Energy UK

The voice of the energy industry

EUK Response: Statutory Consultation on Changes to the Wholesale Methodology

14 June 2022

Introduction

Energy UK is the trade association for the energy industry with over 100 members spanning every aspect of the energy sector – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

We represent the diverse nature of the UK's energy industry with our members delivering over 80% of both the UK's power generation and energy supply for the 28 million UK homes as well as businesses. The energy industry invests £13bn annually, delivers £31bn in gross value added on top of the £95bn in economic activity through its supply chain and interaction with other sectors, and supports 738,000 jobs in every corner of the country.

This is a high-level industry view in response to Ofgem's Statutory Consultation on Changes to the Wholesale Methodology. Energy UK's members may hold different views on particular aspects of the consultation. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

Energy UK welcomes the opportunity to feed in its views on Ofgem's final considerations for price cap methodology reform in response to volatile markets ahead of the October 2022 price cap period. While Energy UK did not put forward a preferred option for price cap reform in our response to the March 2022, we are generally supportive of the proposals put forward by Ofgem for a reduced notice period, and quarterly cap periods with a backwardation allowance.

With regards to backwardation, we welcome Ofgem adopting an ex-ante approach to its allowance, in line with Energy UK's response to the March 2022 consultation. However, we do not believe that Ofgem has set out a robust justification for inclusion of a deadband in the allowance.

Updating the Cap

Energy UK is generally supportive of the proposals Ofgem has put forward. However, some of our supplier members have raised concerns with the impacts that quarterly cap updates will have on liquidity of the products in the market.

Current market conditions do not allow for suppliers to be able to effectively hedge in line with a quarterly price cap due to the market being set up for seasonal trading and overall low liquidity in the power market. In the absence of intervention from Ofgem or the Government, the only feasible solution at suppliers' disposal to mitigate liquidity risks is to take action, which could require suppliers to systematically diverging from the price cap hedging methodology to reduce their exposure.

We believe that as a prudent regulator Ofgem must work with industry as soon as possible to ascertain the scale of the issue, its potential impact on consumers and the market, and whether there are any suitable mitigating solutions that could be implemented.

Notice Period Reduction

Energy UK is generally supportive of Ofgem's proposals to reduce the notice period for cap level updates for October 2022 and beyond. In our response to the March 2022 consultation, Energy UK suggested that Ofgem must ensure it considers in full any wider impacts or unintended consequences on suppliers' operations or costs and include appropriate solutions within its final decision. For example, whether the existing prescriptive nature of Disadvantageous Unilateral Variations requirements (SLC 23) remain appropriate with a shortened price cap level notice period.

We do not believe that suppliers' concerns regarding unintended interactions between the reduced notice period and existing requirements for customer communications have been fully considered by Ofgem. As well as potential conflicts with the cheapest tariff messaging, there may be complications with the notice period's interaction with price protection windows, such as overlapping windows as a result of customer actions. We are disappointed with Ofgem's response to these issues in its consultation and urge Ofgem to give its full consideration to the interaction of reduced notice period with existing requirements and set out in detail how it understands them operating together from September and each quarterly update onwards.

Backwardation

Energy UK welcomes and supports Ofgem's proposals for an ex-ante approach for its backwardation allowance, in line with our submission to the March 2022 policy consultation.

However, we do not believe Ofgem has put forward a robust and sufficient justification for the inclusion of a deadband within the allowance. The deadband is not needed to levelise costs across seasons because levelisation can be done entirely through the recovery mechanism. Ofgem asserts that "normal market conditions" will return - and that when they do - backwardation costs will be netted off by contango benefits within the life of the cap. There is not enough evidence to suggest that these assertions can be justified in the current landscape.

Energy UK also has remaining concerns with the backwardation allowance's treatment of costs related to volume risk as a result of it being recovered up to 12 months after the actual costs were incurred. If there is more or less default tariff demand than prudently forecasted, the cost of correcting for this can be significant, both in terms of the cost of purchasing that volume and the backwardation costs associated with purchasing that volume.

Given the difficulties in managing volume risk, Ofgem should commit to updating the £/per customer allowance to take account of movement in SVT customers. In doing so, the allowance will more accurately reflect movement in SVT numbers over a twelve-month period, and there then also may be rationale for including a true-up element if there is under or over recovery.[1]

For further information or to discuss anything in this response in more detail please contact Steve Kirkwood on 0207 747 2931 or Steve.Kirkwood@Energy-UK.org.uk.

[1] One member has suggested an alternative method to use the Market Stabilisation Charge and ensuring that its assessment of suppliers' costs include allowances for unrecovered costs that have been incurred.