances where volatility is reflected. This is particularly the case for imbalance costs where we are unable to split imbalance easily. Our imbalance volumes contain generation, retail domestic, retail non-domestic and also volume corrections from historical periods due to the settlement system. Even separating retail from generation is based on an approximation.

We do not think an interim update to the models is something required urgently since it would still require a significant amount of resource and if the review should conclude a new methodology is needed then a new model would need to be developed.

Question 10: What types of customers should we consider in any review (eg multi-register or PPM)? Please explain why

Since Ofgem is limiting this review to additional wholesale allowances, we do not see strong arguments for differentiating by meter type or by payment method. As noted above, certainly with payment method there are no differences between customers from a shaping, balancing and transaction cost perspective.

Question 11: Are there any other key interactions which you consider could affect the scope of any review? Please explain your answer

In addition to the three interactions Ofgem has mentioned (price cap extension, future operating cost review, headroom), we consider that the EBIT margin review is relevant. In particular, how Ofgem may treat collateral as part of capital employed could have read across to transaction costs.

Furthermore, the current code modification proposals relating to UIG allowance and its application to PPM interact with Ofgem's consideration of PPM and should be taken into account such that the cap appropriately recompenses suppliers.

ScottishPower
March 2023

⁶ We have proposed running a "shadow supplier"