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Consultation

Reassessing the wholesale allowance in the first default cap period: May 2020 consultation

Publication date:	Monday 18 May	**Contact:**	Anna Rossington
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Response deadline:	Friday 26 June	**Email:**	retailpriceregulation@ofgem.go.uk

We are consulting on our proposals to adjust the default tariff cap in order to retrospectively correct the wholesale allowance in the first cap period. This follows Judicial Review of our decision on the wholesale allowance in the first cap period. We would like views from people with an interest in the default tariff cap. We would also welcome responses from other stakeholders and the public.

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at **Ofgem.gov.uk/consultations**. If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

Contents

Executive summary

Reviewing our decision

In November 2019, the High Court concluded that Ofgem should reconsider the wholesale allowance for the first cap period of the default tariff cap ("the cap"), and make such adjustments as we consider appropriate.[1]

We have concluded that the wholesale allowance in the first cap period was too low. We propose to include an adjustment allowance in the fifth cap period (between 1 October 2020 and 31 March 2021). That will allow suppliers to charge an additional £5.91 per gas customer with typical consumption in the fifth cap period and £1.74 per electricity customer with typical consumption. In annualised terms, our proposed adjustment will increase the published cap levels for gas and electricity by £7.81 and £3.08 respectively.[2]

This statutory consultation sets our proposals and the reasons for them. We explain:

- our reassessment of suppliers' comparable wholesale costs and how those costs were affected by suppliers' historical hedging strategies before May 2018;
- our reconsideration of the wholesale allowance in the first cap period; and
- how we propose to adjust the cap in future cap periods.

Reassessment of suppliers' comparable costs

In our 2018 decision to implement the default tariff cap we considered suppliers' wholesale costs, based on an assumption about a typical supplier's historical hedging strategy up to May 2018.[3] The High Court found that we had not sufficiently tested or explained that assumption and that it was likely wrong. It ruled that we reassess our decision in light of evidence on suppliers' historical hedging strategies.

We have assessed the historical hedging strategies and comparable wholesale costs of the large energy suppliers (British Gas, EDF, Eon, Npower, Scottish Power, and SSE).[4] By May 2018, these suppliers had already purchased a substantial proportion of the energy they

[1] [2019] EWHC 3048 (Admin): https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html
[2] Before Payment Method Uplifts, EBIT, VAT, and headroom, which are percentage figures that we apply to all allowances.
[3] Ofgem (2018), Default tariff cap decision. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview
[4] We discuss suppliers as they were during the first cap period. Since the first cap period, suppliers have consolidated.

would deliver during the first cap period, so they were unable to align with the observation windows we used to the set the wholesale allowance.

The impact on each supplier varies, as each used different historical hedging strategies up to May 2018. However, most of the suppliers had historical strategies that meant their comparable costs exceeded the wholesale allowance in the first cap period and half had comparable costs below the allowance in the second cap period. The impact in the second cap period is minor, so we propose to exclude it from our considerations.

An appropriate allowance

In our 2018 decision, we set the allowance in the first cap period using the standard approach for a winter cap period. In other words, we chose not to include a transitional arrangement in the first cap period.[5] In the light of the evidence provided, we consider that we should have used a transitional arrangement to set the wholesale allowance in the first cap period.

We propose that we should have set the wholesale allowance in the first cap period so that it reflected the weighted average impact that each supplier's historical hedging strategies had on its comparable costs.

An appropriate adjustment

We propose to introduce a new allowance in the default tariff cap methodology: an adjustment allowance. This allowance will increase the level of default tariff cap for a limited time. To adjust for the wholesale allowance in the first cap period, we propose to set the adjustment allowance for one cap period (1 October 2020 to 31 March 2021) at a level that offsets the impact of our 2018 decision on a per customer basis.

Suppliers estimate that they will serve 15% fewer default tariff customers in the fifth cap period than they did in the first cap period (due to customers switching to competitors or cheaper tariffs). 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 account for suppliers' customer losses.

[5] In our September 2018 consultation we stated "In our May [2018] consultation we proposed a transitional arrangement, where we could set the direct fuel allowance for the first cap period using a different observation window from the one we would normally use to analyse forward contracts. We now propose to use our standard approach for a winter cap period"

1. Introduction

What are we consulting on?

1.1. This statutory consultation reassesses the wholesale allowance in the first cap period. We conclude that we should have set the allowance higher to reflect the impact suppliers' historical hedging strategies had on their comparable wholesale costs. We propose to include an adjustment allowance in the fifth cap period to reverse the impact of our 2018 decision.

1.2. We propose to add an adjustment allowance into 'Annex 8 – adjustment allowance' of standard condition 28AD of the electricity and gas supply licences. We publish the changes we propose to make to the licence condition alongside this consultation.

1.3. In this consultation we do not, as a matter of style, ask questions explicitly about each specific aspect of our proposals and methodology. We present our proposals, the reasons and modelling underpinning them, and the issues we have considered. We invite stakeholders to comment on the contents of the consultation, providing their views and evidence as appropriate.

Context and related publications

Context

1.4. We introduced the cap on 1 January 2019, protecting over 11 million customers on standard variable and default tariffs (which we refer to collectively as "default tariff customers"). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.

1.5. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ("The Act"). The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying

efficient costs. In doing so, we must have regard to four statutory "needs", including an efficient supplier's ability to finance its licensed activities.[6]

1.6. The cap comprises several allowances, each relating to different cost categories. We update the level of each allowance every six months, to reflect changes in the underlying costs. The Act requires that we set one cap level for all suppliers.[7]

1.7. To ensure a common understanding of the issues, in Chapter 2 we describe the important points regarding wholesale costs, the wholesale allowance in the default tariff cap, the transition problem, our 2018 decision on the wholesale allowance in the first cap period, and the judicial review of that decision.

1.8. In the subsequent chapters we explain how we have reassessed suppliers' comparable wholesale costs in the relevant cap periods (Chapter 3), reassessed the allowance in the first cap period (Chapter 4), and proposed to adjust future cap periods to correct for the error in the first cap period (Chapter 5). In Chapters 3-5, we also consider stakeholders' views on the challenges we set out in our January 2020 consultation.

Related publications

1.9. The relevant publications are:

- An overview of our 2018 decision: Ofgem (2018), Default tariff cap decision – Overview. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

- A detailed description of our wholesale methodology: Ofgem (2018), Default tariff cap decision – Appendix 4: wholesale costs. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf

[6] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[7] Domestic Gas and Electricity (Tariff Cap) Act 2018; section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

- The High Court's judgement: British Gas Trading Ltd, R (on the application of) v The Gas and Electricity Markets Authority & Ors [2019] EWHC 3048 (Admin) (13 November 2019). https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html

- Our January 2020 consultation on our reassessment of the wholesale allowance in the first cap period: Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation

Consultation stages

1.10. This is a statutory consultation. We invite stakeholders to submit representations on or before **Friday 26 June 2020.** We appreciate that some consultees are focussed on responding to COVID-19. The deadline reflects that we must publish a decision on the proposals in the consultation by the end of July, in order to have effect in the next cap period (1 October 2020 to 31 March 2021).

1.11. We expect to publish a decision on these proposals by the end of July 2020. On 7 August 2020 we will announce the cap levels for the fifth cap period (1 October 2020 to 31 March 2021. That announcement will take account of our decision on these proposals.

How to respond

1.12. We want to hear from anyone interested in this consultation. Please send your response to retailpriceregulation@ofgem.gov.uk on or before Friday 26 June 2020. Please respond to this consultation as fully as you can.

1.13. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.14. You can ask us to keep your response, or parts of your response, confidential. We'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit

permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.15. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we'll get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.16. If the information you give in your response contains personal data under the General Data Protection Regulation 2016/379 (GDPR) and domestic legislation on data protection, the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 1.

1.17. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

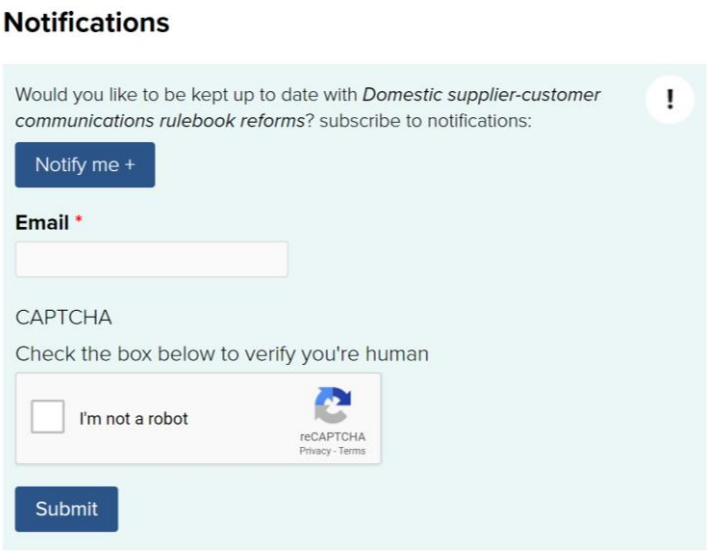
1.18. We believe that consultation is at the heart of good policy development. We welcome any comments about how we've run this consultation. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website. Ofgem.gov.uk/consultations. Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status.



2. The transition problem

In this chapter we describe the important points regarding wholesale costs, the wholesale allowance in the default tariff cap, the transition problem, our 2018 decision on the wholesale allowance in the first cap period, and the judicial review of that decision.

This chapter seeks to ensure a common understanding of the issues.

Introduction

2.1. Stakeholders' responses to our January 2020 consultation showed that they have varying interpretations of the wholesale allowance, the transition problem, and our 2018 decision. In this chapter we explain the key issues in detail, to ensure a common understanding. In Chapters 3 to 5 we respond to suppliers' views, referring to sections of the explanation we provide in this chapter.

Wholesale costs

Wholesale prices vary over time

2.2. Wholesale prices vary over time. Figure 2.1 shows the wholesale price on each trading day between 1 January 2017 and 31 December 2018 for contracts for energy delivered in the first quarter of 2019, January to March ("Q1 2019").

2.3. That variation in wholesale prices can be risky for suppliers. If suppliers purchased all of the energy contracts they needed at the time they needed them (i.e. when their customers consume energy), then their cost would be unpredictable and volatile. They may get a very low price. They may get a very high wholesale price. In the example below, if a supplier purchased all of their energy in September, they would have paid a higher price than at most times in the preceding 24 months. Either way, that volatility would make a supplier unable to ensure that its tariffs reflected the wholesale costs it would incur.

Figure 2.1: Wholesale prices for Q1 2019 gas contracts over time and the average cost for two hypothetical hedging strategies

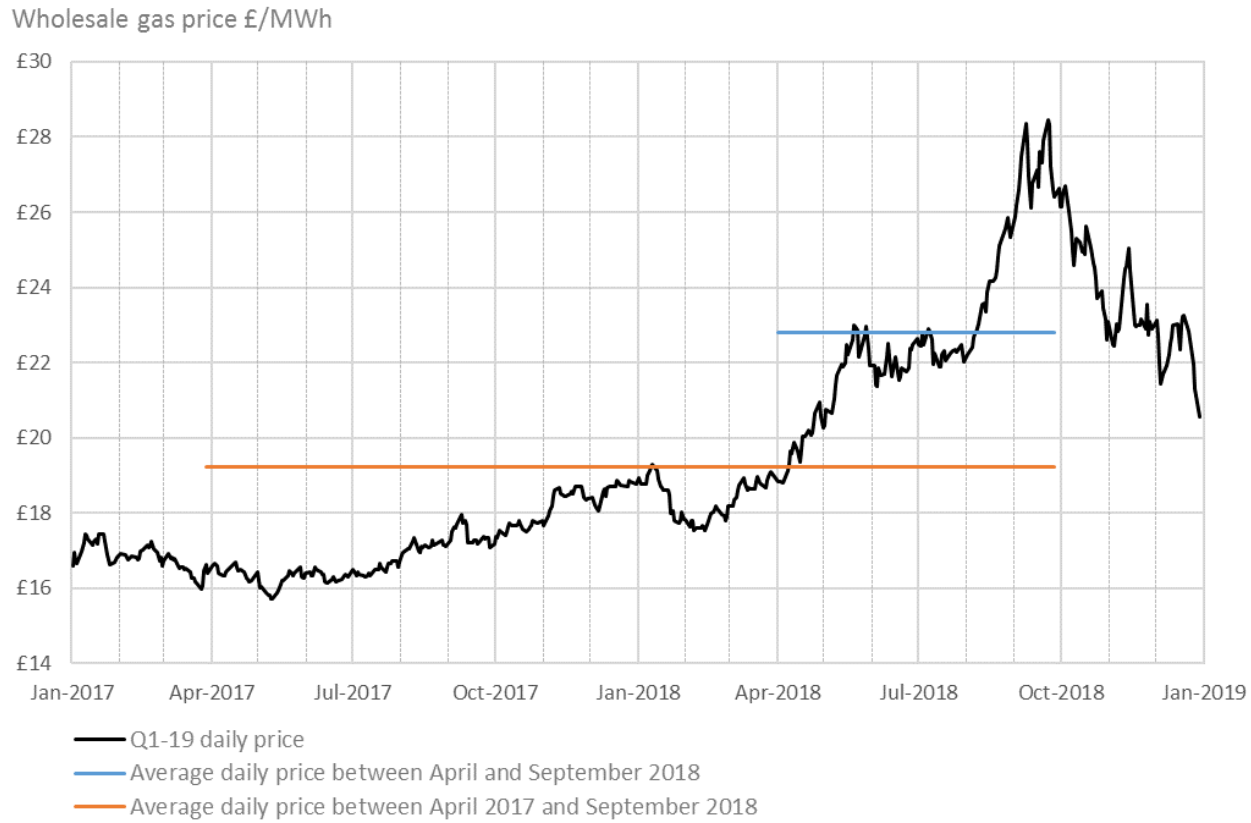
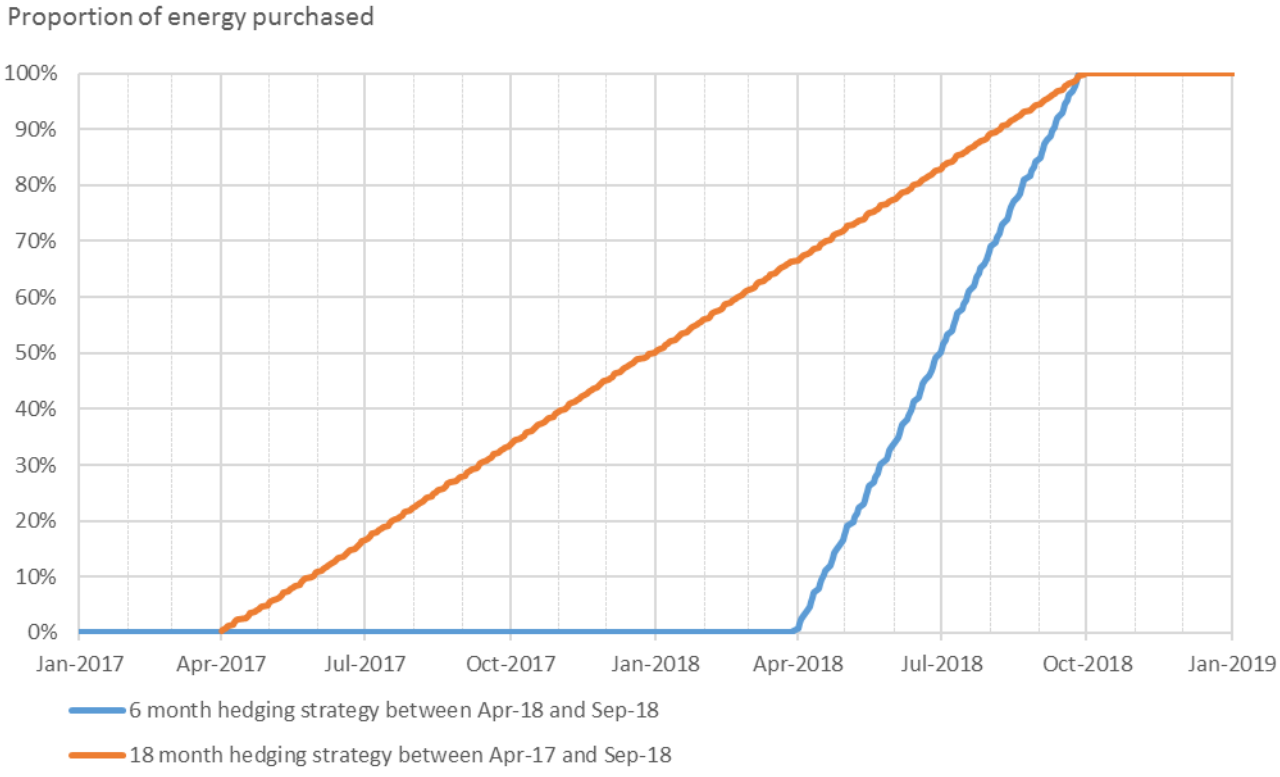


Figure 2.2. Proportion of energy purchased for Q1 2019 using the two hypothetical hedging strategies shown in Figure 2.1



Hedging strategies

Spreading purchases over time

2.4. A supplier can reduce its exposure to volatile wholesale prices. Firstly, it can buy energy contracts in advance. Secondly, it can spread those purchases over time, each day buying a small proportion of the total volume of energy it needs to deliver. Using that approach, a supplier's costs would reflect the weighted average of the wholesale prices it paid for forward energy contracts over the period. This approach makes the wholesale costs a supplier will incur in a future period of time more predictable and more stable.

2.5. A supplier's "hedging strategy" (as we use the term) determines when, and in what proportions, it purchases the energy it needs to deliver in future periods. Figure 2.1 shows the average cost of purchasing gas for Q1 2019 during the six months between April and September 2018 and the average costs during the 18 months between April 2017 and September 2018.

2.6. Figure 2.2 shows how any supplier using one of those two hedging strategies would accumulate its energy needs for Q1 2019. In this example, the six-month strategy is 'shorter' (closer to the point of delivery) and the 18-month strategy is 'longer' (further from the point of delivery).

The movement in wholesale prices

2.7. A short hedging strategy is not necessarily more costly than a long one, it depends on how market prices change. If wholesale prices never changed, then each hedging strategy would incur the same average cost. In that scenario, whenever a supplier purchased contracts, and whatever proportion of its energy needs it purchased, the price per unit of energy would be the same. In reality, wholesale prices change, so it matters when a supplier purchased energy, and what proportion of its energy needs it purchased. Depending on the timing, proportion, and prices, the average cost of its purchases across the period will differ.

2.8. Wholesale prices for Q1 2019 increased dramatically from April 2018, so a shorter strategy for Q1 2019 was more expensive than a longer one. Given the prices shown in Figure 2.1, a hypothetical supplier, Supplier A, using the six-month strategy would have purchased a large proportion of its gas when wholesale prices were high (the

average price during the period was £22.79 per MWh). Another hypothetical supplier, Supplier B, using the 18-month strategy would purchase a much greater proportion of its volume when wholesale prices were lower (the average price is £19.22 per MWh, 6.1% less than for Supplier A). In this case, Supplier B has lower costs than Supplier A. But the reverse would have been true if wholesale prices had *fallen* from April 2018, rather than increased.

Objectives

2.9. Historically, suppliers had different hedging strategies. As a result, no two suppliers had exactly the same wholesale cost for the same period.

2.10. Although suppliers' specific strategies differed, their overarching objective was the same. Before we introduced the cap, suppliers would aim to have relatively stable, predictable, and similar wholesale costs to each other (and therefore, similar hedging strategies to each other). A supplier with a very different strategy to its competitors would risk having very different wholesale costs. That could be a cost advantage. But it could be a disadvantage. If a supplier had higher costs than its competitors it could either pass those costs on to customers and risk losing them to lower-cost suppliers, or absorb the high cost itself. Broadly, the disadvantage of high costs was greater than the advantage of low costs, so suppliers were incentivised to have as similar costs as possible.[8]

2.11. Since we introduced the default tariff cap the suppliers who are pricing at the cap level share a new common overarching objective. They seek to align the profile of their hedging strategies with the observation window of wholesale prices that we use to set the wholesale allowance. This ensures that their comparable wholesale costs reflect the wholesale allowance in the cap.

Other costs in the wholesale allowance

2.12. There are other wholesale costs components in the wholesale allowance of the cap. We include these other components in the allowance to account for shaping costs, forecast error, transaction costs, transmission and distribution losses (or unidentified gas), and

[8] For the avoidance of doubt, suppliers are not allowed to share their hedging strategies. We do not suggest that suppliers co-ordinated their hedging strategies or formally copied each other.

uncertainty. We also provide a cost component in the allowance for Capacity Market costs.

2.13. We are not reassessing these subcomponents. Our approach to these subcomponents of the wholesale allowance was not challenged. In our reassessment of hedging strategies, we must maintain the relationship between the observation window and other allowances that we envisaged in our 2018 decision. Otherwise the methodology will not function as intended. We achieve this by recalculating suppliers' average comparable wholesale costs in £ per MWh *before applying the other allowances* in the wholesale methodology, as set out in Annex 2 to the licence.

The wholesale allowance

The wholesale allowance methodology

2.14. In our 2018 decision we described our methodology for setting the wholesale allowance in the default tariff cap.[9] It has the following major features:

- a six-month observation window of wholesale prices;
- annualised contract prices, to spread out the impact of seasonal prices (high costs in winter and low costs in summer) across the year;
- standardised uplifts for 'shaping', forecast error, transaction costs and transportation losses.

The observation window

2.15. For winter cap periods (which run between 1 October and 31 March the following year), the observation window takes the average wholesale price offered between 1 February and 31 July preceding that winter. For summer cap periods (April to September), the observation window takes the average wholesale price offered between 1 August and 31 January preceding that summer.

[9] Ofgem (2018), Default tariff cap decision – Appendix 4: wholesale costs. https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf

2.16. Suppliers seeking to manage their wholesale costs within the wholesale allowance in the cap should align when, and in what proportions, they purchase energy contracts with the relevant observation window. Figure 2.3 shows how a hypothetical supplier would accumulate the energy it needs to deliver in a winter cap period. Figure 2.4 shows how a hypothetical supplier would accumulate the energy it needs to deliver in a summer cap period.

Figure 2.3: Profile for standard observation window for a winter cap period

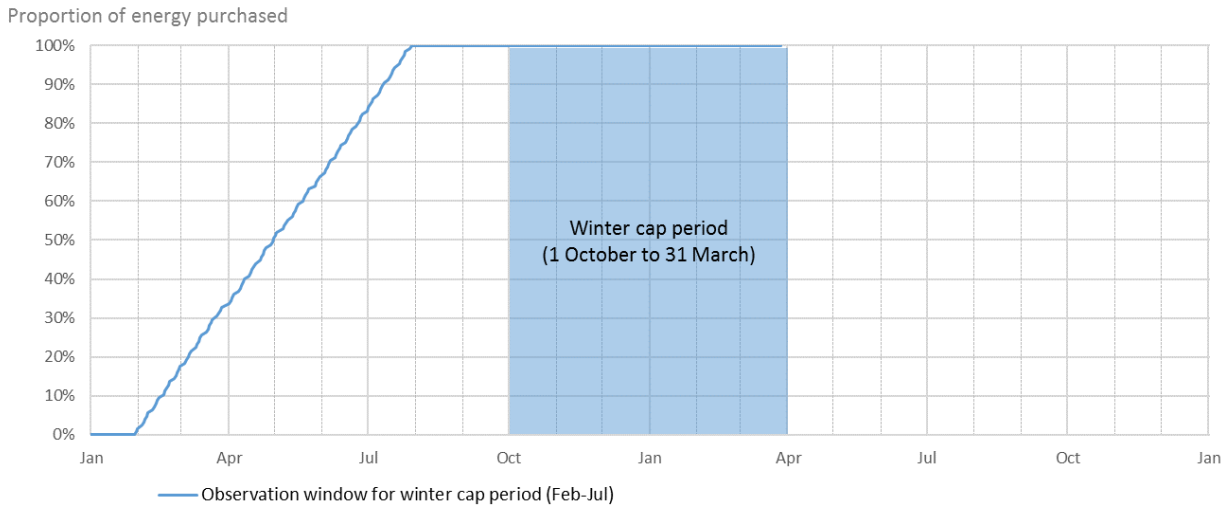
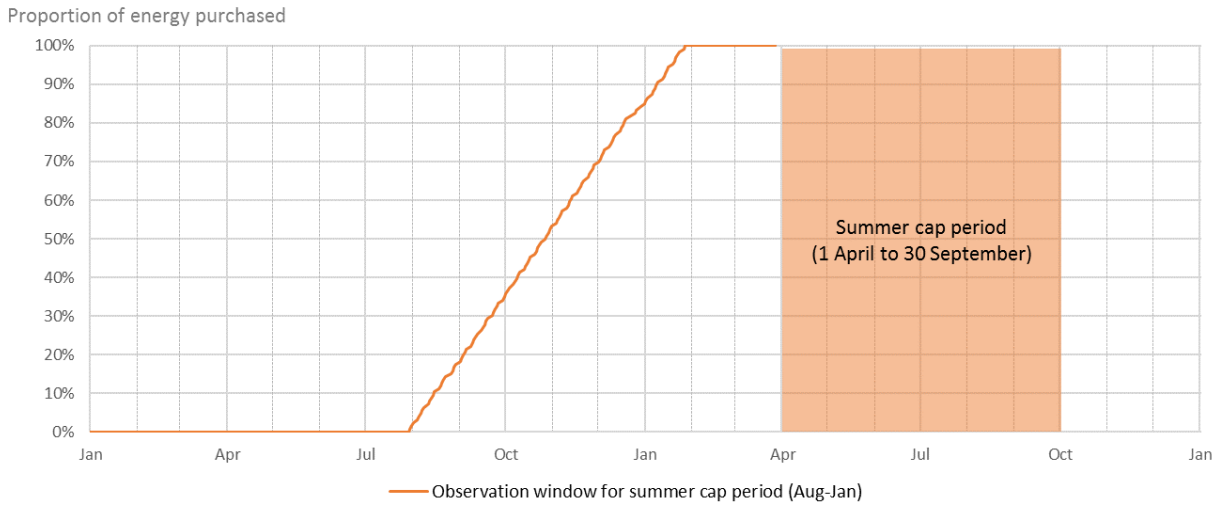


Figure 2.4: Profile for standard observation window for a summer cap period



Seasonal and annualised contract prices

2.17. We adjust the contract prices in the observation window. Wholesale prices are higher in winter than in summer (see Figure 2.5). In our 2018 decision we decided to smooth winter's peak prices and summer's trough in prices into an annualised price. We do this by weighting the contracts for a specific quarter or season, by the other quarters or season in a 12-month period of time. On that basis and by design, the observation window understates costs in winter and overstates them in summer. Before the cap, suppliers charged their customers annualised tariffs.

2.18. Figure 2.5 shows the average price of gas contracts for each quarter for a 12-month period between 1 October 2018 (the start of winter) and 30 September 2019 (the end of the following summer). The annualised price is an average price, weighted by the demand for energy in each quarter.

Figure 2.5: Seasonal prices for gas contracts and the annualised costs (£/MWh)

	Q4 18	Q1 19	Q2 19	Q3 19	Annualised
Average price between 1 February and 31 July 2018	19.20	20.42	15.83	14.96	18.81
Difference between annualised and seasonal price	-0.39	-1.61	+2.98	+3.85	
Consumer demand in the period	33%	42%	17%	8%	100%

Source: Ofgem analysis

Standardised uplifts

2.19. The observation window uses wholesale prices for specific contracts. These are forward contracts for non-granular periods of time. For gas, we observe prices for quarterly contracts, and for electricity we use seasonal contracts (six-month long block of time relating to winter and summer). We observe the mid-point price offered each day of each contract.[10] We do not expect that suppliers would have purchased these contracts. We expect only that the profile of the energy they accumulate follows the observation window profile (so that the timing and proportions of energy purchased reflects the observation window).

[10] Ofgem (2018), Default tariff cap: decision – overview. Appendix 2 - Cap level analysis and headroom. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

2.20. Suppliers will purchase different contracts over time. In particular they will convert non-granular contracts into granular contracts for shorter periods of time. That is because they require granular contracts to match the shape of consumers' demand, but a long time in advance only non-granular contracts are available. These transactions do not affect the amount of energy a supplier has purchased for a quarter, only the 'shape' of where they allocate that energy within the quarter. The overall volumes are the same. When a supplier is closer to the point of delivery they may not purchase the non-granular contracts at all.

2.21. To account for shaping costs we combine a single standardised percentage uplift to the weighted average price of the contracts in the observation window. This is not a hedging strategy, but sets an overall allowance that suppliers should be able to manage their cost within.

2.22. In addition, suppliers will also buy and sell granular contracts as their estimate of consumers' energy demand changes. For instance, in a cold winter, a supplier may need more energy than it normally would at that time of year. In a mild winter it may need to sell off excess energy. These adjustments come at a cost as suppliers tend to buy and sell at the same time (as the weather affects each supplier).

2.23. To account for forecast error we set the wholesale allowance using a fixed level of demand (Typical Domestic Consumption Value) and a standardised uplift for forecast error based on average variation from seasonal normal.

2.24. We calculated the standardised uplifts for shaping and forecast error together as the activities are difficult to disentangle and it is unnecessary to do so. We disclosed the model of this uplift alongside our September 2018 statutory consultation.[11] The key point is that the model reflects average long run costs of shaping and forecast error. In specific cap periods, suppliers' actual experience will differ.

2.25. We include other standardised uplifts for transaction costs and transportation losses. For losses, suppliers purchase energy from electricity generators but some of that is lost in transmission and distribution. Similarly for gas, customers receive less gas than

[11] Ofgem (2018), Default tariff cap: September 2018 consultation. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-overview-document

suppliers purchase, due to leakages among other things. In the allowance we apply a standard uplift to account the average level of loss. For each supplier, their losses may be above or below average.

The relationship between comparable wholesale costs and accounting costs

A series of allowances

2.26. In any single cap period, the wholesale allowance will not match a supplier's accounting wholesale costs in that cap period. The wholesale allowances work in series, not in isolation. Over multiple cap periods, a supplier's aggregate accounting costs over those periods should reflect the aggregate wholesale allowances.

2.27. This is a deliberate outcome of the methodology that we consulted on and published in our 2018 decision. Below we set out the principal reasons for this approach: seasonal prices; the costs of shaping and forecast error; and other costs, such as losses.

Seasonal prices

2.28. A supplier's accounting costs are seasonal. Contracts for the energy it delivers in winter are more expensive (per unit of energy) than contracts for the energy it delivers in summer. We decided that the wholesale allowance should use annualised prices – smoothing winter's peak prices and summer's trough in prices across the year (see paragraphs 2.17 to 2.18 above).

2.29. The impact of this annualised approach is that a supplier will only partially recover its accounting costs in winter. However, its accounting costs in the following summer will be lower than the wholesale allowance for that period. It will over-recover its accounting costs in that period. All else being equal, over the year, its combined accounting costs should reflect the combined allowances.

2.30. On this basis, we can never compare the wholesale allowance (stated in annualised terms) to a supplier's accounting costs in the same period (which are stated in seasonal terms). Any comparison needs to consider the cost of the energy a supplier has purchased in comparable annualised terms.

2.31. It is also important that the wholesale allowance in every cap period maintains the same relationship with accounting costs. If, for example, we set the first allowance (over three months of the winter period) in line with accounting costs and subsequent

allowances with annualised costs, then customers would be overcharged. They would pay for the high seasonal cost of that energy in the winter period, and then pay for a portion of the seasonal winter price again in the summer period. For this reason, we compare the allowance to "comparable wholesale costs" rather than accounting costs, and each cap period must use a consistent treatment.

Shaping and forecast error

2.32. We set the standardised uplift of shaping and forecast error using a standardised assessment of the average impact. In some cap periods the cost to suppliers will be higher, in other periods it will be lower (or even a benefit). In the long run the average impact is a net cost in line with the uplift we allow for (see paragraphs 2.19 to 2.25).

2.33. As with seasonal costs, this uplift means that we cannot compare suppliers' accounting costs in a cap period with the allowance in that period. We must also be consistent across cap periods as the allowances recover these costs in series, not in isolation. Using a different approach would lead to suppliers under-recovering or customers being undercharged.

The transition problem

Suppliers unable to align

2.34. In a 'normal' cap period, a supplier adopts a hedging strategy so that it accumulates energy for the forthcoming cap period at the same time and in the same proportions as the observation window in the wholesale allowance for that cap period. If the supplier aligns the profile of how it accumulates energy with the observation window, then its wholesale costs will reflect the wholesale allowance *in the way we intended*.

2.35. When we were designing the cap, there were two reasons a supplier might have been unable to align with the observation windows in the cap.

- "Retrospectivity": If the observation window, or a portion of it, is in the past and a supplier had not purchased contracts at the same time and in the same proportions as the profile in that historical portion of the observation window, then its comparable costs would be misaligned. That supplier cannot go back in time and purchase energy at the relevant time in the relevant proportions. All it can do is purchase the relevant proportion of contracts at the current market

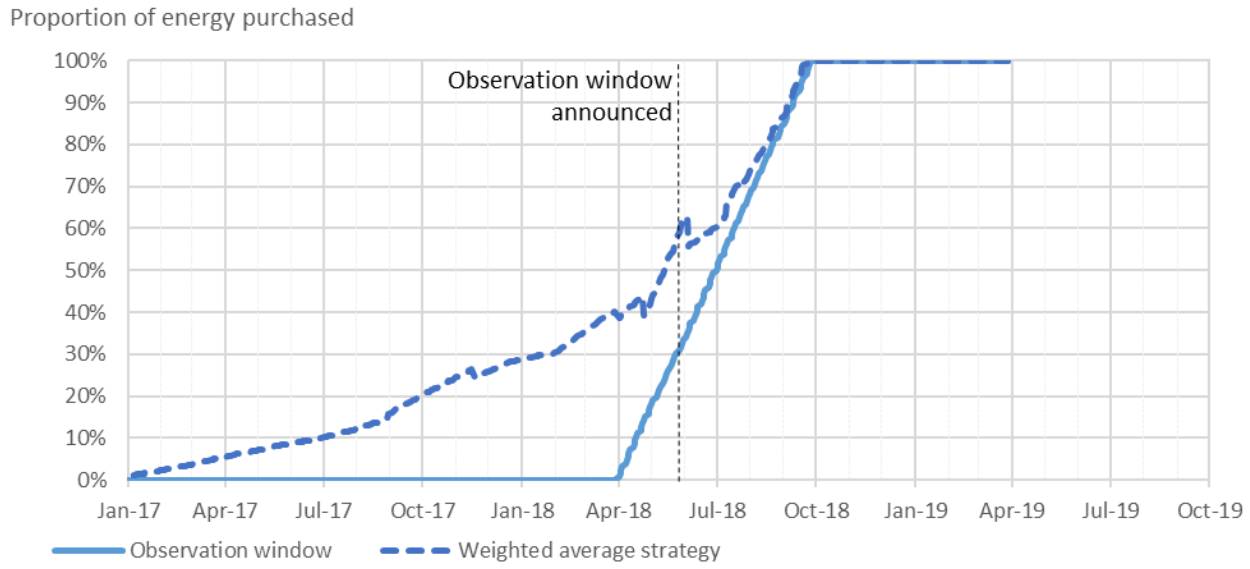
price, which may be higher or lower than the average cost in the observation window. This problem was consistently highlighted by one stakeholder throughout our consultation process on the default tariff cap.

- "Historical hedging strategies": If a supplier had already purchased energy for delivery in a cap period at a time, and in proportions, not included in the observation window, then that supplier would also not be able to align its hedging strategy with the observation window. It could not go back in time and not purchase contracts it already holds. It could hold onto those contracts, which may be cheaper or more expensive than the corresponding volumes in the observation window. Alternatively, it could sell those contracts at the current price, which may be lower or higher than the average price it paid. That loss or gain on sale is part of its cost to serve. Either way, its comparable costs would not align with the allowance.

2.36. Figures 2.6 and 2.7 shows suppliers' weighted average historical hedging profile for their energy needs in the first and second cap periods compared with the observation windows we announced for those cap periods on 23 May 2018. It is clear that the 'retrospectivity' issue applied to the first cap period only; when we announced the observation window on 23 May 2018, two months of that April-September observation window were already in the past. For the second cap period (and any subsequent cap periods) the observation window was in the future.

2.37. The 'historical hedging strategies' issue applied to *any* cap period where suppliers had already, by May 2018, purchased a significant proportion of the energy they would deliver in a forthcoming cap period. Figures 2.6 and 2.7 show that, by 23 May 2018, suppliers, on average, had already bought a substantial proportion of the energy they would deliver in the first two cap periods. They purchased that energy at prices that differed from those in the observation windows.

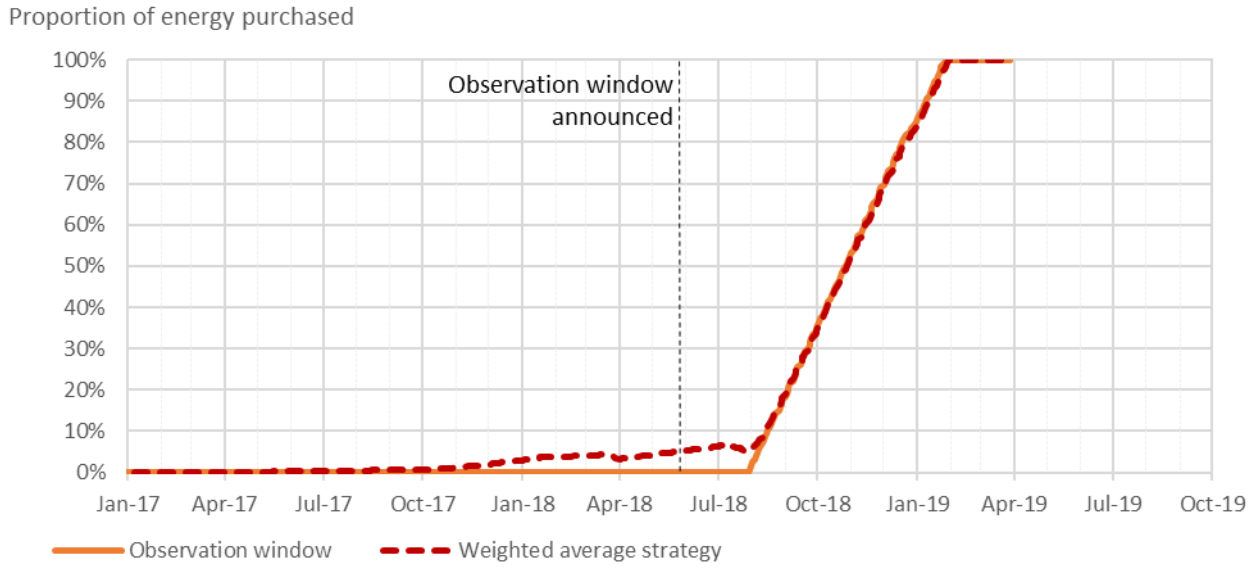
Figure 2.6: The observation window and proportion of energy purchased by suppliers for the first cap period (weighted average volumes)



Source: Data provided by six large suppliers in February and March 2020.

Notes: Each supplier has a different strategy. This profile is the average proportion of each suppliers' energy needs that had been purchased up to that day, weighted by market share of default tariff customers.

Figure 2.7: The observation window and proportion of energy purchased by suppliers on average for the second cap period



Notes: See Figure 2.6

2.38. Under the Act, we had to set a single wholesale allowance for all suppliers.[12] This was a challenge when suppliers were unable to align to the observation window in the allowances, and were misaligned to different extents. Each supplier would incur costs that differed from each other, which would not necessarily result from inefficiency. As a consequence, a single wholesale allowance would never reflect each suppliers' costs and those suppliers would not be able to adjust their costs to reflect the allowance.

2.39. We called this challenge "the transition problem". It was an unavoidable outcome of transitioning from a pre-cap regime (when suppliers had pre-existing and different purchasing strategies) to a capped regime (when each supplier could follow the single pre-arranged hedging profiles in the wholesale allowance). In our September 2018 consultation we explained that "we considered, but do not think it justified, delaying the cap, as suggested by some suppliers. Some suppliers hedge a very long time in advance, so even a cap introduced in April 2019 would risk that suppliers under- or over-recover their costs due to contracts they had already purchased. Although it might mitigate the effect, it would substantially delay protection to customers, the objective of the Act."[13] In other words, suppliers' historical hedging strategies meant that the impact of the transition problem was not limited to the first cap period, so we could not wait until the transition problem had passed. We had to protect customers as soon as was practicable after the Act was passed.

Our 2018 decision on the allowance in the first cap period

Considering transitional arrangements

2.40. In March 2018, we published a working paper on how we might design the wholesale allowance. We suggested that we might adopt the methodology already used to calculate the wholesale allowance in the PPM cap. We said that suppliers could match the hedging profile implied by the index (observation window).[14]

[12] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 2(2)(b) http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[13] Appendix 4, paragraph 4.20, Ofgem (2018), Default tariff cap September 2018 consultation https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_4_-_wholesale_costs.pdf
[14] Ofgem (2018), Working paper #1: setting the default tariff cap, paragraph 5.32. https://www.ofgem.gov.uk/system/files/docs/2018/03/working_paper_1_-_design_issues_-_for_publication.pdf

2.41. We outlined reasons why we might need to change the index (observation window), including "transition". We described the problem caused by historical hedging strategies, stating "many suppliers purchase a significant proportion of their customers' energy a long period in advance of delivery. This implies that some companies may have already purchased some energy for customers on default tariffs in 2019." In addition, we described the 'retrospectivity' issue, stating "similarly, using the existing model to set a cap to be in place for the end of 2018 would involve indexing the cap to observations of wholesale prices prior to the design being formally confirmed in the final licence condition. We will consider any implications of this for the design of the cap."[15]

2.42. In our May 2018 consultation, published on 23 May 2018, we proposed how we might set the observation windows in the wholesale allowance. As suggested in our working paper, we proposed to use the approach used in setting the PPM cap. For winter cap periods, we would index to an observation window of wholesale prices between 1 February and 31 July preceding the winter. We would index a summer cap period to an observation window of prices between 1 August and 31 January (see paragraphs 2.15 to 2.16 above).

2.43. We also proposed a transitional arrangement, adjusting the observation window in the first cap period, which we intended to mitigate the impact of the transition problem. That transitional arrangement would use an observation window between 1 April and 30 September 2018, increasing the proportion of the observation window that was still in the future at the point of publication. Our proposed observation window (April-September) reduced the impact of the 'retrospectivity' issue compared with the standard observation window for a winter cap period (February-July).

Reassessing our May 2018 proposal

2.44. In our September 2018 consultation, we proposed to set the first cap period using the standard observation window for a winter cap period (February-July).[16] In other words,

[15] Ofgem (2018), Working paper #1: setting the default tariff cap, paragraph 5.33. https://www.ofgem.gov.uk/system/files/docs/2018/03/working_paper_1_-_design_issues_-_for_publication.pdf

[16] Ofgem (2018), Default tariff cap September 2018 consultation https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_4_-_wholesale_costs.pdf

we scrapped the transitional arrangement we had proposed in May. We did not assume that any supplier had actually purchased energy using a strategy that aligned to the February-July observation window. We assumed that the standard observation window would set an allowance in the first cap period that better accounted for the impact of the transition problem than the transitional (April-September) observation window would have done.[17]

2.45. We estimated that the April-September observation window did not mitigate the impact of the transition problem; in fact we estimated that it was likely worse than the standard observation window (i.e. having not transitional arrangement at all). Wholesale prices had increased substantially and persistently since April 2018. Contracts purchased before May 2018 would have been substantially cheaper than the prices in the observation windows. We considered that, on average, suppliers' historical hedging strategies (that they used before May 2018) would mean that their comparable wholesale costs would be substantially less than our May proposals allowed for. We considered that customers would be significantly overcharged if we maintained our transitional arrangement.

Our 2018 decision on the wholesale allowance in the first cap period

Our decision

2.46. In our 2018 decision, we chose to set the wholesale allowance in the first cap period using the February-July observation window (i.e. the standard approach for a winter cap period and not a transitional arrangement).

2.47. We estimated that a supplier with a 'typical' historical hedging strategy would have comparable costs in the first cap period slightly below the allowance we had proposed for that period. We also concluded that each supplier's comparable costs would vary around that average depending on their historical hedging strategy. Some suppliers would partially recover their comparable costs. Others would over-recover them.[18] In

[17] Ofgem (2018), Default tariff cap September 2018 consultation, Appendix 4, paragraphs 4.1-4.21. https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_4_-_wholesale_costs.pdf.
[18] In paragraph 3.165 of Appendix 4 to our November 2018 decision. In paragraph 4.19 of our September 2018 consultation we considered this variation would be inevitable. Ofgem (2018), Default tariff cap: decision – overview. Appendix 4 - Wholesale. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

our 2018 decision we acknowledged that one supplier had said that the allowance in the first cap period was below its costs.[19]

2.48. In addition, we estimated that a supplier with a 'typical' historical hedging strategy before May 2018 would have comparable wholesale costs in the second cap period that were below the allowance for that period. We stated "if a supplier had less favourable costs *in the first cap period* than one using a typical [historical hedging] approach, then we should consider how the second cap period might mitigate this. The second default tariff cap period will start in April 2019. Our May and statutory consultations proposed that we would set the allowance for the second cap period using an observation period between August 2018 and January 2019. That allowance will be higher than the costs of any supplier that used a typical 18-month observation period before we published our consultation in May 2018, as they would have already purchased some of the energy in advance."[20]

2.49. We did not consider the impact of historical hedging strategies on subsequent cap periods, as we assumed the impact to be minor, if any.[21]

2.50. Taking the impact of a 'typical' historical hedging strategy on a supplier in the first two cap periods together, we considered that using the standard observation window for the first cap period was appropriate. We concluded that a transitional arrangement in the first cap period was not needed to mitigate the impact of historical hedging strategies.

2.51. Note that we concluded that the average, or typical, supplier would have costs just below the allowance in the first cap period and below the allowance in the second period. The implication of that analysis in our 2018 decision was that we should have set a transitional arrangement in the first cap period that was *lower* than the wholesale

Ofgem (2018), Default tariff cap September 2018 consultation, Appendix 4. https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_4_-_wholesale_costs.pdf

[19] Ofgem (2018), Default tariff cap: decision – overview. Appendix 4 – Wholesale, para 3.154. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

[20] Ofgem (2018), Default tariff cap: decision – overview. Appendix 4 – Wholesale, para 3.166. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

[21] For example, a simple 18-month strategy for the third cap period (winter 2019-20) would start in April 2018, just before our May consultation and after we published working paper.

allowance we set using the February-July observation window. That would account for the average comparable costs we estimated.

2.52. We had not proposed a lower transitional arrangement in our September 2018 consultation and did not consider that we could introduce one in our decision. We considered our decision to be a binary choice between the two proposals we had consulted on. In addition, our estimate of typical costs was only approximate. Maintaining a net benefit in the second cap period provided insurance to guard against the risk that actual comparable costs in the first cap period were higher than we had assumed.

2.53. In this reassessment it is now possible to set a new and accurate transitional arrangement, based on the actual impact that historical hedging strategies had on suppliers' comparable costs. In light of the evidence we now have, we consider that an accurate transitional arrangement in the first cap period would have been higher than the allowance we set.

Estimating the impact of the transition problem

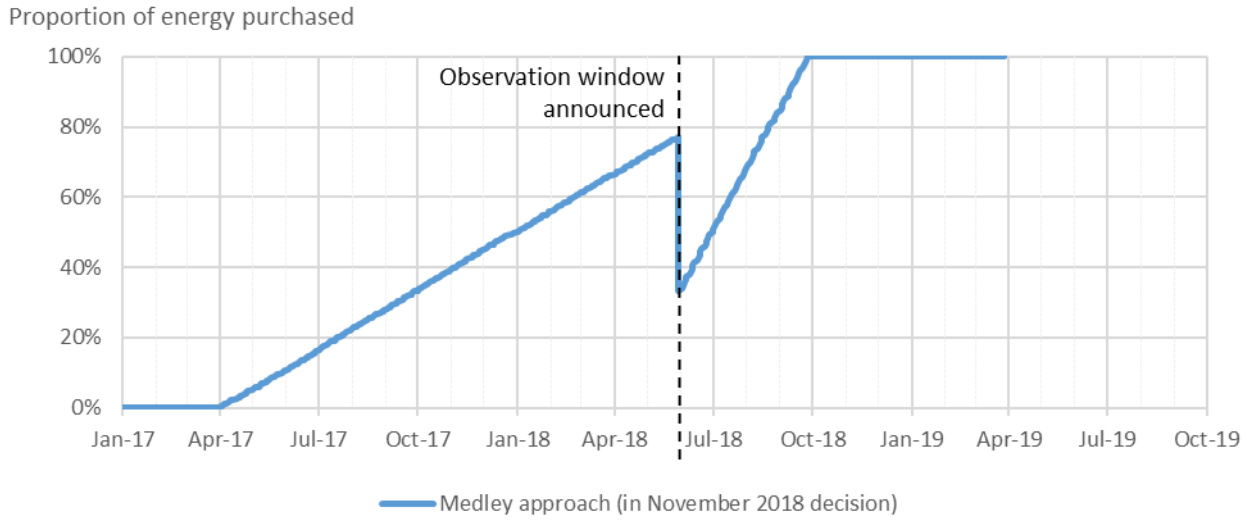
2.54. In our 2018 decision, we estimated the impact of historical hedging strategies on the first cap period, by calculating comparable costs for a notional 'typical' supplier with an 18-month hedging strategy up to May 2018. A supplier would only be able to follow the proposed observation windows after May 2018.

2.55. We estimated a 'typical' supplier's comparable costs by applying the observation window in reverse – matching the timing and proportion of volumes in the wholesale allowance methodology to a 'typical' supplier's historical hedging strategy pre-May 2018, and only using the published observation windows after May 2018. We called this representation of a 'typical' hedging strategy "the medley approach" (an 18-month strategy up to 24 May 2018 and the observation windows thereafter). Figure 2.8 shows how the medley approach would accumulate volumes for the first cap period.

2.56. Our decision maintained all other aspects of the wholesale methodology (contracts, prices, annualised prices, and the standardised uplifts were treated as normal – see paragraphs 2.14 to 2.33). So, if the medley approach reflected the average hedging strategy suppliers had used, then our estimate reflected their average comparable costs.

2.57. We did not estimate a typical supplier's accounting costs. In paragraph 3.164 of our 2018 decision on wholesale costs, we explained that "actual costs" referred to suppliers' comparable wholesale costs, not their accounting costs. We highlighted two main reasons for this: the treatment of seasonal wholesale prices, and the 'shaping' costs of converting non-granular contracts into granular ones. We estimated typical actual costs using the wholesale allowance methodology and our estimate of a 'typical' historical hedging strategy in the place of the observation window. In effect, that estimated a wholesale allowance for a supplier with a 'typical' accumulation of energy for the first cap period, not typical accounting costs for that period.

Figure 2.8: The medley approach for the first cap period



Reassessing the historical hedging assumption

2.58. British Gas challenged our 2018 decision on the wholesale allowance in the first cap period. It successfully demonstrated that our "Hedging Assumption", regarding a 'typical' historical hedging strategy (when, and in what proportions, suppliers had typically purchased energy before May 2018) was not based on what suppliers actually did, had not been tested with suppliers, and was likely inaccurate. The Court ruled that we must reconsider the wholesale costs allowance we set for Q1 2019 in the light of the information that we now have (on suppliers' actual hedging strategies before May 2018), and such other information as we consider appropriate, and make such adjustments to that allowance as we consider appropriate in the light of that reconsideration.

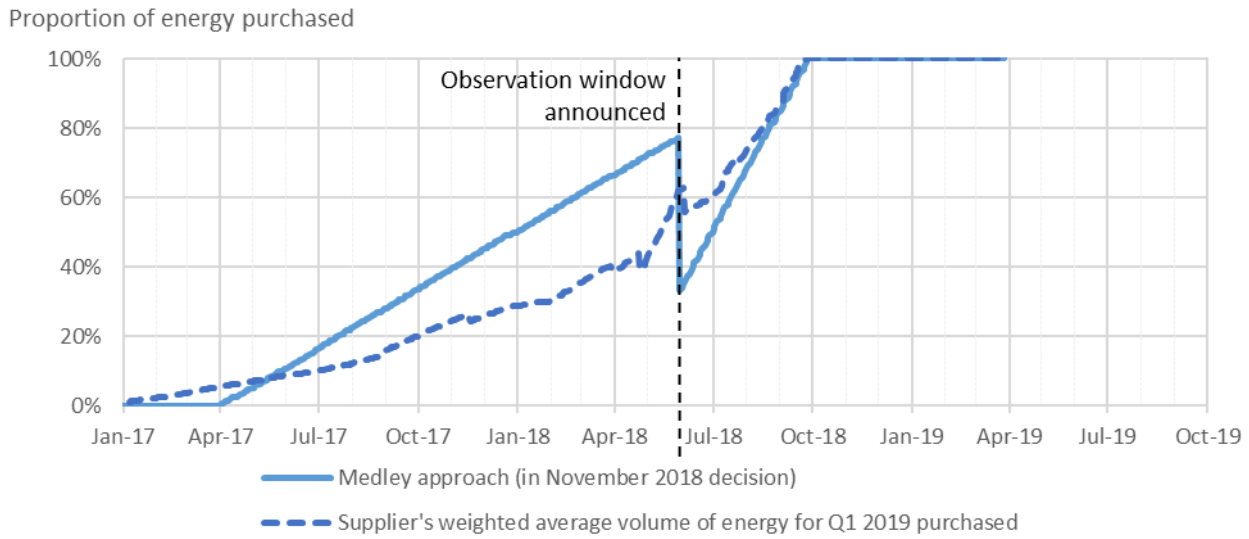
2.59. We have collected evidence from suppliers on their actual historical hedging strategies before May 2018. The strategies differ, but we discuss their average profile below for explanatory purposes.[22]

2.60. Figure 2.9 shows suppliers' average hedging strategy compared with the medley approach we assumed in our decision. It is clear that, on average, suppliers' historical hedging strategies before May 2018 prevented them from aligning with the observation windows in the wholesale allowances. However not to the extent we assumed. Therefore, the impact suppliers' historical hedging strategies had on their comparable costs in the first cap period differed from what we anticipated in our 2018 decision.

2.61. On that basis, we now consider that the allowance in the first cap period likely did require a transitional arrangement, in order to account for the impact of suppliers' historical hedging strategies, although not necessarily the April-September observation window we had proposed in May 2018.

2.62. In Chapters 3 to 5 we explain the key points and judgments in our reassessment of the wholesale allowance in the first cap period. We conclude that we should have set a transitional arrangement for the wholesale allowance in the first cap period.

Figure 2.9: Suppliers' average historical hedging strategy's impact on alignment with the first observation window



[22] As discussed in paragraphs 2.4 and 2.5 above, each supplier accumulated its energy needs over time. Our 'average hedging strategy" is the weighted average of each supplier's volume profile on each day.

3. Assessing suppliers' comparable wholesale costs

In this chapter, we analyse the impact of each relevant supplier's historical hedging strategies on its comparable wholesale costs.

Stakeholders should consider our proposals and explain the reasons why they agree or disagree with them as fully as they can.

Summary of proposals

3.1. For each supplier, we have calculated comparable wholesale costs using their historical hedging strategies. We did so using data from each supplier on their hedging strategies and the actual volumes of energy they accumulated over time.

3.2. Suppliers' comparable wholesale costs varied extensively. Due to the historical contracts they purchased before May 2018, each supplier was unable to align to the observation window for the first cap period, and half were unable to align to the observation window in the second cap period.

3.3. We conclude that we should have used a transitional arrangement to set a wholesale allowance in the first cap period that was higher than the wholesale allowance we chose, and less than the transitional arrangement we had proposed in our May consultation. In Chapter 4 we discuss at what level we should have set the wholesale allowance in the first cap period.

3.4. For our assessment of suppliers' comparable costs we propose to:

- restrict our analysis to large domestic energy suppliers that seek to follow the observation windows in the wholesale allowance (in practice, this means the 'six large suppliers' only);
- analyse the impact that these suppliers' historical hedging strategies (that were in place up to May 2018) had on their comparable wholesale costs in the first two cap periods, but not subsequent cap periods; and

- analyse these suppliers' wholesale costs in comparable terms to the wholesale allowance, not their accounting costs.

3.5. Below, we explain our assessment of the suppliers' comparable costs, and how they compare to the wholesale allowances in the cap. We also respond to stakeholders' views on the three analytical challenges we explained in our January 2020 consultation.[23] Below we discuss:

- our assessment of suppliers' comparable wholesale costs;
- which suppliers we include in the scope of our analysis (challenge 1);
- which cap periods we propose to consider when reassessing the allowance in the first cap period (challenge 2); and
- how we ensure that our cost estimates are comparable with the wholesale allowance (challenge 3).

Our reassessment of suppliers' comparable wholesale costs

Overview

3.6. For each supplier, we have calculated comparable wholesale costs using their historical hedging strategies. We have collected data from each supplier on their hedging strategies and the actual volumes of energy they accumulated over time.

3.7. Suppliers' comparable wholesale costs varied extensively. Due to the historical contracts they purchased before May 2018, each supplier was unable to align to the observation window for the first cap period, and half were unable to align to the observation window in the second cap period.

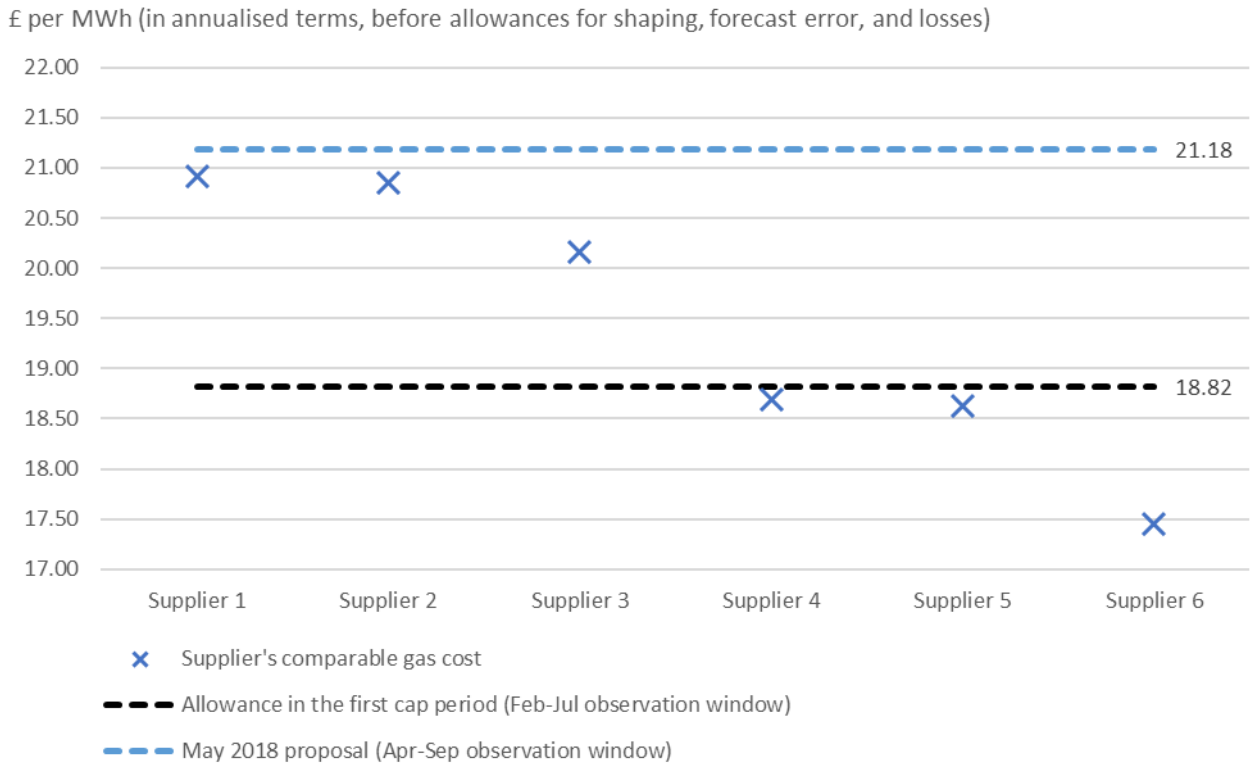
[23] Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation

Suppliers' comparable costs in the first cap period

3.8. Figures 3.1 and 3.2 show each supplier's comparable wholesale costs in the first cap period per unit of gas and electricity compared with comparable wholesale price in the wholesale allowance (stated in annualised cost per MWh before applying the standardised uplifts for shaping costs, forecast error, and other factors such as transmission losses).

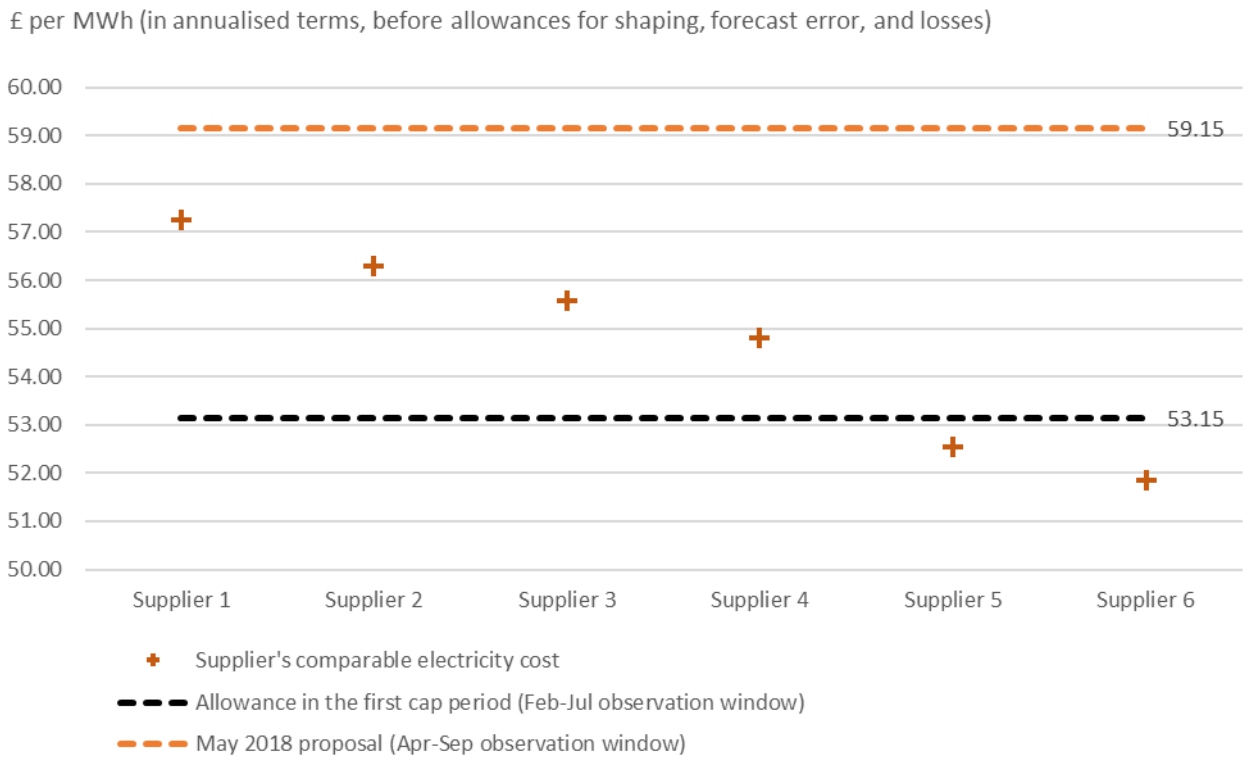
3.9. Three of the six suppliers had comparable gas costs above the allowance. Four of the six suppliers had comparable electricity costs above the allowance. The extent of the variation depends on each supplier's historical hedging strategy. Those who purchased the most energy before May 2018 have the lowest costs. Those who purchased the least energy before May 2018 have the highest costs.

Figure 3.1: Suppliers' comparable gas costs in the first cap period



Note: We order suppliers' costs by size for each fuel separately. "Supplier 1" for gas costs is not necessarily the same supplier as "Supplier 1" for electricity costs.

Figure 3.2: Supplier's comparable electricity costs in the first cap period



Note: We order suppliers' costs by size for each fuel separately. "Supplier 1" for electricity costs is not necessarily the same supplier as "Supplier 1" for gas costs.

Suppliers' comparable cost in the second cap period

3.10. Three of the six suppliers were aligned with the observation window (Aug-Jan) for the second cap period. They had not purchased energy for summer 2019 before May 2018. The other suppliers had purchased energy for summer 2019 using their historical hedging strategies up to May 2018. Their costs were below the allowance in the second cap period, but one supplier was only marginally so. The amount of the energy these suppliers purchased before May 2018 was much less than they purchased for the first cap period, so the extent of the difference between their comparable costs and the allowance in that period is less.

The total impact of the transition problem

3.11. In our 2018 decision we considered whether to set the allowance in the first cap period using the standard observation window, or a transitional observation window. In either case we did not consider that suppliers would have purchased energy in line with the relevant observation window. We considered whether the allowance set using either window would approximate suppliers' comparable costs, taking into account the impact of the transition problem (in total).

3.12. In the light of the evidence provided, neither of the policy options we considered in our 2018 decision (the February-July observation window and the April-September observation window) reflected suppliers' comparable wholesale costs. Most suppliers had comparable costs above the first cap period wholesale allowance due to their historical hedging strategies. All suppliers had comparable costs substantially below the transitional arrangement we had proposed in our May 2018 consultation.

3.13. We conclude that we should have set a new transitional allowance in the first cap period to account for the impact of the transition problem. In Chapter 4 we consider at what level we should have set the allowance in the first cap period in the light of evidence on how suppliers' historical hedging strategies affected their comparable wholesale costs.

Challenge 1: suppliers in scope

Options

3.14. In our 2018 decision we considered the likely impact of our decision on the six largest standard variable tariff (SVT) suppliers at that time, who we believed would serve 90% of all default tariff customers in the first cap period. We considered that smaller suppliers' costs would not affect our decision.

3.15. In our January 2020 consultation we proposed to adopt the same approach. However, we noted that one supplier, Bulb, had grown rapidly. By the definition we used in our 2018 decision, Bulb was a large supplier of customers with SVTs in the first cap period. We consulted stakeholders on whether or not we should include Bulb in our assessment of costs.

Our proposal

3.16. We propose to restrict our analysis to large domestic energy suppliers that aim to follow the observation windows in the wholesale allowance. In practice, this means we

assess the costs of six large suppliers only (British Gas, EDF, Eon, Npower, Scottish Power, and SSE).[24] We exclude Bulb and small suppliers from our analysis.

Rationale for excluding small suppliers

3.17. In our 2018 decision, we concluded that we would not increase the wholesale allowance to reflect small suppliers' wholesale costs, even if they had very high comparable costs. We did not estimate their comparable wholesale costs.[25]

3.18. In response to our January 2020 consultation, suppliers agreed that we should not include small suppliers in our analysis of suppliers' comparable wholesale costs.

3.19. We propose to exclude small suppliers for two reasons.

- Most small suppliers had few default tariff customers as a proportion of their customer base, so their finances were less exposed to the level of the default tariff cap.

- Few default tariff customers were served by small suppliers in the relevant cap periods, so small suppliers' comparable wholesale costs should have limited impact on the level of protection default tariff customers required (on average). The additional value to our analysis of each small supplier is increasingly limited, yet the time and resources required to analyse each additional supplier's comparable wholesale costs is similar.

Rationale for analysing six large suppliers only

3.20. We propose to analyse the costs of six large suppliers because:

- collectively, these suppliers served a high proportion of default tariff customers during the first cap period, so the costs they incurred serving those customers

[24] Since the first cap period, suppliers have consolidated. Eon purchased Npower. OVO Energy purchased SSE. For this assessment we analyse each supplier as they were during the first cap period.
[25] Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.167-3.169. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

are relevant considerations when reassessing the wholesale allowance of the first cap period; and

- default tariff customers are a significant proportion of each supplier's business, so they are exposed to the level of the cap.

3.21. We propose to exclude Bulb from our assessment because, unlike the other large suppliers, it did not attempt to align its hedging strategy with the observation window in the wholesale allowance. Nor did it attempt to manage its hedging strategy in a similar way to the six large suppliers before we introduced the cap. On that basis, we do not need to consider how much the transition problem (its historical hedging strategies before May 2018) constrained Bulb's ability to align with the observation windows. Bulb chooses not to align.

3.22. As we discussed in Chapter 2 (2.9-2.11), the other large suppliers have different specific hedging strategies, but they share an overarching objective. The transition problem is relevant for these suppliers because each supplier was affected by the transition from one regime to the other, being unable to align their costs.

Considering stakeholders' views

Bulb's hedging strategy

3.23. In response to our January 2020 consultation, all suppliers (including Bulb) considered that we should exclude Bulb from our analysis of large suppliers' costs.

3.24. Some suppliers noted that Bulb does not attempt to align its costs to the observation window in the cap, and therefore its historical hedging strategy and comparable costs are not relevant considerations. We agree with this assessment.

Competitive tariffs

3.25. Many suppliers advised we exclude Bulb because its tariff is not a default tariff; it is competitively set. At face value, this is not a relevant consideration. The Act applies to

all SVTs and all default tariffs.[26] Bulb's tariff is relevant because it is an SVT, regardless of whether it is competitively set or not.

3.26. Many suppliers suggested that we exclude Bulb because its tariff is both set substantially below the cap level and not with reference to the cap level.[27] By itself, this is not a relevant consideration. In principle, Bulb could set its tariff for reasons other than just cost reflectivity. It would be possible for its comparable wholesale costs to be typical, and its tariff to be atypical.

3.27. However, Bulb's pricing strategy does mean that it has different incentives to the incumbent large suppliers and, for that reason, it manages its hedging strategy differently. It passes through changes in the wholesale price much faster than the incumbent large suppliers historically chose to, and faster than our wholesale methodology does.

3.28. For the avoidance of doubt, for the remainder of this consultation we use "suppliers" to refer to the six large energy suppliers in our analysis.

Challenge 2: relevant cap periods

Options

3.29. In our January 2020 consultation we explained that we intended to assess how suppliers' historical hedging strategies before May 2018 affected their comparable hedging costs in each of the first three cap periods. We expected that the impact on the third cap period may be minor, and we may not analyse costs on that basis. We noted that British Gas successfully challenged our assumption that suppliers would have maintained typical historical hedging strategies until 23 May 2018 (when we published the observation window in our May 2018 consultation) and that we saw no principled reason to restrict our analysis to consider the impact of those historical

[26] Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1. http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[27] See Table 3 of our January 2020 consultation. It shows that Bulb's dual fuel tariff was £124 below the cap in the first cap period (on average). Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation

strategies on the first cap period only, and not consider their impact on the second cap period.

Our proposal

3.30. We now propose to analyse the impact suppliers' historical hedging strategies had on their comparable wholesale costs for the first cap period only.

3.31. We propose to exclude the impact historical hedging strategies had on suppliers' comparable costs for cap periods two and three (and subsequent cap periods).

Rationale

3.32. We consider that, on average, supplier's historical hedging strategies prevented them from aligning with the observation windows for the first two or three cap periods. In principle, we are content to disregard suppliers' comparable costs in cap periods where the impact of their historical hedging strategies was minor. We consider that the impact was only material in the first cap period. On that basis, we limit our considerations to that period only.

An overview of stakeholders' views

3.33. In response to our January 2020 consultation, all of the large suppliers considered that we should restrict our analysis to suppliers' comparable wholesale costs in the first cap period only. They strongly disagreed that we should consider the impact their historical hedging strategies had on their comparable wholesale costs during the second cap period (and subsequent cap periods).

3.34. Suppliers had different interpretations of the transition problem, the wholesale allowance, and our 2018 decision, which influenced their views. In Chapter 2, we explained in detail the transition problem (paragraphs 2.34 to 2.39) and the considerations preceding and included in our 2018 decision on whether or not to include a transitional arrangement when setting the wholesale allowance in the first cap period (paragraphs 2.40 to 2.53).

3.35. Below we consider suppliers' views in detail highlighting key sections of that explanation where necessary. We consider their views in four themes:

- our decision on the wholesale allowance in the second cap period;

- the relevance of comparable costs in the second cap period;
- suppliers' entitlement to their benefits in the second cap period; and
- the materiality of suppliers' benefit in the second cap period.

Considering our decision on the wholesale allowance in the second cap period

3.36. Two suppliers argued that our decision on the wholesale allowance in the second cap period had not been challenged. On that basis, they advised that the relationship between their comparable wholesale costs and wholesale allowance in the second cap period (and subsequent cap periods) was not a relevant consideration for our review.

3.37. It is irrelevant that our decision on the wholesale *allowance* on in the second cap period was not challenged.

3.38. Our decision on how we should set the wholesale allowance in the first cap period *in order to address the impact of the transition problem* was challenged. The transition problem (and specifically our hedging assumption that suppliers would have maintained a typical historical hedging strategy up to May 2018 which British Gas challenged) logically and empirically applies to the second cap period (see Figure 2.7 in Chapter 2). On that basis, suppliers' comparable costs in the second cap period are relevant to our decision on the wholesale allowance in the first cap period.

3.39. One supplier reasoned that we must have assumed in our 2018 decision that the second cap period had been set at the correct level (i.e. reflecting suppliers' comparable wholesale costs in that period).

3.40. This is incorrect. In our 2018 decision we concluded "that [the second wholesale] allowance will be higher than the costs of any supplier that used a typical 18-month observation period before we published our consultation in May 2018, as they would have already purchased some of the energy in advance."[28]

[28] Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.166. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

3.41. Two suppliers considered that whatever the difference between suppliers' actual comparable wholesale costs in the second cap period and the wholesale allowance, it would not have affected our 2018 decision on the allowance in the first cap period.

3.42. This is not correct. Our consideration of the transition problem in the second cap period did affect our decision on the allowance in the first cap period. In our 2018 decision we considered the impact on suppliers with comparable costs of the above the allowance in the first cap period was mitigated by the second cap period, in which we assume a supplier with a typical strategy would have lower costs than allowed for. If the impact in the second cap period was much greater than we assume, that impact could over-compensate suppliers and fail to protect customers (see 2.46 to 2.53).[29]

Considering the relevance of comparable costs in the second cap period

3.43. Regardless of the fact that, in our 2018 decision, we considered a typical supplier's comparable wholesale costs in the second cap period when setting the wholesale *allowance* for the first cap period, some suppliers stated that we should not have done so. This point of view might explain why some suppliers have wrongly assumed that any reassessment of the allowance in the first cap period would necessarily exclude the impact of suppliers' historical hedging strategies on subsequent cap periods.

3.44. As explained in Chapter 2, we have never adopted a principle that wholesale costs and the allowance must align in each cap period. In Chapter 2 (paragraphs 2.26 to 2.33) we explain that the wholesale allowances work in series, not in isolation. Spreading costs from one period (such as any winter cap period) into another cap period is a common feature of the wholesale methodology we consulted on and set in our 2018 decision.

3.45. One supplier argued that the transition problem, by definition, did not apply to the second cap period. On that basis, it argued we should not consider suppliers' comparable costs in that period.

[29] Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.165. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

3.46. This is not correct. Figure 2.7 (in Chapter 2) shows that, on average, suppliers' historical hedging strategies prevented them from aligning with the observation window in the first two cap periods (see 2.33 to 2.38). Three suppliers were not aligned due to the contracts they purchased using historical hedging strategies.[30]

Considering suppliers' entitlement to benefits in the second cap period

3.47. Many suppliers pointed out that the High Court's judgment only instructed us to reassess the wholesale allowance in the first cap period.[31] On that basis, they concluded that we must assess how suppliers' actual historical hedging strategies (before May 2018) affected their comparable wholesale costs in the first cap period (or subsequent cap periods) and ignore how their historical hedging strategies (before May 2018) affected their costs in the second cap period.

3.48. The High Court ruled that we reassess our decision on the wholesale allowance in the first cap period. As explained above, our 2018 decision on the wholesale allowance in the first cap period considered suppliers' comparable costs in the second cap period, as we sought to account for the impact of the transition problem.

3.49. In addition, British Gas challenged our decision on the grounds that our hedging assumption about suppliers' historical hedging strategies up to May 2018 was wrong. The High Court concluded that assumption about historical hedging strategies was not supported by evidence and likely wrong. We have reviewed that assumption to understand each supplier's actual historical hedging strategy (see 2.40 to 2.53).[32] That assumption affects suppliers' comparable costs in each of the first two cap periods, as stated in our 2018 decision.

3.50. Two suppliers considered that any reassessment of the wholesale allowance for the second cap period (or subsequent cap periods) would be an "unsignalled and a retrospective regulatory change". They argue that the profits they made in the second

[30] As discussed in Chapter 2 (2.34-2.39), "retrospectivity", by definition, does not apply to the second or subsequent cap periods. That is irrelevant. As explained in paragraphs 2.40 to 2.53, from the working paper in March 2018 to our 2018 decision, we considered suppliers' historical hedging strategies to be concern as well. Evidently, that problem was not restricted to the first cap period.
[31] [2019] EWHC 3048 (Admin), Paragraph 90.
https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html
[32] Technically we considered the impact the transition problem (historical hedging strategies) had on *all* cap periods, only we assumed that suppliers could align to the observation windows for the third and subsequent cap period, or that the extent to which they could not align would be minor.

cap period (i.e. the difference between its comparable wholesale costs and the wholesale allowance in that period) should not be subjected to unexpected ex post expropriation.

3.51. This view relies on a misunderstanding of our 2018 decision on the wholesale allowance in the first cap period. As in Chapter 2, our decision on the *allowance* in the first cap period considered the *impact* of the transition problem on the comparable wholesale costs of a supplier with a typical historical hedging strategy for the second cap period (2.46 to 2.53).

3.52. In a sense, our reassessment is retrospective. That is the nature of a reassessment. However, in reassessing the wholesale allowance in the first cap period it is not surprising that we reconsider the considerations and assumptions we made at the time.

Considering the materiality of suppliers' benefits in the second cap period

3.53. Several suppliers have suggested that we should not analyse suppliers' comparable wholesale costs in the second cap period because there is no difference between suppliers' comparable costs and the allowance, or that the difference is minor.

3.54. Three suppliers considered that the impact that historical hedging strategies would have on the second cap period would be small, so they recommended that we focus only on the cap period most affected – the first cap period – and disregard the second cap period (and subsequent cap periods). A consumer organisation suggested our approach should depend on whether the impact was material or not, to avoid nugatory work.

3.55. We broadly agree with stakeholders that it is not necessary to address each cap period if the impact if minor. In principle, we are content to disregard suppliers' comparable costs in cap periods where the impact of their historical hedging strategies was minor. The scale of the impact is an empirical question so we have gathered data and analysed suppliers' comparable costs.

3.56. For the first cap period, the impact is clearly material. So, we consider these costs in our reassessment of the wholesale allowance in the first cap period.

3.57. For the second cap period, the impact is relatively minor. On average the impact is about £2 per dual fuel customer with typical consumption in the first cap period. As a non-recurring financial impact, this is not a significant variance over the life of the cap. In addition, half of the suppliers had short historical hedging strategies and were aligned with the observation window for the second cap period, and another supplier was more or less aligned. These suppliers received very little financial benefit. We are prepared to exclude suppliers' benefits in the second cap period, on the grounds that the impact is minor.

3.58. We also propose to exclude the third cap period (and subsequent cap period) on the grounds that the impact would be negligible.

Challenge 3: comparable wholesale costs

Our proposal

3.59. We propose to analyse suppliers' comparable wholesale costs in the relevant cap periods, not their accounting costs. By 'comparable wholesale costs' we mean that each supplier's wholesale costs are stated in comparable terms to the wholesale allowance (for example, accounting for annualised prices). The wholesale allowance never matches a supplier's accounting cost in an isolated cap period.

3.60. In practice we propose to estimate suppliers' comparable costs in each cap period by using the wholesale allowance methodology (as described in our 2018 decision), except that we replace the observation window with a supplier's actual profile of the energy volumes it purchased using its historical hedging strategy. In effect, we calculate a personalised wholesale allowance for each supplier.

3.61. Through bilateral discussions with suppliers we have made further refinements to how we calculate suppliers' comparable costs based on their hedging strategies, which we discuss below.

Rationale

3.62. Assessing suppliers' comparable wholesale costs, not their accounting costs, ensures that the wholesale allowance protects customer in the way it was intended to.[33]

3.63. The distinction between accounting costs and comparable costs is important because the wholesale allowances work in series, not in isolation – they reflect accounting costs across multiple periods, not in each period. For that reason, every wholesale allowance must be set on the same basis. If the first allowance or allowances reflected accounting costs, and subsequent allowances used our standard methodology, then customers may pay for the same costs twice (for example, paying the accounting costs of winter in the winter cap period and then also paying for a portion of those winter costs again in the summer cap period which we set using annualised prices, not low summer prices).

3.64. Using the comparable costs approach maintains the principle behind the approach we took in our 2018 decision. We replace the observation window with a supplier's hedging profile and keep all other aspects of the methodology the same. The difference with our 2018 decision is that we use evidence on each supplier's actual hedging profile, rather than an estimate of the average hedging strategy (the medley approach) (see paragraphs 2.54 to 2.57). We do so to provide greater transparency to each supplier on how their hedging profile and comparable costs compare to the average costs, to which we have regard when setting the allowance.

3.65. This approach focusses on the differences between the observation window, and when suppliers purchased energy and in what proportions. That assumption was the focus on the judicial review, and the only aspect of our 2018 decision that was challenged. The way our methodology treats other aspects of wholesale costs should stay the same as these were not challenged. Our treatment of all other aspects of suppliers' wholesale costs is, and must be, the same as our standard methodology (2.58 to 2.62).

[33] In Chapter 2 (2.26 to 2.33), we explain the difference between suppliers' comparable wholesale costs and their accounting costs. For example, supplier's accounting costs are seasonal, and include the specific impact of shaping and changes in demand that may have been more favourable or less favourable that average. The wholesale allowance smooths the peaks and troughs in suppliers' accounting costs across multiple cap periods.

Considering stakeholders' views on our methodology

3.66. In our January 2020 consultation, we explained that we need to assess wholesale costs in a comparable way to the allowance. We said that we cannot assess suppliers' costs by looking at the accounting cost they incurred in the first quarter of 2019. If we did so, then the wholesale allowance would not protect default tariff customers in the manner we intended. Customers could be overcharged, for example by paying for high seasonal winter prices twice.

3.67. Below we consider suppliers' views on our methodology. In particular:

- accounting costs;
- excluding energy delivered in Q4 2018.

Considering suppliers' accounting costs

3.68. In response to our January 2020 consultation, some suppliers considered that we should use suppliers' accounting costs to reassess the wholesale allowance in the first cap period. One supplier stated that it was unclear why our assessment of costs needed to treat seasonal costs consistently with the wholesale allowance.

3.69. For the reasons stated in our January 2020 consultation and discussed in detail in Chapter 2 (see paragraphs 2.26 to 2.33) we needed to ensure that our assessment of wholesale costs treats seasonal prices, shaping costs, and forecast error in the same way as the wholesale allowance because the allowance under-recovers costs in some periods and over-recovers them in others (see Figure 2.5). If we set the wholesale allowance on a different basis in different periods then customers may be overcharged, or suppliers may under-recover.

3.70. One supplier noted that consistency was not a goal in and of itself. For the avoidance of doubt, we do not seek consistency for its own sake. We seek a consistent relationship between the wholesale allowance and suppliers' costs to ensure the methodology operates as intended and thereby protects customers.

3.71. One supplier argued that the first cap period was bespoke. It argued that we intended to set that first allowance in line with the accounting costs suppliers incurred. That is incorrect. In Chapter 2 (paragraph 2.56) we explain that our 2018 decision considered

costs in comparable terms and explicitly ruled out comparing the allowance to accounting costs.[34]

Considering hedging strategies for winter 2018

3.72. In our original assessment of comparable costs in the first cap period we analysed wholesale prices for winter 2018-19 contracts. These contracts covered Q1 2019 (the first cap period) and Q4 2018, the last three months before we introduced the default tariff cap (2.54 to 2.57). That approach was consistent with the way we calculate the wholesale allowance for a normal winter cap period. However, the first cap period was not a normal winter cap period, it was shorter.

3.73. All suppliers argued that we should exclude the volume of energy they purchased for delivery in Q4 2018. They argued that considering this energy is not necessary to account for seasonal pricing, and it would distort our assessment of their comparable costs for the first cap period (Q1 2019).

3.74. We agree with suppliers. Our assessment of their comparable wholesale costs for the first cap period should only analyse how they accumulated volumes of energy for that specific period, not winter 2018-19 as a whole.

3.75. Analysing how suppliers purchased energy for Q4 2018 would distort our assessment. Firstly, some suppliers used different strategies for Q4 2018 and Q1 2019, as only the latter period was subject to the cap. In that case, a supplier's purchases for Q4 2018 provide no information about how that supplier purchased energy for Q1 2019, which is what we must consider.

3.76. Secondly, even where suppliers used a common strategy for both quarters in winter 2018-19 (as our 'medley approach' assumed), including Q4 2018 gives the impression that suppliers purchased energy for Q1 2019 three months earlier than many of them did. As wholesale prices were lower at the start of 2018, that approach would artificially reduce our estimate of suppliers' comparable costs for Q1 2019. In either

[34] Ofgem (2018), Default tariff cap: decision, Appendix 4 – wholesale. Para 3.164. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

case historical hedging strategies for Q4 2018 are not relevant to our assessment of how suppliers' historically purchased energy for 2019.[35]

Minor changes to modelling historical hedging strategies

3.77. Suppliers made other suggestions to refine our analysis of comparable costs. The impact of these changes is relatively minor, but we have included them. We have adapted the model to include rateable strategies and to use trading days, rather than calendar days.

Considering deviations from suppliers' baseline hedging strategies

3.78. Some suppliers enquired how we would treat their historical hedging strategy if their evidence on how they accumulated energy for Q1 2019 (and other cap periods) showed they did not actually follow their baseline strategy in practice. In this section, we use hypothetical examples as we cannot discuss specific suppliers' strategies.

3.79. Suppliers sometimes deviate from their baseline hedging strategy. There are two principal reasons for this.

3.80. Firstly, a baseline hedging strategy is an idealised model. In practice, a supplier may not be able to follow the approach precisely. Fidelity will depend on the availability and liquidity of specific contracts at specific times. This issue affects all suppliers in our analysis. Where this is the main cause of deviation, the relationship between the modelled baseline strategy and the actual profile of purchased energy is a close one.

3.81. Secondly, some suppliers have the latitude to deviate from their baseline strategy (usually within agreed parameters) in order to achieve lower average costs. This was the case for some of the suppliers in our analysis, but not all. As an illustrative example, in 2019 the wholesale price was falling. If a supplier thought the costs would continue to fall, it might purchase less energy at that time, compared with if it followed its baseline strategy. The supplier would do this in the hope that it could purchase a higher proportion of its energy later on, when prices would be lower. Alternatively, if it

[35] We do use wholesale prices from Q4 2018, along with wholesale prices from Q1 2019 and summer 2019, to weight the high seasonal costs of contracts in Q1 2019.

thought energy prices would increase, then it may 'accelerate' its purchasing strategy. On that basis, it would purchase a higher proportion of its energy at that time than if it aligned with its baseline strategy. It would do so in the hope that it would purchase a lower proportion of its energy in the future, when prices would be higher. Depending on wholesale prices and the individual supplier's agreed parameters and practices, deviation between the baseline strategy and supplier's actual profile of energy purchases can be relatively wide, depending on the latitude provided and choices made.

3.82. In each case, we have discussed the extent of deviation and the reasons for it with each supplier. Our principle is that where the impact of these deviations directly affected the wholesale costs of the retail energy supplier[36] then we use the actual profile of the energy volumes the supplier purchased, not the baseline strategy that it deviated from (i.e. the supplier's change in approach is relevant because it affected the cost to serve its customers. The deviations were not profits or losses attributed to trading activities outside the retail business). In practice, some suppliers have a very close relationship between their actual profile and baseline strategy (as the main cause of deviation was practical constraints). Others do not have a close relationship, if they accelerated or decelerated their purchases within agreed parameters.

3.83. We do not consider whether these deviations were efficient or not. We take them at face value. For some suppliers, the baseline strategy would have incurred lower costs (with the benefit of hindsight). For other suppliers, following the baseline strategy would have incurred higher costs. Ultimately we set the allowance having regard to suppliers' costs on average. So the extent to which suppliers were lucky or unlucky has a diluted impact on the final result.

Considering suppliers' gains or losses selling historical contracts

3.84. Two suppliers questioned how we would treat the gains (or "windfalls") suppliers made when they excess contracts they purchased under their historical hedging strategies. For the reasons set out below, we include these gains (or losses) on sale in our assessment of costs.

[36] As opposed to representing the gain or losses of a speculative trading activity.

3.85. Suppliers adjust their hedging strategies over time. These adjustments can have a large impact on a supplier's wholesale costs because they purchase or sell a large proportion of their total energy needs in a short period of time (when prices could be very high or very low, compared with the average price over the entire hedging period).

3.86. Figures 3.3 and 3.4 show hypothetical hedging strategies for illustrative purposes only. We discuss hypothetical situations so that we can avoid discussion individual suppliers' trades; the principles are the same. At the beginning of June 2018, Supplier X in Figure 3.3 and Supplier Y in Figure 3.4 abandoned their historical hedging strategy (an 18-month linear strategy) and on 1 June both adopted the transitional observation window we announced in May 2018. Under the historical strategy, each supplier had purchased 77% of the energy it required for Q1 2019. Under the new strategy, they only required 33% at that point in time. That means each supplier held excess contracts for 44% of their energy needs.

3.87. In these hypothetical scenarios, Supplier X and Supplier Y align to the same baseline hedging strategy and have the same historical costs at the point they align. However, despite having the same baseline strategy, they treat their excess contracts differently, which means they end up with different cost.

3.88. At the beginning of June 2018, Supplier X has excess contracts (a higher proportion of its energy needs than its hedging strategy requires). Supplier X holds on to those contracts and stops purchasing energy. By late August 2018, its baseline hedging strategy 'catches up' with the energy Supplier X has already purchased. At that point, Supplier X's energy volumes are aligned to its hedging strategy (it has 77% of its energy needs). However, its comparable costs are not aligned with the wholesale allowance. It purchased all of its contracts before June 2018, when prices were lower than between April and August 2018. Therefore, in mid-August its costs would be lower than a supplier that had followed the observation window up to that point and held the same proportion of its energy needs. In our assessment, we consider how each supplier actually accumulated the energy it required to determine its comparable costs.

Figure 3.3: A hypothetical supplier changing its strategy in June 2018 - Supplier X

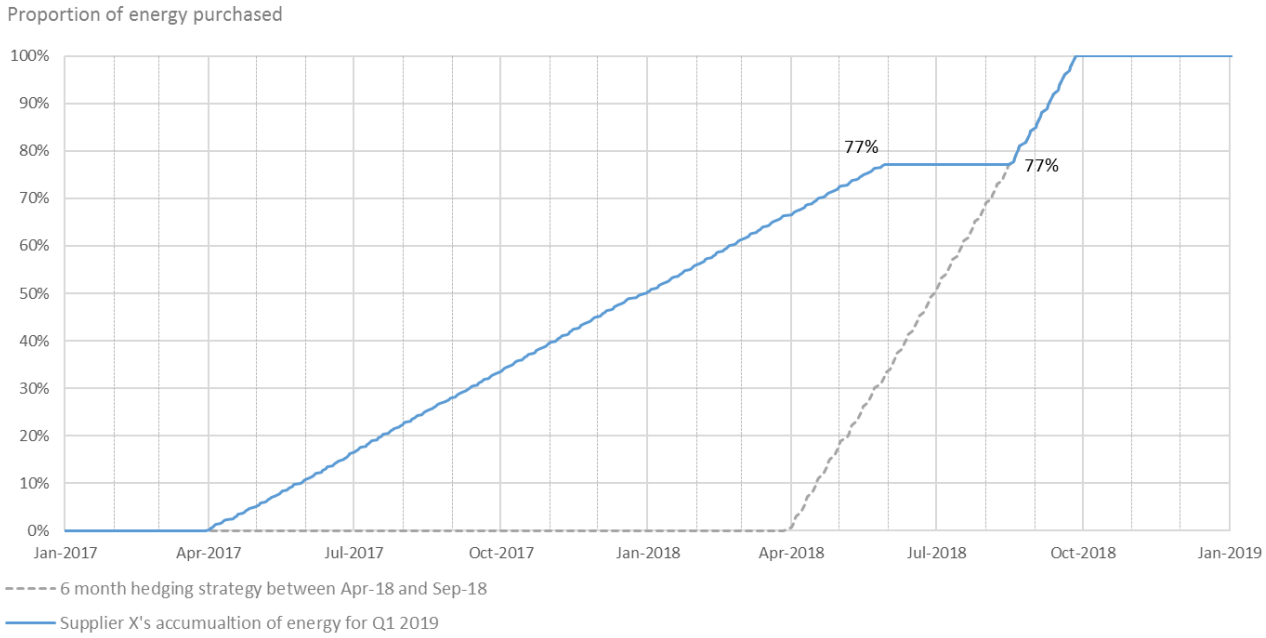
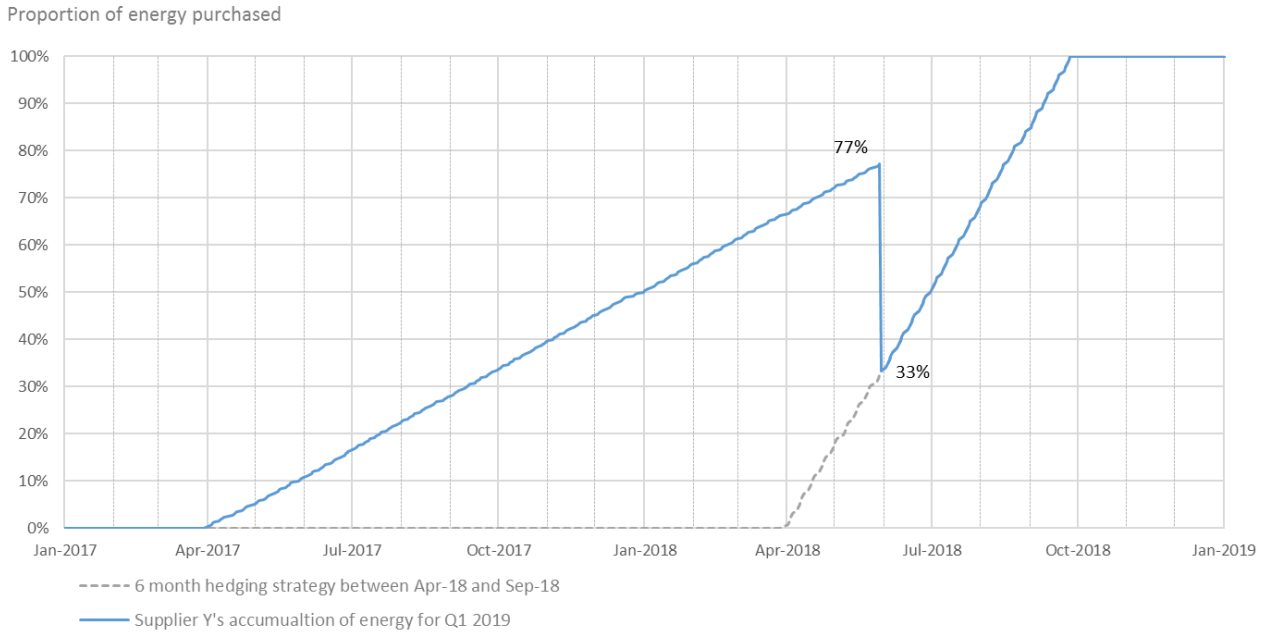


Figure 3.4: A hypothetical supplier changing its strategy in June 2018 - Supplier Y



3.89. Supplier Y takes a different approach to Supplier X. It aligns its volumes to the new baseline hedging strategy earlier. To do so, it sells its excess contracts, reducing the volume of energy it holds to the level required by the new baseline strategy. If the wholesale price at that time was above the average cost of the contracts it sold, then Supplier Y makes a gain on that sale. If the wholesale price is below the average cost of the excess contracts, Supplier Y incurs a loss on that sale. In this case, the wholesale price in late-June 2018 was higher than the average cost of the excess contracts, so Supplier Y made a gain.

3.90. Selling those cheap historical contracts for a gain reduces Supplier Y's costs for the first cap period, just as Supplier X reduced its cost by holding on to its cheap historical contracts. That gain is part of Supplier Y's net costs in purchasing energy to deliver in Q1 2019. If Supplier Y had incurred a loss, then the net cost of all its activities to purchase energy for the first cap period would have increased. Those gains or losses are relevant because Supplier Y is not speculating on volatility in the wholesale market (i.e. it is not buying and selling contracts in order to make a profit from trading activities). It is an energy supplier; it purchases energy contracts for delivery. In doing so, a supplier must adjust its position over time, managing its net wholesale costs and risk for that period. Those adjust incur gains and losses that are part and parcel of its net costs. On that basis, we include the gains and losses suppliers made when selling their excess historical wholesale contracts back to the market.

Considering how suppliers invested financial benefits

3.91. One supplier stated that we should not consider its gain on the sale of contracts, as it passed that gain on to its customers, by delaying an increase in its SVT. For the reasons below, we do not consider how a supplier invested the profit it made from a sale to be relevant to our assessment of costs.

3.92. Whether a supplier made a gain selling excess contracts, or achieved lower costs by holding onto cheap contracts, its achieves a financial benefit – lower net costs. In our January 2020 consultation we said that, in principle, our starting point is that we would be indifferent to how suppliers invested that benefit (whether it be a gain from sale, or avoid costs). By delaying a tariff increase a supplier seeks to defend (or increase) its market share. This is a potential benefit to a supplier to be weighed against any other investment opportunities in its business.

3.93. We maintain this view even if the supplier moved the financial benefit from the Q1 2019 accounting period to the Q4 2018 accounting period. If a supplier's costs for Q1 2019 were below the allowance that we would have set using the April-September observation window it would have had lower comparable costs in that period, making a gain. It could move that gain into the previous accounting period, by trading contracts to increase its costs in Q1 2019 and reduce its costs in Q4 2018 by an offsetting amount. The total energy volumes in each period would be unchanged. The total costs across both periods would be unchanged. The supplier would have just moved its gain from one accounting period into another one before choosing how to invest the proceeds.

3.94. If the investment (delaying a price increase) was successful, the supplier should have gone into 2019 with more customers than it otherwise would have done. The supplier would have weighed that potential benefit against other potential investments.

4. Reconsidering the wholesale allowance in the first cap period

In this chapter we reassess the wholesale allowance in the first cap period, and consider what transitional arrangement we should have included to account for the impact of suppliers' historical hedging strategies on their comparable costs.

Stakeholders should consider our proposals and explain the reasons why they agree or disagree with them as fully as they can.

Summary of proposals

4.1. We consider that we should have set a transitional wholesale allowance in the first cap period to account for the impact suppliers' historical hedging strategies before May 2018 had on their comparable costs in the first cap period. In light of the evidence provided, suppliers' historical hedging strategies meant that their comparable costs were higher than we had allowed for.

4.2. We propose that our transitional arrangement should have set an allowance in line with the weighted average impact suppliers' historical hedging strategies had on their comparable costs. On that basis, the allowance in the first cap period should have allowed suppliers to recover an additional £5.91 from each default gas tariff customer with typical consumption in the first cap period and £1.74 from each default electricity tariff customer with typical consumption.[37] That would have allowed the six large suppliers to charge an additional £85m in the first cap period.

4.3. Below, we explain our reconsideration of the wholesale allowance in the first cap period. We also respond to stakeholders' views on the analytical challenges we

[37] This is expressed as an average across Great Britain. In practice, we calculate the weighted average £ per MWh before applying other allowances including transmission and distribution losses, which are different in each of the 14 regions.

explained in our January 2020 consultation: that we must set a single cap and suppliers' comparable wholesale costs vary.

Reassessing the allowance in the first cap period

Considering suppliers' weighted average comparable costs

4.4. Figures 4.1 and 4.2 show how suppliers' comparable costs in the first cap period varied from the wholesale allowance (in £ per MWh before applying other multipliers for shaping costs, forecast error, and losses). Taking a weighted average of suppliers' comparable costs, their gas costs were £1.06 per MWh above the level they were allowed to charge (before applying other wholesale allowances), and their electricity costs were £1.65 per MWh above the level they were allowed to charge (before applying other wholesale allowances).

4.5. In the first cap period, a customer with typical consumption[38] would have consumed 5.03 MWh of gas and 0.88 MWh of electricity. After applying other wholesale costs, suppliers were able to charge such a gas customer £5.91 less than they would have charged if we had set the allowance in line with suppliers' weighted average gas costs. The would have been allowed to charge such an electricity customer £1.74 less than they would have charged if we had set the allowance in line with suppliers' weighted average electricity costs.

[38] Typical Domestic Consumption Value. TDCV for gas customers is 12,000 kWh, 42% of which is consumed in Q1. TDCV for single electricity customers is 3,100 kWh, 28% of which is consumed in Q1.

Figure 4.1: Difference between comparable gas costs and the allowance in Q1 2019

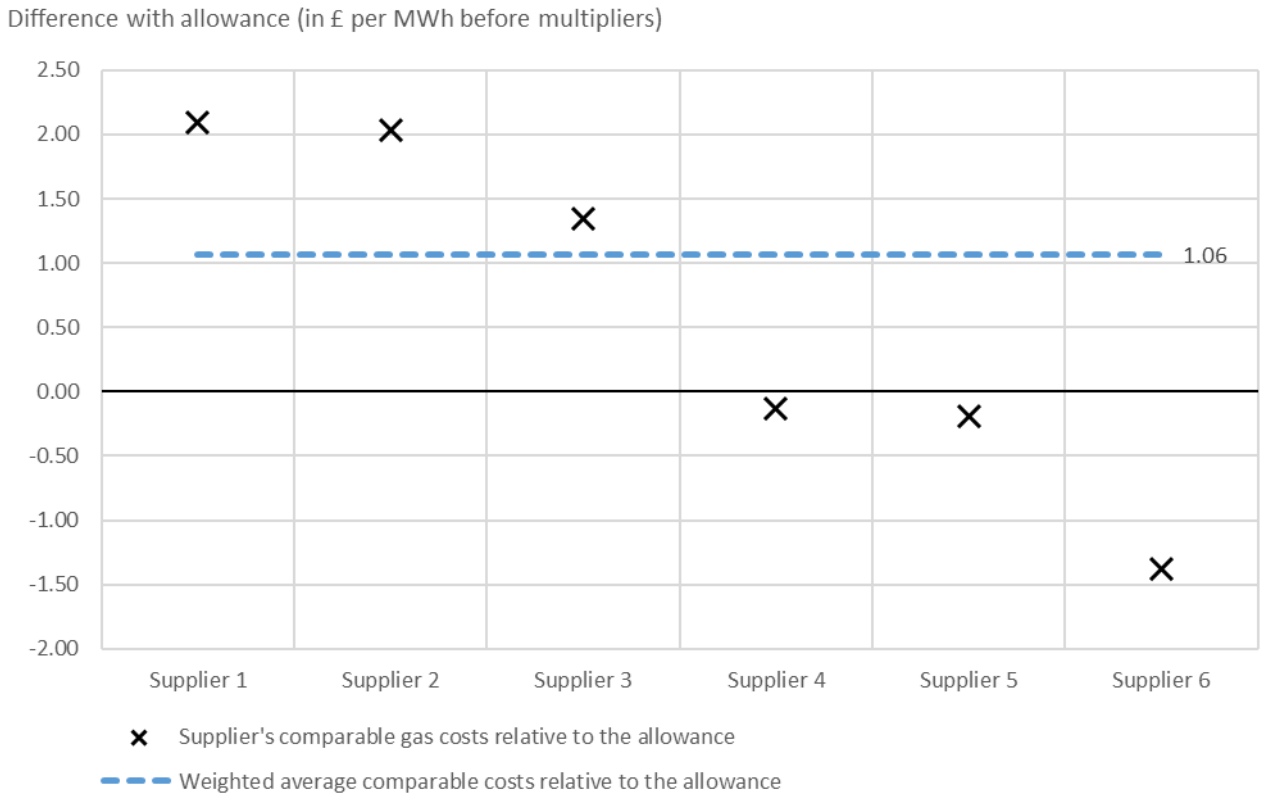
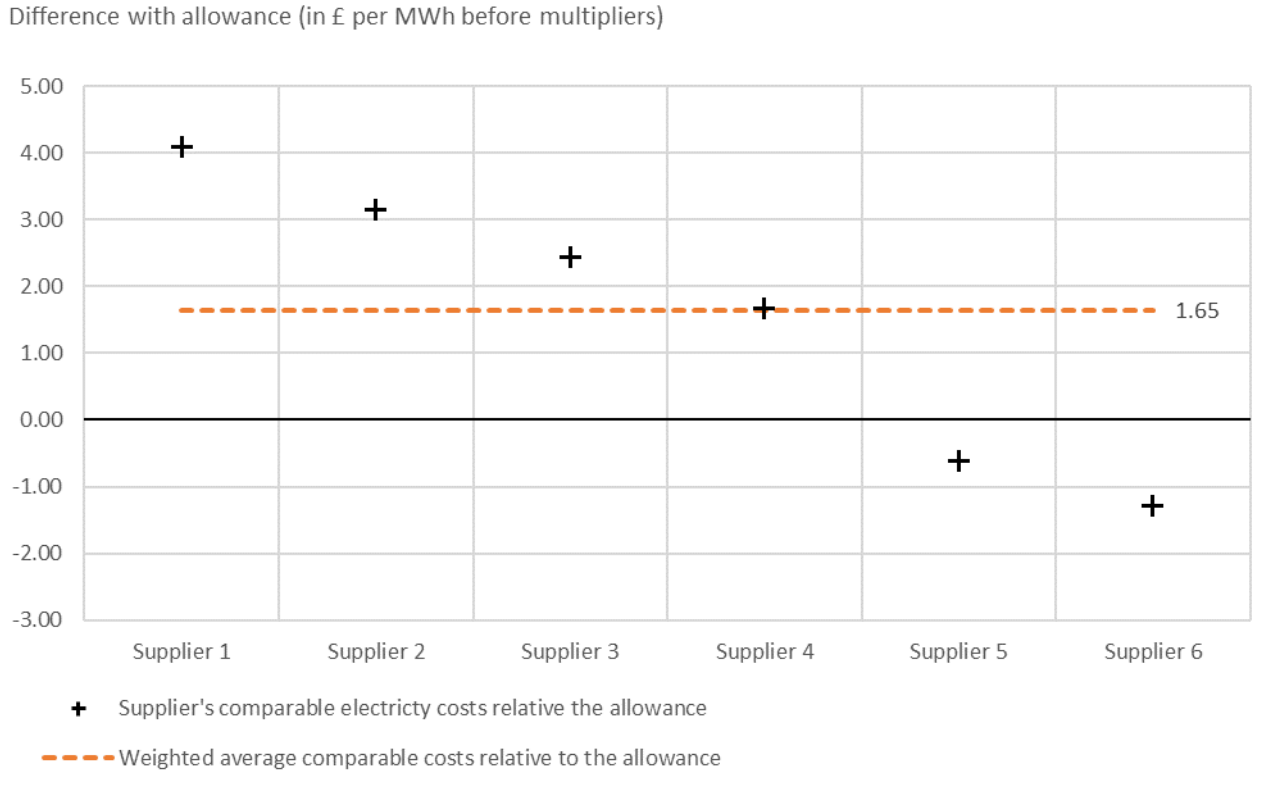


Figure 4.2: Difference between comparable electricity costs and the allowance in Q1 2019



Challenge 4: variation in costs

Options

4.6. Suppliers' costs vary. The Act requires that we may not make different provision for different holders of supply licences.[39] Therefore, no level of wholesale allowance could reflect *each* supplier's comparable wholesale costs. At whatever level we set the allowance, some suppliers will be at a disadvantage compared to others.

4.7. In our January 2020 consultation we considered how we might set the single wholesale allowance. We could set the allowance in line with:

- the highest costs, ensuring that all suppliers could recover their costs;
- the lowest costs, ensuring that no default tariff customer paid more than the cost of supplying them energy; or
- the average costs, ensuring that customers were not charged more than the average cost of supplying them energy.

4.8. We proposed to set the allowance in line with the average of suppliers' comparable costs. We recognised that there are different ways to calculate an average. We said that we would consider using a weighted average, simple mean, or median. We noted that our starting point was that the weighted average would be most appropriate, but that may depend on the distribution of suppliers' costs.[40]

Our proposal

4.9. We propose to have regard to the weighted average of suppliers' comparable wholesale costs. Using a weighted average means that the allowance in the first cap

[39] Domestic Gas and Electricity (Tariff Cap) Act 2018. Section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[40] Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation

period would have been higher than some suppliers' comparable wholesale costs, and lower than others'.

Rationale

4.10. In our January 2020 consultation we explained that we would consider the appropriateness of the wholesale allowance in the first cap period with reference to the customer protection it affords to customers and the statutory "needs" set out in section 1(6) of the Act.[41]

4.11. In seeking to protect customers, we consider that tariffs should not exceed underlying efficient costs. In having regard to an efficient supplier's ability to finance its activities, we consider it desirable that the allowance is at the level of suppliers' costs, but not that this needs to be achieved. Indeed, in this specific context, it cannot be achieved for each supplier at the same time.

4.12. The weighted average of suppliers' comparable costs best describes the underlying comparable costs of serving default customers as a group. The weighted average multiplied by the total number of customers should reflect suppliers' aggregate comparable costs. In effect, it is the simple mean of the costs associated with each customer. This approach does give more prominence to suppliers that have a lot of customers, which (strictly speaking) is not relevant when regarding wholesale costs. The simple mean better reflects the comparable cost around which we would expect suppliers' wholesale costs to vary. In this case, suppliers with the most customers happened to have higher costs, so the weighted average is higher than the simple mean, but the difference is marginal.

Considering stakeholders' views

4.13. Most suppliers favoured a weighted average of suppliers' comparable costs. Some preferred a simple mean. If we used a median, some considered we should select the

[41] Domestic Gas and Electricity (Tariff Cap) Act 2018. Section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted

costs of the supplier serving the median customer, not the costs of the median supplier (where there is a difference).

4.14. One supplier favoured the transitional allowance we had proposed in our May 2018 consultation, set using the April-September observation window. In addition, it considered that we should not set the allowance lower than the comparable cost of the supplier with the highest costs.

Considering our May 2018 consultation proposal

4.15. The transitional arrangement we proposed in our May 2018 consultation would set an allowance higher that any suppliers' comparable costs. For the reason we stated in our September 2018 consultation and 2018 decision, that would not protect customers and is inappropriate.[42]

Considering the supplier with the lowest costs

4.16. Setting the allowance at the level of the supplier with the lowest cost would protect customers – no customer would have paid more than the underlying efficient costs of serving them. However, the other suppliers would only partially recover their costs. The customers of those suppliers would all pay less than the underlying cost of supplying them with energy.

Considering the supplier with the highest costs

4.17. Setting the allowance at the level of the supplier with the highest cost would protect the customers *of that supplier*. They would not have paid more than the underlying cost of supplying them energy. All other suppliers could over-recover their costs. That would not protect their customers, all of whom would pay more than their underlying costs.

4.18. We do not consider that Section 1(6) of the Act requires that we set the wholesale allowance above the costs of the majority of default tariff customers. That would not

[42] [2019] EWHC 3048 (Admin), paragraph 14.
https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html

protect those customers. We have regard to an efficient supplier's ability to finance its activities, but that is not the same thing as achieving them. In this case, where efficient comparable wholesale costs vary, we have considered each suppliers' costs and consider that the average level protects default tariff customers.

Considering median costs

4.19. We do not propose to use median comparable wholesale costs. We are only analysing six suppliers' costs, so consider the median to be inappropriate.

4.20. In our 2018 decision we sought to consider 'typical' costs. When discussing retail energy we often use 'typical' interchangeably with 'median'. For example, a customer with 'typical' consumption is one that consumes energy at the median level (the Typical Domestic Consumption Value). This is the 50th percentile customer. Half of customers consume less. Half of customers consume more.

4.21. A potential benefit of using the median comparable wholesale costs would be removing the influence of suppliers with high and low costs, basing our decision on the middle value. That would remove the impact of outliers that might otherwise skew our analysis. In their responses, the large suppliers considered that their costs would not be outlying and we should not remove them or reduce their influence. Furthermore, some suppliers noted that variation in wholesale costs is not a matter of efficiency, and that any removal of outliers would suggest that we considered those costs to be inefficient.

4.22. We do not propose to remove outliers from our sample of suppliers, nor do we seek to reduce the influence of suppliers with costs at the far ends of the range of costs, so a median is unnecessary in that respect. Having reviewed suppliers' historical hedging strategies we agree that the variation in suppliers' comparable costs is in line with the variation we would expect from suppliers following a common overarching objective, but using different hedging strategies (see paragraphs 2.9 to 2.11).

4.23. We consider that the low number of suppliers in the sample makes choosing the median value unreliable. Firstly, if we take the costs of the supplier serving the median *customer*, then the average is very sensitive to whether the third or fourth supplier in our sample serves that median customer. The substantial drop or increase in the estimate shows the flaw in selecting the median customer: the costs of each customer

in the range are not independent. Whereas the TDCV uses over 10 million independent data points in our sample of costs; we have six (the costs of the suppliers).

4.24. Secondly, selecting the median supplier is also unsatisfactory. On that basis, we would base our estimate on the mid-point between the two middle suppliers; in other words, the simple mean of the middle two suppliers. This is better than selecting the costs of the median customer, but is not preferable to the simple mean of *all* suppliers.

Considering simple mean or weighted average.

4.25. Most suppliers supported analysing suppliers' comparable costs using a weighted average – i.e. giving more prominence to the suppliers that serve more customers. Some suppliers supported a simple mean, giving equal weight to each supplier's costs.

4.26. Each supplier's costs should vary around the simple mean of suppliers' comparable costs. A supplier's comparable wholesale cost is not affected by the number of customers it serves. The simple mean of the comparable costs of all suppliers is closer to the spirit of the cost of an efficient supplier, whilst bearing in mind that the variation of each individual supplier around the simple mean of all suppliers is not inefficient.

4.27. A weighted average would give more prominence to the costs of suppliers with a lot of customers. This is a purely descriptive approach. It best describes the actual underlying comparable costs of serving customers. The weighted average multiplied by the total number of customers would equal the suppliers' aggregate comparable costs. In effect, it is the simple mean of the costs associated with each customer.

4.28. As it describes costs from customers' perspective, we consider that we should set the allowance no higher than the weighted average of suppliers' comparable costs. A large supplier with very low costs could move the weighted average below the simple mean. In practice, the weighted average of suppliers' comparable wholesale costs is higher than the simple mean as some of the largest suppliers had higher costs.

4.29. As the Act seeks to protect default customers we propose to use the weighted average as it is the closest representation of the costs associated with customers as whole.

Headroom

4.30. One stakeholder was surprised that we made no reference to headroom. It considered that we should use headroom to absorb the impact of errors such as this. On that basis, it advised we make no adjustment for the impact on suppliers, however we measure it.

4.31. It is correct that we included the headroom allowance as one of the mechanisms to accommodate risk of error. However, we also guarded against error by using conservative assumptions when setting the allowances. This, rather than headroom, is how we intended to address the risk of error in our estimates of a typical supplier's comparable wholesale costs. For instance, we used the standard observation window and did not reduce the wholesale allowance in the first or second cap periods to the level of costs we expected a typical supplier to incur (we estimated that typical costs would be slightly less than the first allowance and also less than the second allowance, see paragraph 2.48).[43]

4.32. The reassessment we have now carried out obviates the need for using conservative assumptions, as we now consider each supplier's actual hedging strategies. The reassessment shows we need to make a correction as suppliers incurred higher cost than we anticipated, which is not covered by either conservative assumptions in the wholesale allowance or our consideration of headroom.

[43] Ofgem (2018), Default tariff cap: decision – overview, paragraph 3.165 and 3.166. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

5. Adjusting future allowances

In this chapter, we consider how to adjust future allowances to account for the transitional allowance that we would have set in the first cap period.

Stakeholders should consider our proposals and explain the reasons why they agree or disagree with them as fully as they can.

Summary of proposals

5.1. We propose to introduce a new allowance in the default tariff cap methodology: an "adjustment allowance". This allowance will increase the level of the cap for a limited number of cap periods.[44]

5.2. To correct for our decision on the wholesale allowance in the first cap period, we propose to set the adjustment allowance so that:

- we increase the maximum variable charge and not the standing charge;
- we set the amount we seek to recover per customer with typical consumption (adjustment charge) on a per customer basis; and
- we include it in the cap for the fifth cap period only, starting on 1 October 2020.

[44] This allowance will remain part of the licence and be set a £0 once we have made the adjustment relating to the wholesale allowance in the first cap period. At present we have no plans to use the adjustment allowance for any other adjustment. If, in future, we consider that some other adjustment is necessary then any proposal to use the adjustment allowance for that purpose would be subject to consultation.

5.3. The calculations of the adjustment allowance are included in Annex 8 to SLC 28AD (electricity and gas), published alongside this consultation. On that basis the adjustment allowance will be:

- £7.81 for a gas customer with typical consumption (stated in annualised terms), allowing suppliers to recover £5.91 per customer (76% of gas annual consumption is in winter), and about £52m in aggregate during the fifth cap period.

- £3.08 for an electricity customer with typical consumption (stated in annualised terms), allowing suppliers to recover £1.74 per customer (57% of electricity annual consumption is in winter), and about £18m in aggregate during the fifth cap period.

5.4. For the avoidance of doubt, the ongoing wholesale methodology as set out in Annex 2 to SLC 28AD (electricity and gas) shall apply in future cap periods as normal.

5.5. Below, we explain our proposals in detail. We also respond to stakeholders' views on the two challenges we set out in our January 2020 consultation. We explain:

- the structure of the adjustment allowance;

- setting an appropriate adjustment charge (challenge 5); and

- setting an appropriate adjustment period (challenge 6)

The structure of the adjustment allowance

Options

5.6. In our January 2020 consultation we proposed to introduce an adjustment allowance as a sub-allowance within the wholesale allowance.[45] Alternatively we could include the adjustment allowance as an independent allowance in the cap.

5.7. We also considered whether to set the adjustment allowance so that it recovers wholesale costs through variable charges or standing charges.

Our proposal

5.8. We propose to modify the default tariff cap methodology, introducing an "adjustment allowance", independent from the wholesale allowance. Alongside this consultation, we have published drafts of the necessary modifications to standard licence condition (SLC) 28AD, and a new annex (Annex 8) to SLC.28AD, which calculates the value of the adjustment allowance in each period.

5.9. We propose to set the adjustment allowance so that it changes the maximum variable charge in the default tariff cap. It will not affect the standing charge in the cap. In practice, that means the adjustment allowance is zero when we calculate the cap level at nil consumption. Below, we consider the level we would set the adjustment allowance at when calculating the cap at Typical Domestic Consumption Value (TDCV).[46]

5.10. To calculate the adjustment charge, we calculate the incremental £ per MWh that suppliers should have been able to charge in the first cap period (the weighted average comparable £ per MWh minus the allowed £ per MWh). We then apply a volume adjustment factor, which recognises that suppliers will apply the adjustment charge for longer than three months (the length of the first cap period). In other words,

[45] Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation, paragraph 4.2 https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation

[46] Note that we calculate the default tariff cap using the TDCVs at the time of our decision (12,000 kWh for gas and 3,100 kWh for electricity).

customers will consume more MWh in the adjustment period than they consumed in the first cap period, so we need to adjust the unit charge per MWh to ensure the total amounts match.[47]

Rationale

The licence

5.11. We consider it more transparent to show the adjustment allowance separately from the wholesale allowance, which is an allowance for wholesale sale costs in the current cap period.

5.12. The adjustment allowance will remain part of the licence and be set at £0 once we have made the adjustment relating to the wholesale allowance in the first cap period. If, in future, we considered that some other adjustment was necessary, then any proposal to use the adjustment allowance (as we propose it here, or in some amended form) would be subject to consultation.

PPM customers

5.13. Alongside this consultation we are proposing to protect default tariff customers with prepayment meters (PPM) under the cap. PPM customers incur the same wholesale costs as customers using alternative payment methods, but the adjustment relating to the wholesale allowance should not apply to them. They were not in scope of the cap during the first cap period.

Variable charges

5.14. We consider it appropriate to set the adjustment allowance so that it recovers money through the variable charge, as customers incur wholesale costs in proportion to the amount of energy they consume.

5.15. A customer's consumption changes with the weather (among other factors), so it is unlikely that the amount suppliers recover from a customer over the period that the

[47] See Annex 8 to the licence, published alongside this consultation.

adjustment allowance is in place will match the under-allowance that customer benefited from in the first cap period. Depending on their consumption in each period, a customer may pay back more or less than they would have done in the first cap period.

5.16. We could not recover money through the standing charge. This would make the amount suppliers recover more predictable, as the recovered amount would not change with consumption. However, it would not adequately protect customers. In the first cap period each customer received a benefit in proportion to their consumption, with those consuming the most energy receiving the largest benefit. If we adjusted the standing charge, each customer would pay the same adjustment in absolute terms, disproportionately over charging customers with low consumption and under charging customers with high consumption.

Adjusting the charge for differences in the period length

5.17. In Chapter 4 we consulted that the allowance was too low in £ per MWh. The first cap period, when the allowance should have been higher, was only three months long. The adjustment period, when the correction will be charged, will be longer. Customers will consume more energy in that adjustment period than they did in the first cap period. If we set the adjustment charge so that it matched the original error (in £ per MWh), then suppliers would be able to charge customers more than they require.

5.18. We calculate a volume adjustment factor, which recognises that suppliers will apply the adjustment charge for longer than three months. For gas, we multiply the adjustment charge by 55%, as customer use 34% of their annual energy in Q1 and 42% in Q1.[48] For electricity, we halve the adjustment charge, as customer consume 27.5% of their annual energy in each of Q4 and Q1.

[48] See Annex 8 to the licence, published alongside this consultation.

Challenge 5: setting an adjustment charge

Options

5.19. We seek to reverse the impact (as much as is possible) of setting the wholesale allowance in the first cap period too low.

5.20. In our January 2020 consultation we considered two options for setting the adjustment charge (the amount we seek to recover from each customer with typical consumption). We could reverse the impact of our 2018 decision:

- On a per customer basis: in the first cap period, a typical dual fuel default tariff customer paid £7.65 less than we should have allowed for (£5.91 for their gas supply and £1.74 for their electricity supply). This approach would offset that benefit for each customer.

- On a collective basis, accounting for changes in customer numbers: in the first cap period, the six large suppliers would have charged default tariff customers £85m (£62m for gas and £23m for electricity) more than we allowed them to. This approach seeks to offset that amount in full.

5.21. Collectively, the six energy suppliers expect to serve 15% fewer default tariff customers in the fifth cap period (1 October 2020 to 1 April 2021) than they served in the first cap period. On that basis, setting the adjustment allowance on a per customer basis would mean that suppliers would collect 85% of the revenue that they would have collected from their customers in the first cap period. Setting the cap on a collective basis would mean that default tariff customers pay 18% more than the benefit they originally received in the first cap period.

Our proposal

5.22. We propose to set the adjustment change on a per customer basis, not increasing the charge to account for the reduction in suppliers' customer numbers.

5.23. We update the £ per MWh adjustment by CPIH.[49]

Rationale

5.24. In our January 2020 consultation, we explained that we could not reverse the impact of our 2018 decision for both customers and suppliers. Either customers would pay more than the benefit they originally received, or suppliers would recover only part of the money they would have charged.

5.25. We noted that, under section 1(6) of the Act, we must protect customers on default tariffs and – amongst other things – have regard to an efficient supplier's ability to finance its licensed activities. On that basis, we stated that our starting point was that the combined impact of the under-allowance in the first cap period and the adjustment allowance should net out from an individual customer's perspective. A customer should not pay more than the benefit they received.[50]

An overview of stakeholders' views

5.26. In their responses to our January 2020 consultation, most suppliers supported setting the charge on a collective basis accounting for their customer losses. Suppliers considered that they, in aggregate, should recover the revenue they would have made in the first cap period. On that basis, suppliers would need to charge their remaining customers more, to make up for customers that switch to their competitors, or switch to a cheaper tariff. They considered that in ensuring we protect customers effectively, we must also make reasonable efforts to enable suppliers to recover losses, and that it would be regrettable if this was not possible.

5.27. One supplier in principle supported the simplicity of setting the adjustment allowance on a per customer basis, but only in circumstances where customer numbers had not materially changed.

[49] See Annex 8 published alongside this consultation.
[50] Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation, paragraph 4.23. https://www.ofgem.gov.uk/publications-and-updates/reassessing-wholesale-allowance-first-default-tariff-cap-period-january-2020-consultation

Our considerations

Fewer default tariff customers

5.28. In the first cap period, the large suppliers served about 10.5 million gas default tariff customers and 13.1 million electricity default tariff customers. In the fifth cap period, suppliers (collectively) expect to have 15% fewer default tariff customers, although the expected losses for each supplier vary around that average.

Protecting default tariff customers

5.29. If we set the adjustment allowance on a per customer basis, then the impact on a customer that had a default tariff in the first cap period and the adjustment period would net out. They would pay back in the adjustment period an amount that offset the benefits they received in the first. New default tariff customers that were not default customers in the first cap period would incur additional costs that did not reflect their costs. Customers that had default tariffs in the first cap period, but no longer do, would not pay back the benefit they received. These two circumstances are unavoidable, if regrettable.

5.30. If we set the adjustment allowance on a collective basis, then default tariff customers would pay back 18% more in the adjustment period than the benefit they received in the first cap period. New default tariff customers would pay that additional amount, having received no benefit in the first place. Customers that are no longer default tariff customers would not pay back the benefit they received.

5.31. Setting the adjustment allowance on a per customer basis would better protect default tariff customers.

Considering the impact on suppliers

5.32. In protecting customers on default tariffs, we must have regard to an efficient supplier's ability to finance its licensed activities.[51] In this specific context, we consider

[51] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted

each supplier's wholesale costs were efficiently incurred. We consider it desirable that suppliers can recover the money they would have charged in the first cap period, but we do not consider this an absolute constraint on our decision. The primary focus of the Act is to protect customers.[52]

5.33. The impact of any adjustment will differ for each supplier. The Act requires that the cap is a single level for all suppliers.[53] We cannot provide each supplier with the money that they would have recovered in the first cap period, had the allowance been higher. For the reasons stated in Chapter 4, we consider the aggregate (average) impact on suppliers.

5.34. Had we set the wholesale allowance in the first cap period in line with suppliers' weighted average comparable wholesale costs, then suppliers would have charged customers about £85m more (£23m for electricity and £62m for gas).

5.35. If we set the adjustment allowance on a collective basis, the 18% surcharge to each customer would offset suppliers' customer losses. Suppliers could collect £85m from their customers in the adjustment period.

5.36. If we set the adjustment allowance on a per customer basis, suppliers would collect about 15% less (depending on the accuracy of their estimated customer losses). We take the view that this impact on suppliers has to be considered in context. First, we can only avoid it by charging each remaining customer 18% more than their costs justify. Secondly, we should consider how the second cap period might mitigate this. That allowance was higher than suppliers' comparable costs, as they had already purchased some of the energy in advance. The benefit to suppliers was about £2 per dual fuel customer, which is over £20m in total.

5.37. We consider that we cannot both protect default tariff customers and ensure that suppliers can collect the revenue they would have collected in the first cap period. We consider that setting the adjustment allowance on a per customer basis best achieves

[52] [2019] EWHC 3048 (Admin), paragraph 14.
https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html
[53] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2).
http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

the objective of the Act to ensure protection of existing and future customers who pay standard variable and default rates.[54]

Declaratory relief

5.38. One supplier considered that we must adjust for customer losses, on the basis that the High Court awarded British Gas declaratory relief. In its view, we must set the adjustment allowance at a level that allows that supplier to recover the money it would have charged in the first cap period (i.e. accounting for the customers that British Gas no longer serves). As we set one allowance for all suppliers, it considered that it, and other suppliers, would receive "vicarious relief" by charging at the level that was appropriate for British Gas (whether or not it reflected their own costs).

5.39. This view misunderstands the judgment. The Court ruled that Ofgem should reassess the allowance in the first cap period and "make such adjustments as it considers appropriate in the light of that reconsideration".[55]

Impact on switching rates

5.40. One supplier agreed with our proposal not to consider the impact that our 2018 decision had (or the impact that the adjustment allowance would have) on suppliers' default tariff customer numbers. It consider that the relationship with switching rate was unclear, at best.

5.41. Our decision reduced the savings default customers could have made by switching, compared with the savings they would have made had we set the cap at the correct level. In principle, this should have meant that suppliers lost fewer customers during that period than they would have done otherwise. In addition, the adjustment allowance would now increase savings and increase incentives to switch. This impact is difficult to impossible to estimate and the two periods should offset to some extent.

[54] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[55] [2019] EWHC 3048 (Admin), paragraph 90. https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html

Challenge 6: Adjustment period

Options

5.42. We have considered setting the adjustment allowance over one cap period or two cap periods.

- One cap period: Using this approach, the adjustment allowance, which is stated in TDCV annualised terms, would be £7.81 for gas (the adjustment would only be in place for six months during winter, so would recover £5.91 in that time), and it would be £3.08 for electricity customers (recovering £1.74 during the winter).

- Two cap periods. Using this approach, the adjustment allowance would be £5.91 for gas customers and £1.74 for electricity customers because the adjustment period includes 100% of customers' annual consumption.

Our proposal

5.43. We propose to include the adjustment allowance for one cap period (the first cap period), beginning from October 1 2020.

Rationale

5.44. We consider that the impact on default tariff customers is similar under either approach. Customers pay the same amount either way.

5.45. In principle, it is preferable for customers that we reduce the size of the adjustment allowance in each period. A longer adjustment period spreads the impact out over time. In addition, price comparison websites and suppliers state tariffs in annualised terms. Using a short adjustment period would make the adjustment seem larger than is actually the case, which should increase switching (theoretically). In practice, the difference between the annualised amount and the actual amount to be recovered is not large, so we do not weigh this consideration heavily.

5.46. In our January 2020 consultation we set out two factors we would consider when setting the adjustment period. First, the potential expiry of the cap. We do not consider this a significant issue when choosing between the two options.

5.47. Second, that default tariff customers may continue to switch to cheaper tariffs and competitor suppliers. A shorter adjustment period reduces the uncertainty about what losses suppliers might incur. A shorter adjustment period also reduces the period of time in which each supplier might lose more customers.

Considering stakeholders' views

Stakeholders' views

5.48. Most suppliers' supported a six-month adjustment period (i.e. one cap period), on the basis that customer losses would reduce the amount they would recover. One supplier considered that we should seek to resolve the issue as soon as possible, but the choice between setting the adjustment period over one cap period or two cap periods would depend on the materiality of the adjustment. Similarly, one stakeholder considered an adjustment over one cap period may be appropriate if the materiality was low. We consider this to be case.

5.49. One supplier proposed a three-month adjustment period, as the cap may end in December 2020. For the reasons stated below, this circumstance is less likely than the alternative and a three-month correction period would be impractical in any case.

5.50. One supplier, on the condition that we accounted for customer losses, had no strong views about whether we set the adjustment period over one cap period or more.

Considering the potential expiry of the cap

5.51. The cap could expire at the end of 2020, or it could be extended for 12 months. If it is extended, then it may expire in 2021 or be extended each year until 2023 at the latest.[56] In August 2020 we will publish our recommendation to the Secretary of State whether or not he should extend the cap. The Secretary of State will not publish a decision before we publish our decision on the adjustment allowance.

[56] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 8. http://www.legislation.gov.uk/ukpga/2018/21/section/8/enacted.

5.52. If the cap is not extended, then the adjustment allowance will only be in effect for three months. If we set a single adjustment period, then suppliers should recover 45% of the amount intended from gas customers and about 50% from electricity customers (considering normal consumption patterns). If we set the adjustment period over two cap periods, suppliers would recover 34% and 28% respectively. On that basis, if the cap expires at the end of 2020, a shorter adjustment period is been preferable.

5.53. However, it would be impractical to set the adjustment allowance so that it recovers the adjustment costs in the first three months of winter 2020. If the cap is extended, which most suppliers acknowledged to be more likely than not, the adjustment allowance would continue until April 2021, overcharging gas customers by 125% (i.e. more than double the amount intended) and electricity customers by around 100% (i.e. double the amount intended). In that case, we would need another correction during the summer 2021 cap period to recover that over payment. That series of corrections would be unacceptably disruptive to customers and suppliers.

5.54. Some suppliers suggested we should clarify what other remedy we might introduce if the cap is not extended. If that happens, we will consider whether another remedy is necessary at that time.

5.55. If the Secretary of State extends the cap, then, with respect to the expiry of the cap, there is no difference between setting the adjustment period over one cap period or two cap periods. The cap would be place until December 2021 at least.

5.56. We would not set the adjustment period over three or more cap periods, as the likelihood of the cap ending before the adjustment period was over would increase with each assessment of the conditions for effective competition as set out in section 7 of the Act.

Considering suppliers' declining customer base

5.57. Each supplier's default tariff customer base is likely to continue changing, although the rate of change is uncertain, in aggregate and for individual suppliers. This is a challenge, regardless of whether we decide to adjust the adjustment charge to account for aggregate customer losses (as we have proposed above).

5.58. Estimating suppliers' ability to retain their customers is difficult over a longer adjustment period. If we attempted to adjust for losses, the risk of error increases the

longer we set the adjustment period. Each supplier has different attrition rates, so the disparate impact that the adjustment allowance could have on each supplier will also increase.

Appendix 1 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, "Ofgem"). The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

Your personal data will not be shared with other organisations.

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for the duration of the consultation and decision, until the cessation of any related legal proceedings.

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data

- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at https://ico.org.uk/, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system.

9. More information For more information on how Ofgem processes your data, click on the link to our "Ofgem privacy promise".