

Ofgem
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23/10/23

Dear Price Cap Team,

We are writing in response to Ofgem's letter updating on the wholesale costs review. The proposals provided in this letter, reflect a fundamental departure from previous wholesale cost reviews, and, if pursued, raise serious concerns about the investability of the sector.

Energy UK and our members support Ofgem's policy of making adjustments to the price cap where *"a change in the costs facing suppliers is material and systematic, considering the market as a whole¹"* and where *"the type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes²"*.

We acknowledge that this could, in principle mean an increase in or an ad hoc adjustment upwards or downwards (subject to the requirements for an alternative approach as outlined below). However, as we move out of the energy wholesale crisis, the tools and mechanisms for adjustments should be clearly proportionate to the task. When Ofgem introduced previous wholesale allowance adjustments, which happened to be increases in allowed recovery, this was clearly the case. These allowances were in response to extreme exogenous events to manage critical market risks arising from the limitations of the existing price cap methodology to account for these very specific events.

The approach outlined in the letter is markedly different. Ofgem's proposed framework is based on attempting to judge a distinction between 'external events' and 'commercial actions'. Ofgem states it will 'most likely' seek evidence of a common perceived 'external event' to justify a wholesale cost adjustment³. Though, the document does not rule out an adjustment being made on the basis of an outcome involving commercial action.

Such a distinction rarely exists, as commercial decisions are normally made with reference to external events (for example, anticipated weather or demand patterns). What such an approach appears likely to amount to is a backwards rationalisation. Ofgem is examining outturn financial results for differences to its forecast allowance and then attempting to "match" those differences to some external events.

¹ Ofgem (2021), Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 4.16. <https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesalevolatility-default-tariff-cap>

² Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

³ Ofgem (2023) Review of additional wholesale costs in the default tariff cap: update <https://www.ofgem.gov.uk/sites/default/files/2023-10/Review%20of%20additional%20wholesale%20costs%20in%20the%20default%20tariff%20cap%20-%20update.pdf>

This is clearly a slippery slope, as Ofgem will constantly be under pressure to repeat the exercise as results vary from forecasts, providing allowances where outturn costs are above the allowance, and claw-backs where they are below. In essence, this creates a rolling 'float and true-up' targeting an outturn margin (without the clear structure a planned 'float and true-up' provides), which will create uncertainty, undermine incentives, and ultimately result in consumer detriment as a result of a less efficient, less investable, market.

Instead, and consistent with past price cap methodology and previous wholesale cost reviews, Ofgem should set out, specifically and up front, what risks the price cap, in combination with external events has created, along with a hypothesis as to how this may have resulted in under- or over-compensation for a notionally efficient supplier.

Where there is no clear hypothesis, no adjustment should be made, as originally intended, outturn costs will differ from the price cap allowance in any given period for both the market as a whole, and for any given supplier, but over time, this should even out.

We do not understand why Ofgem is not examining what a notional supplier's assumed efficient behaviour is in response to an external event.

The exceptionality of the circumstance for an adjustment must be clear and defined transparently. If it is not, then it will contradict previous periods of significant and systematic supplier under-recovery of costs under the price cap, which have notably not led to wholesale cost adjustments. This is despite the centrality of wholesale costs to the price cap allowance and future allowances drawing into the adequacy of previous allowances.

An alternative approach:

We set out 4 key principles that a proposed approach should follow:

- **It should reflect Ofgem's objectives and duties as set out in the Tariff Cap Act**

As stated previously in wholesale cost allowance decisions "*an allowance intended for efficient costs is in customers' long-term interests*".⁴ As a result, we see the proposal for "*placing greater emphasis on customer interests by recovering any over-allowance for a future adjustment*" as inappropriate. It assumes the short-term returns alone represent consumer value and should be the sole concern above recognition of the longer-term value attributable to a stable and resilient energy market.

Such an approach does not explicitly set out to balance the needs of current and future consumers, which is necessary to maximize the consumer value in line with Ofgem's objectives. Doing so would require a balance that gives due regard to a suppliers' ability to recover efficient costs and operate with confidence.

- **Ofgem's approach to wholesale market review should be consistent with past approaches**

In Ofgem's decision on the price cap methodology it states:

⁴ Ofgem (2022) Price Cap – Decision on possible wholesale costs adjustment, <https://www.ofgem.gov.uk/sites/default/files/2022-08/Price%20Cap%20-%20Decision%20on%20possible%20wholesale%20cost%20adjustment.pdf>

“The type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes”⁵

Ofgem is now seeking to change the methodology through this review to move beyond “unforeseen” events.

Further, Ofgem have previously stated as a test for considering changes in the price cap:

“We broadly consider the case for amending the cap methodology against the test of whether a change in the costs facing suppliers is material and systematic, considering the market as a whole”⁶

This means that a change must be clearly systematic in relation to the whole of the market. It is therefore not enough to be a discernible trend through a composition of supplier performance. A retrospective allowance adjustment should be evidenced as an event that effected the whole market.

- **Transparent methodology that is balanced in its applicability**

Suppliers continue to view Ofgem’s data gathering as inadequate to make an appropriate assessment of the costs incurred over the relevant period. Ofgem need to ensure a common basis of supplier costs to minimise issues with separating different costs and the likely comparability issues between suppliers. Ofgem should reveal all underlying data and calculations via a confidentiality ring.

The proposed approach appears to be solely at Ofgem’s discretion because it will provide a view based on commercially sensitive information through an as yet undefined methodology. This creates a clear asymmetry. However, where an external event can alter the appropriateness of the intended allowance materially and systematically it should be possible that suppliers can also propose such changes. They are best placed to recognise them as they occur. We do not necessarily endorse such an approach, as we generally prefer that allowances are not adjusted ex-post except for in reaction to extreme circumstances, however, if Ofgem is minded to lower that bar as appears to be the case, then it should be a more transparent and balanced approach.

- **Should not alter the balance of responsibility for costs in the price cap**

Ofgem’s proposed distinction between commercial actions and external events will lead to a much broader and inclusive definition of assumed notional supplier behaviour which further discourages diversity and competition in the energy market. This will create perverse incentives on suppliers, for example reducing incentives to seek customer value and to instead favour the assumed behavioral model in the price cap.

Suppliers make commercial decisions every day to manage the risk of external events, many of which Ofgem has never suggested would be in scope of a price cap adjustment. For example,

⁵ Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16. <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

⁶ Ofgem (2021), Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 4.16. <https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesalevolatility-default-tariff-cap>

suppliers make commercial decisions to manage wholesale price risk, weather risk, customer behaviour risk and competition risk. The potential cross over between commercial actions and external events in seeking to define a systematic and material unforeseen event will be highly problematic. Ofgem should not need to be more prescriptive of an efficient supplier behaviour to define an external event if this review is consistent with past claims about supplier ownership of risk. The proposed change to an allowance review will alter the dynamic of the price cap where *“each supplier makes their own commercial hedging decisions and does so at their own risk – any incremental profits or losses made will reflect a variance to the expected profit allowance.”*⁷

RFI methodology concerns

We would also highlight that following the RFI putback process, we think there are methodological issues with Ofgem’s approach to collecting and using supplier data for this review. As a result, a number of suppliers have commissioned an external consultancy to review and quality assure their revised RFI input. This will involve a short write up of the consultancy findings for each participating supplier. We think that it is critical for due process that Ofgem fully consider this evidence.

Please do get in contact if you would like to discuss this response further.

Kind regards

Ed

⁷ *ibid*