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Sent by email to: Dan.Norton@ofgem.gov.uk; priceprotectionpolicy@ofgem.gov.uk

Dear Dan

Review of additional wholesale costs in the default tariff cap

As Ofgem acknowledges in its open letter of 18 July 2023[1], the scope of this proposed review is unexpected. Ofgem's updated Price Cap – Programme of Work stated that Ofgem may review whether there are "additional wholesale costs incurred over winter 22/23 that are materially and systematically different to the allowances."[2] Ofgem now proposes to extend the review to include April – September 2023, and to investigate the possibility of both higher and lower wholesale costs over this period (compared to cap allowances).

Ofgem should take great care before taking any decision to review these costs, and great care before making any decisions further to any review. Not only is the subject matter under consideration extremely complex (as we explain further below), any review may have important implications for supplier financeability, competition and confidence in the regulatory regime. It is particularly important to consider how any review would be consistent with the Government's aim for the energy retail market to become "More resilient and investable"[3] and Ofgem's Decision on Strengthening Financial Resilience[4].

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[1] Price cap – Open letter on reviewing additional wholesale costs | Ofgem Page 1, paras 1 and 2
[2] Price Cap - Programme of Work: Update | Ofgem Table A1.1
[3] Draft Strategy and Policy Statement, page 23 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1155717/strategy-policy-statement-energy-gb-consultation.pdf
[4] Decision on Strengthening Financial Resilience | Ofgem
These changes in the Government and Ofgem's approach to regulation of the energy retail market have been provoked by the 26 suppliers – serving around 4 million customers – that failed from mid-2021 at significant cost to consumers. As the Government acknowledges in its vision for the future of the energy retail market:
"The cost to consumers of supplier failures in both domestic and non-domestic markets from July 2021 to May 2022… was approximately £2.7 billion, or around £94 per customer bill. These figures do not include the cost of the Bulb Energy Special Administration Regime, which has cost taxpayers £2.8 billion from November 2021 to 31 March 2023."

If Ofgem proposes to take any action subsequent to any review of wholesale costs incurred and forecast between October 2022 and September 2023, it would need to do so on the following basis:

1. **It would need to clearly and fully set out the legal basis for any proposals**, including the interpretation of Section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018. Ofgem has recognised that in the past it has unduly prioritised short-term consumer benefits of switching to lower priced deals over longer-term benefits of investment and supplier resilience. Ofgem's interpretation of Section 1(6) should reflect its change in prioritisation following the Oxera report[5]. If the proposals include "clawback" of alleged over-recovery, we would expect to see analysis as to whether that is legally permissible – in our view, clawback is unlikely to be permissible as a general proposition as it would be in breach of the presumption against retrospectivity[6].

2. **Depending on materiality of any proposals, it would need to undertake and publish a full quantitative impact assessment (IA).** Any such IA would need to consider impacts on supplier finances, commercial incentives, competition and distributional effects between different supplier and customer groups. The IA would need to consider, for example, how the same £ customer allowance would impact different suppliers differently, for example because of their different financial positions and customer mix.

3. **It would need to follow a full and proper consultation process that is appropriate to the circumstances.** Ofgem suggests that this review is urgent. However, the circumstances may be different to previous reviews where there was a significant risk of suppliers being unable to recover their efficient costs and a corresponding risk of further supplier failures. Given the difficulty in separating different costs and probable comparability issues between suppliers and between periods, Ofgem should reveal underlying data and calculations to suppliers' independent advisers via a confidentiality ring.

We elaborate on these points with further examples of questions that Ofgem would need to consider before deciding to proceed with a review, and as part of any review:

a) **The risks that suppliers are reasonably expected to manage, and those that they are not**. We do not believe that it would be Ofgem's intent to compensate suppliers in either direction for variance between consumption forecasts for expected customers compared to actuals, including because of weather. Our position has consistently been that Ofgem is entitled to consider variances in cost that suppliers are unable to manage because of price cap design. The key example of this was customers unexpectedly staying on SVT because of spot wholesale prices being higher than the cap hedge.

b) **Benchmarking.** If any benchmarking is undertaken further to any review, Ofgem should not cherry pick and should consider whether and how to ensure logical and evidential consistency with previous decisions. In its Decision of 4 February 2022[7], Ofgem used a weighted average to calculate additional wholesale allowances. In its Decision of 4 August 2022[8], Ofgem used a lower quartile benchmark. We consistently advocated the

[5] https://www.ofgem.gov.uk/publications/ofgem-publishes-report-its-regulation-energy-market
[6] See, for example, Plewa v Chief Adjudication Officer, [1995] 1 AC 249
[7] Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap | Ofgem
[8] https://www.ofgem.gov.uk/publications/price-cap-decision-possible-wholesale-cost-adjustment

use of the weighted average where suppliers cannot reasonably be expected to manage these costs. Ofgem took a different view in August 2022: Ofgem argued that more efficient suppliers would have lower additional unhedged and unexpected SVT customer costs in periods when spot wholesale prices exceed the cap hedge.

c) **Cost offsets.** Ofgem's updated Price Cap – Programme of Work says that it will "consider cost offsets where appropriate"[9] for any short-term review of additional wholesale costs.

   i. We submitted analysis to Ofgem on 17 December 2021 in response to its first consultation on additional wholesale costs that showed that headroom was more than exceeded by costs not accounted for in cap allowances. We have reminded Ofgem of this submission a number of times, including most recently on 23 June 2023 in our response to Ofgem's Call for Input on the Operating Cost Allowances Review. Ofgem has still not responded to our December 2021 analysis.
   ii. We have made at least five formal representations[10] to Ofgem concerning the material and systematic shortfall in Contracts for Difference (CfD) allowances compared to suppliers' efficient costs. This shortfall in CfD cost recovery is still yet to be resolved.

Backwardation cost recovery

Ofgem is also considering whether to change the backwardation cost recovery period from 6 months to 12 months.

As we communicated to Ofgem on 29 December 2022 and 5 January 2023 in response to the MSC and EBIT consultations respectively, we believe that it is in the best interests of customers for any outstanding backwardation costs to be recovered via a retained MSC. To the extent that this does not happen and suppliers are exposed to backwardation cost recovery risk, it should be included in the risk/working capital calculation within the EBIT allowance. To the extent that the recovery period for backwardation costs is extended, the EBIT allowance would need to increase commensurately.

I hope that this letter is helpful and clear. To reiterate, Ofgem's approach to considering whether a review is necessary and any review itself are important from a supplier confidence perspective. If Ofgem proceeds with any review, it should do so with an open mind. As Ofgem's thinking is at an early stage, this letter must also be read in that light – it represents our initial views and we naturally reserve our rights to respond as we see fit to the forthcoming consultation.

Yours sincerely

Alun Rees
Head of Wholesale and Retail Market Design and Policy

[9] Ibid, Table A1.1
[10] Consultation response 17 May 2022; Letter to Neil Lawrence 7 September 2022; EBIT Consultation response 05 January 2023; EBIT Statutory Consultation response 27 June 2023; Consultation response 28 July 2023