Decision

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Price Cap - Decision on the process for updating the Default Tariff Cap methodology and setting maximum charges

Subject	Details
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We consulted in November 2021 on proposals to modify the licence to introduce an ability for us to amend the cap outside of our routine six-monthly cycle, where exceptional circumstances apply. This document sets out our decisions for proceeding with the licence modification.

We have considered stakeholders responses, noting concerns around the additional uncertainty this policy may bring. To address these concerns, we have introduced a clear test framework to assess a situation before triggering an in-period adjustment. We have published non-confidential responses alongside this decision.

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Executive summary

We introduced the default tariff cap ('cap') on 1 January 2019, which currently protects around 22 million households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap protects domestic customers on default tariffs, ensuring that they pay a fair price for their energy, reflecting its underlying costs. The cap is set using a bottom-up cost assessment approach. We update the level of the cap on a six-monthly cycle in February and August for the respective April and October cap periods.

There has been a record rise in global gas prices over the last six months. We published several consultations to respond to these circumstances. Today we are also announcing changes to the cap level from 1 April 2022 that will cover an uplift to the wholesale cost allowance to allow for costs incurred by suppliers. As part of today's package, we are also launching a consultation on cap reforms to be implemented by October 2022.

When introducing the cap, we set the licence conditions to enable us to carry out a cap update every six months (February and August). This means, under the current licence conditions, we are unable to set the cap level outside the scheduled updates without a licence modification. The inability to update the cap more frequently reduces the flexibility for us to consider how best to respond to exceptional circumstances, such as the one we are currently seeing.

In November 2021, we consulted on proposals to modify the licence to set out a power to make an in-period adjustment to the cap level in exceptional circumstances. The in-period adjustment can be an increase or a decrease in the cap level based on the impact of the exceptional circumstance at the time of triggering the policy. Having reviewed stakeholder responses to our consultation, we have decided to proceed with the modification. We have considered stakeholders concerns around the additional uncertainty this policy may bring. To address these concerns, we have introduced a clear test framework for using an in-period adjustment.

Introducing the policy will help to manage the risk of the cap allowances materially deviating from efficient costs in exceptional circumstances. While the policy may somewhat increase uncertainty for industry and customers as there is reduced forward visibility on when the cap will be updated, we consider that our intention to only use an in-period adjustment in exceptional circumstances limits that uncertainty. We have also designed a set of criteria that we would expect a situation to meet before we trigger an in-period adjustment. This will help stakeholders understand the situations when we would consider using this tool.

We have decided to implement a framework that consists of a set of qualitative criteria which will be guided by quantitative data. We have not introduced strict thresholds based on metrics as this would reduce our ability to respond to a variety of unknown future situations and risk the policy becoming ineffective when needed. The framework consists of five criteria:

- **Rare**: a rare event in either nature or scale, the consequence of which was not wholly included in the calculation of the current cap.
- **Externally caused**: the cause of the event is external to suppliers within the energy market.
- **Not reasonably avoidable**: when even suppliers who have taken reasonable steps to mitigate the impact of the event have limited or no success and face unavoidable changes to their costs.
- **Appropriate**: the event impacts the efficient costs of supply.
- **Requires urgent action**: urgent action by Ofgem is deemed necessary within the remaining cap period, to mitigate otherwise potential long-term and/or enduring impacts on the market and customers.

We are introducing this tool to enable us to react to exceptional circumstances. We will consider the nature of the exceptional circumstances as well as suppliers' ability to implement any changes when consulting and implementing the updated cap level. This means that, if appropriate and necessary, we will shorten the consultation or implementation period compared to the timings set out in the Tariff Cap Act.

When we make a decision to carry out an in-period adjustment, it will apply for the remainder of that cap period up until the start of the next cap period. However, we may still consider additional costs incurred during previous periods that relate to the exceptional circumstance.

Overall, we consider our test framework provides additional clarity to stakeholders on how we would assess exceptional circumstances. It provides a balance between giving industry certainty and providing the necessary flexibility to deal with a range of exceptional circumstances that may be detrimental to suppliers and customers. We will consider whether any further changes are required to the in-period adjustment policy once we have implemented any reforms to the cap methodology resulting from our work on 'Adapting the price cap methodology for resilience in volatile markets'.

1. Introduction

Subject of this decision

The cap

1.1. We introduced the default tariff cap ('cap') on 1 January 2019, which currently protects around 22 million households on standard variable and default tariffs (which we refer to collectively as "default tariffs"). The cap protects domestic customers on default tariffs, ensuring that they pay a fair price for their energy, reflecting its underlying costs. The cap is one of the key activities which fall within the outcome "consumers pay a fair price for energy and benefit from rights and protections" within our Forward Work Programme for 2021-22.[1] [2] We set the cap by considering the different costs suppliers face. The cap is made up of a number of allowances which reflect these different costs.

1.2. At present, our scheduled cap update process works on a six-monthly review cycle. Updates to the cap level occur in February and August in a given year, which respectively apply for cap periods starting in April and October of that same year.

1.3. When introducing the cap, we set the licence conditions to enable us to carry out a cap update every six months (February and August). This means, under the current licence conditions, we are unable to set the cap level outside the scheduled updates without amending the licence conditions.[3] This makes it difficult to respond to situations that may require an interim cap update, such as exceptional circumstances that need addressing more quickly.

Current market developments

1.4. The scale and pace of wholesale price increases over recent months represents an unprecedented challenge to the GB energy market. There has been a record increase in global gas prices over the last six months, with wholesale prices quadrupling in the last year. Market volatility remains well above historical levels, and the pressure this has placed

[1] Ofgem (2021), Forward work programme 2021/22
https://www.ofgem.gov.uk/publications/forward-work-programme-202122
[2] We are currently consulting on our draft Forward Work Programme for 2022-23.
Ofgem (2022), Forward Work Programme Consultation.
https://www.ofgem.gov.uk/publications/202223-forward-work-programme-consultation
[3] To note, section 6 of the Tariff Cap Act states Ofgem must review the level at which the cap is set, at least every 6 months. It does not prescribe when that review needs to take place.

on industry can be clearly seen – 29 energy companies have exited the market or been put in special administration over the last year.

1.5. To ensure that the cap reflects the costs, risks and uncertainties facing suppliers, we published a range of documents consulting stakeholders on proposals to amend the cap.[4] To address the issues raised by high and volatile wholesale energy prices on an enduring basis, we are putting in place an enhanced regulatory approach to ensure energy suppliers pursue sustainable business models, minimising risks to customers and the market.

1.6. Alongside this decision document we have also published a decision, following consultation, on whether the recent rise in wholesale prices has caused the level of the cap to materially depart from the efficient cost level allowed for in the cap. In that decision, we set out our position to amend the Wholesale Additional Risk Allowance,[5] for gas and electricity, to a level that accounts for the increased efficient and material costs incurred by suppliers this winter.[6,7]

1.7. In addition, we are considering whether we need to make changes to the cap to build further resilience to price volatility. We published a call for input which discussed changes that could be made to the cap methodology to ensure that it is more resilient to extreme commodity price volatility whilst continuing to protect customers.[8] Informed by views from stakeholders, we have issued a 'Consultation on Medium Term Changes to the Price Cap Methodology', seeking feedback on how our potential reforms could be implemented.[9]

[4] Ofgem (2021), Overview of 19th November 2021 Price cap consultations, https://www.ofgem.gov.uk/publications/overview-19th-november-2021-price-cap-consultations
[5] As this term is defined in the standard licence conditions of the electricity supply licence and the gas supplier licence, consolidated versions of which are available on this page.
[6] Ofgem (2021), Price Cap – Consulting on the potential impact of increased wholesale volatility on the default tariff cap https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap
[7] Ofgem (2022), Decision on the potential impact of increased wholesale volatility on the default tariff cap, https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[8] Ofgem (2021), Adapting the price cap methodology for resilience in volatile markets https://www.ofgem.gov.uk/publications/adapting-price-cap-methodology-resilience-volatile-markets
[9] Ofgem (2022), Consultation on Medium Term Changes to the Price Cap Methodology, https://www.ofgem.gov.uk/publications/consultation-medium-term-changes-price-cap-methodology

1.8. We will continue to progress these cap reform options alongside implementing the ability to make in-period adjustments. However, these reforms to the cap methodology will not be in place until October 2022.

Scope of this decision

1.9. This decision follows our consultation in November 2021 ('November 2021 consultation') on our proposals to modify the licence to introduce the ability for us to amend the cap outside of our routine six-monthly cycle, where exceptional circumstances occur.[10]

1.10. The November 2021 consultation explained our rationale behind having an ability to have an amendment within a cap period (an 'in-period adjustment') in exceptional circumstances. We outlined considerations in relation to the test we would use when assessing whether to use an in-period adjustment and how we would use the power in practice.

1.11. Having reviewed stakeholder responses to our November 2021 consultation, we have decided to proceed with introducing an in-period adjustment policy. We have considered stakeholder concerns that the policy introduces uncertainty and refined our test framework to provide further clarity on when we may use an in-period adjustment. We expect a situation to meet our test framework to be considered as an exceptional circumstance and trigger an in-period adjustment. We provide our detailed considerations in relation to introducing the measure, the test framework and using the measure in Chapter 2.

Related publications

The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018
- November 2018 Default Tariff Cap Decision

The main documents relating to the in-period adjustment and our response to the rise in gas and electricity prices over recent months:

[10] Ofgem (2021), Price Cap - Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges, https://www.ofgem.gov.uk/publications/price-cap-consultation-process-updating-default-tariff-cap-methodology-and-setting-maximum-charges

- Price Cap - Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges
- Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap.
- Decision on the potential impact of increased wholesale volatility on the default tariff cap

Your feedback

General feedback

1.12. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments?

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

2. Introducing the power

Section summary

This chapter sets our decision to proceed with modifying SLC28AD of the gas and electricity supply licences to set out a power to recalculate the cap level within a cap period in exceptional circumstances. We discuss our rationale for introducing the policy, considerations in relation to uncertainty for customers and suppliers, the test framework and using this power.

Context

2.1. Given recent conditions reflecting an unprecedented rise in wholesale gas prices, and as set out in our open letter to industry covering the rising wholesale prices and implications for the regulatory framework, we examined the current design and operation of the cap to determine how the cap might evolve.[11]

2.2. As part of this, our November 2021 consultation set out proposals to modify the licence to introduce an ability for us promptly to amend the cap outside of our routine six-monthly cycle, where exceptional circumstances occur.[12] This was intended so that we could better respond to circumstances that may require an interim cap update, such as exceptional circumstances that need addressing more quickly.

2.3. Where exceptional circumstances apply, we considered that having a mechanism which would set out a power to change the cap level sooner would be important to manage more effectively the risks to the market and to customers. We proposed a test framework that deliberately set a high threshold for using an in-period adjustment. This framework reflected our intention to only use this adjustment in exceptional circumstances.

[11] Ofgem (2021), Rising wholesale energy prices and implications for the regulatory framework, https://www.ofgem.gov.uk/publications/rising-wholesale-energy-prices-and-implications-regulatory-framework

[12] Ofgem (2021), Price Cap – Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges https://www.ofgem.gov.uk/publications/price-cap-consultation-process-updating-default-tariff-cap-methodology-and-setting-maximum-charges

2.4. As part of the framework, we specified that an exceptional circumstance would have to fulfil two conditions to reflect this high threshold: rare and having a high impact without urgent action (see paragraph 2.37 for definition).

2.5. We proposed that in-period adjustments would be forward looking only. This means that if we made an in-period adjustment to the cap, the updated cap level would only apply for the remainder of the existing cap period rather than retrospectively for the whole cap period. However, this was not to say we could not consider additional costs/benefits incurred in previous periods when setting any forward looking adjustments.

Decision

2.6. We have decided to proceed with modifying SLC28AD of the gas and electricity supply licences to set out a power to recalculate the cap level within a cap period in exceptional circumstances. We will consider whether a situation is an exceptional circumstance by assessing it against our test framework.

2.7. We have decided to introduce a test framework that consists of five qualitative tests. We would expect a situation that meets the five tests to be considered an exceptional circumstance and trigger an in-period adjustment. While these tests will be guided by data, we have decided to not set quantitative thresholds. This is because providing prescriptive values would significantly reduce the flexibility needed to deal with unknown future exceptional circumstances. The five tests we will apply when assessing an event or circumstances are: **rare**, **externally caused**, **not reasonably avoidable**, **appropriate** and **requires urgent action** (see the 'test framework' section for definitions).

2.8. In applying any in-period adjustments, we have decided that it would be forward looking only, applying for the remainder of the cap period rather than retrospectively for the entire cap period. The direction of an adjustment could be either upwards or downwards depending on the impact of the specific exceptional circumstance.

Overview of responses

2.9. In response to our November 2021 consultation, we received responses from 20 stakeholders consisting of energy suppliers, consumer organisations and trade bodies. Out

of all respondents, ten disagreed with our proposal to introduce an in-period adjustment, and eight agreed with our proposal.[13]

2.10. In addition, we also received approximately 40,000 responses to our November 2021 consultation through a petition website. Respondents were able to select from agreement or disagreement with a statement on whether Ofgem should or should not change the price cap more frequently than every six months, and add their own commentary. Approximately 3% (just over 1,000) said Ofgem should change the price cap more frequently than every six months. 86% disagreed (34,000) saying that Ofgem should not change the price cap more frequently. 6.9% of respondents made other comments.

2.11. Several stakeholders, whether they agreed with the proposal or not, asked for further clarity on how the proposed test framework would work in practice, with four requesting examples of its potential application.

2.12. Respondents who disagreed with our proposal mentioned five common areas:

- the proposal creates more uncertainty, as Ofgem can make changes to the cap outside of the existing schedule
- Ofgem's focus should be on reforming the cap, rather than introducing an in-period adjustment.
- the test framework, thresholds, and methodology for making that change are not clearly defined.
- there are concerns regarding the process timings that would apply when carrying out an in-period adjustment.
- whether this policy would be used more favourably for upwards adjustments and whether any adjustment should be forward looking only.

[13] There were two stakeholders that did not directly express a position.

2.13. Respondents who agreed mentioned two common areas:

- it is a reasonable approach to allow changes in truly exceptional circumstances, with the original test framework being a sensible approach to a guiding definition.
- the proposal is useful to smooth out large price changes and should be used during the summer to smooth price increases in winter.

Considerations

2.14. In this section, we set out our overall views on stakeholders' comments and provide our detailed rationale for our decisions. We address specific stakeholder comments in Appendix 1.

Introducing the policy

Overall rationale

2.15. We have decided to proceed with modifying SLC28AD of the gas and electricity supply licences to set out a power to recalculate the cap level within a cap period in exceptional circumstances. Where the efficient cost of supplying default tariff customers deviates from the allowances set under the cap in exceptional circumstances, this policy allows us to make an adjustment to reflect this difference.

2.16. The policy aids supplier financeability and resilience by dampening cost shocks caused by an exceptional circumstance. For example, if the cap is underfunding their efficient costs, we could uplift the cap to realign costs and allowances to alleviate pressure on profitability and increase resilience. It also benefits customers as they may see lower costs in the short term if the efficient cost to supply them has reduced due to an exceptional circumstance. Alternatively, customers may see lower costs in the longer-term by avoiding supplier failure and the mutualised costs that follow.

2.17. We acknowledge the policy may bring risks of uncertainty to suppliers and customers. Frequent cap level changes for suppliers may make business planning activities more difficult and increase uncertainty on revenue. Additionally, the possibility of an in-period adjustment may incentivise suppliers to reduce activities to mitigate the impact of large shocks from exceptional circumstances. From a customer perspective, frequent price changes may make budgeting more difficult and lead to confusion (eg from an increase in the volume of communication a customer receives from their supplier). Overall, there is a

clear trade-off between providing certainty on the cap level and ensuring the cap reflects changes in efficient costs during exceptional circumstances.

2.18. We seek to reduce any uncertainty resulting from an in-period adjustment by only using it in exceptional circumstances, where urgent action is required beyond what the six-monthly cap setting process can provide. This limits the frequency at which we would consider using an in-period adjustment. Therefore, the introduction of an in-period adjustment does not mean the cap will update more regularly than the current six-monthly cycle on a frequent basis. This addresses concerns raised by respondents who were not in favour of more frequent cap updates. (Summarised in paragraph 2.10)

2.19. In addition, we are providing more clarity to stakeholders on how we would assess a situation to determine whether it is an exceptional circumstance by setting out a test framework. The test framework consists of five qualitative tests that we would expect a situation to meet before considering an in-period adjustment. The test framework will aid stakeholders in understanding when we may seek to act.

2.20. One stakeholder stated we could make in-period changes to the cap by setting a new cap level using a licence modification process rather than introducing this policy. The stakeholder considered there to be a lack of justification and increased uncertainty. It, therefore, did not consider that our proposals were necessary or proportionate. We consider this policy has benefits over a licence modification. These include that this policy provides a clearer signal that in exceptional circumstances, we may consider an in-period adjustment to the cap. In addition, we set out a clear framework that provides stakeholders some certainty on when we would consider using an in-period adjustment. A licence modification to adjust the cap level would not address stakeholder concerns about uncertainty over how Ofgem will react should another exceptional circumstance present itself or provide clarity on the circumstances in which we would consider adjusting the cap level. Furthermore, when using an in-period adjustment, we can consider shorter timeframes than a licence modification would require should an exceptional circumstance require it.

2.21. On balance, we consider the possibility of making in-period adjustments to the cap yields a benefit for stakeholders through greater resilience during exceptional circumstances for suppliers and lower short/long term costs for customers. We consider

uncertainty, the test framework and using an in-period adjustment in more detail through this section.

Uncertainty – Customers

2.22. Some stakeholders expressed concerns that the proposed adjustment would introduce uncertainty for customers, as the proposal could cause their energy costs to change more frequently. Some reasons included that more frequent price changes at short notice could be unsettling for customers, reduce the ability to budget and lead to an increase in confusion through a greater number of various communications (eg updates on the cap level).

2.23. In addition, the majority of respondents who replied through a petition website stated that Ofgem should not change the cap more frequently than every six months.

2.24. We would only use an in-period adjustment in exceptional circumstances. This is reinforced by setting out a set of tests that we would expect a situation to meet before proceeding with an in-period adjustment. We do not expect customers to see frequent price changes in addition to the scheduled cap updates as a result of this policy given the test framework.

2.25. It is worth noting that in our consultation on medium term changes we are proposing a move to quarterly updates. Moving to more frequent cap updates would result in smaller price changes generally, and a reduction in volume risk which would decrease the long-term costs to customers. Please see our consultation for more detail.[14]

2.26. When making an in-period adjustment, we would consider the impact on customers and ensure they pay a fair price for their energy given the exceptional circumstance. For a downward adjustment where the cost to supply customers has fallen, customers would see an immediate benefit from an in-period adjustment. In the event of an upward adjustment, customers may see lower costs in the longer term. For example, if an upward adjustment

[14] Ofgem (2022), Consultation on Medium Term Changes to the Price Cap Methodology, https://www.ofgem.gov.uk/publications/consultation-medium-term-changes-price-cap-methodology

reduces the risk and number of supplier failures, the cost of those failures passed onto customers will be lower (ie a lower mutualisation costs).

Uncertainty - Suppliers

2.27. Of those who disagreed, most stakeholders expressed concerns that the proposed adjustment would introduce uncertainty into the market, undermine investor confidence and increase the risks of entering the market. This is because, in their view, the proposed test framework did not provide enough certainty on how and when an in-period adjustment could be used. Some stakeholders considered the framework subjective or loosely defined.

2.28. To address these concerns, we revisited and refined the test framework to provide greater clarity on how we would assess a situation to determine whether to consider an in-period adjustment (we discuss the framework in more detail below). We have set an intentionally high threshold for considering an in-period adjustment, which reinforces our view that this policy will not be used frequently and should not affect typical operations.

2.29. In addition, using an in-period adjustment would be subject to consultation. This would give stakeholders an opportunity to provide their representations and raise any concerns around our proposal, which we would consider before making an adjustment.

2.30. Whilst we have minimised supplier uncertainty through providing more detail of our test framework, we recognise this policy will still introduce an inherent level of uncertainty. There is a trade-off between providing more certainty through the framework and being able to respond to a range of unknown situations. We have balanced this trade-off to reach the framework we have decided on. Providing further clarity would reduce the effectiveness of an in-period adjustment, which would not be beneficial for suppliers or customers for the reasons discussed.

2.31. Even if it is the case that this policy may increase supplier uncertainty in individual cases, we consider that the policy could reduce the overall uncertainty suppliers could face in relation to their profitability under the cap. This is because the policy will allow for the cap to better reflect any deviation between efficient costs and the cap due to exceptional circumstances (such as in the current gas crisis). For a downward adjustment, we would seek to apply it only in cases where suppliers have seen a decrease in their own costs and this decrease should be passed on to customers. For example, if a pure pass-through cost was removed.

Wider cap reforms

2.32. Some stakeholders stated that we should focus on other cap reforms instead of the in-period adjustment policy, for example more frequent cap updates.

2.33. In December 2021, we published a call for input on changing the cap methodology to ensure that the cap is more resilient to extreme commodity price volatility whilst continuing to protect customers.[15] Informed by views from stakeholders, we have issued a 'Consultation on Medium Term Changes to the Price Cap Methodology', seeking feedback on how our potential reforms could be implemented.[16] We will continue to progress these cap reform options alongside implementing the ability to make in-period adjustments. However, these reform changes to the cap methodology will not be in place until October 2022.

2.34. Implementing the in-period adjustment will ensure we have the adequate tools to respond in case any exceptional circumstances arise before we consider any cap reforms. We will consider relevant responses in our continued work on these reforms alongside implementing the ability to make in-period adjustments to the cap.

2.35. We will consider whether any further changes are required to the in-period adjustment policy once we have implemented any reforms to the cap methodology.

Test framework

2.36. For the stakeholders that disagreed with the policy, most stated that the proposed test framework to determine whether an in-period adjustment is needed is loosely defined and will create uncertainty. Some stakeholders who agreed with the proposal also made the point that further clarity on when the test may be applied is needed.

2.37. In our November 2021 consultation[17], we proposed two conditions that an exceptional circumstance must meet for an in-period adjustment to be applicable:

[15] Ofgem (2021), Adapting the price cap methodology for resilience in volatile markets https://www.ofgem.gov.uk/publications/adapting-price-cap-methodology-resilience-volatile-markets
[16] Ofgem (2022), Consultation on Medium Term Changes to the Price Cap Methodology, https://www.ofgem.gov.uk/publications/consultation-medium-term-changes-price-cap-methodology
[17] Ofgem (2021), Price Cap – Consultation on the process for updating the Default Tariff Cap methodology and setting maximum charges, paragraph 16 https://www.ofgem.gov.uk/publications/price-cap-consultation-process-updating-default-tariff-cap-methodology-and-setting-maximum-charges

- Rare – Relating to the foreseeability, nature and/or scale of the event

- High impact without urgent action - Leading to irreversible effects on the energy market, customers or could have systemic consequences. The circumstance would need to have a large impact over a short period of time (materiality). An adjustment may also be applied based on potential outcomes due to the fast-moving nature of exceptional circumstances. Not all financial impacts on suppliers would meet the criteria above.

2.38. When designing a framework, there is a trade-off between providing stakeholder certainty and our ability to act in a range of unknown exceptional circumstances, which is the intended role of the in-period adjustment. However, recognising concerns around uncertainty we have further developed the test framework to provide a clearer explanation of the process that will be applied to determine if an in-period adjustment is required or not.

2.39. We have decided to use five tests, developing the test framework previously set out in our November 2021 consultation. To add further clarity, we have split the original "Rare" into three distinct tests (**Rare, Externally caused, and Not reasonably avoidable**) and "High impact without urgent action" into two distinct tests (**Appropriate, and Require urgent action**). We expect an exceptional circumstance to meet our test framework.

2.40. We have decided to establish a test framework that combines qualitative tests and market data to determine if an adjustment is needed. We did not consider a purely qualitative test is appropriate. A solely qualitative approach would reduce transparency as to when we may seek to use an in-period adjustment. It would not provide clarity for stakeholders to address some of the uncertainty concerns set out in responses. It is within our role as an economic regulator to rely on our regulatory judgement when making policy decisions. However, a purely qualitative framework may be seen as too subjective.

2.41. We did not consider a purely quantitative test framework with defined thresholds as appropriate either, given the unknown nature of future events. By its nature, an appropriate circumstance for which we aim to use this power is unknown. Setting and tracking quantitative metrics limits the flexibility of the power to recognise the circumstance. If we used a strict quantitative threshold, we risk not being able to make an adjustment when it is needed most because the situation may differ from the type of threshold we have set. Additionally, there may be a lag in data becoming available following the identification of an exceptional circumstance. This delay could reduce the effectiveness of the measure as we would have less flexibility to respond quickly.

2.42. Our test framework does not set specific threshold values that must be reached, but rather a series of qualitative tests that must be met for us to trigger the in-period adjustment. These tests will be guided by data, for example, considering historical data to aid the assessment of whether an event is "rare". Data will support, but not determine the result of the test, as providing prescriptive values would significantly reduce the flexibility needed to deal with unknown future exceptional circumstances.

2.43. In applying the test framework, we would intend to capture the average market position and apply the tests in an unbiased manner. This would reduce the risk of favouring suppliers with particular approaches or business models when considering impacts and risk mitigations.

2.44. We describe each element of the test framework in more detail below.

Rare

2.45. **Definition**: Rare event in either nature or scale, the consequence of which was not wholly included in the calculation of the current cap.

2.46. We aim to ensure that an in-period adjustment is only considered in circumstances that do not occur frequently (nature) and/or where the scale is exceptional (scale). This particular element sets a high bar as the trigger for considering use of the in-period adjustment. We consider that ensuring a high bar will reduce frequency of use, thus addressing stakeholder concerns relating to consumer and supplier uncertainty (discussed earlier in the paper).

2.47. We consider that using a strict quantitative threshold to define rare raises the question of what an appropriate value and metric to use are, and whether those will be applicable to future unknown events. If the threshold is too high for the policy's intended purpose it would restrict the use of the adjustment.

2.48. We may use historical data to assess the scale and frequency of an event compared to past norms on a case-by-case basis in order to define an event as rare. For example, considering past 10 years of data on an event. If an event occurred multiple times in rapid succession, we may still consider whether it is rare or not in the context of historic trends prior to the first successive occurrence depending on the circumstances.

2.49. Events that may be considered as rare by nature could include natural disasters such as storms and floods. Rare events by scale could include situations that lead sharp

increases in costs, larger than those seen historically. For example, an event that leads to a historically sudden and sharp change in wholesale prices due to global supply chain disruption.

2.50. A sudden government intervention could also be considered a rare situation. Typically, government policy changes are made known with sufficient lead time for us to accommodate within the cap review cycle. However, where a government intervention occurs within accelerated timelines, this may not be possible. For example, the government furlough scheme introduced during the Covid-19 pandemic was implemented far more rapidly than typical policies. If a similar intervention were to be made by the government on factors that influence energy supply costs, it would be considered a rare event. Where a series of such rapid interventions are made within a short time-period, we may still consider each intervention as rare within the wider context of the last few years.

Externally caused

2.51. **Definition**: The cause of the event is external to suppliers within the energy market.

2.52. Through this criterion, we seek to ensure that an in-period adjustment is only applied to exceptional circumstances that are caused by a source external to the energy market suppliers. This test is designed to prevent adjustments being used for issues which suppliers themselves have created or have control over through their business decisions or practises.

2.53. We may consider quantitative data to support identifying whether a cause is external, such as supplier pricing data. However, there may be cases where non-quantitative data is required to assess whether a situation is externally caused.

2.54. The in-period adjustment is not intended to enable poor supplier behaviour or penalise positive behaviour. For a downward adjustment, we would not seek to penalise suppliers where they have carried out positive behaviour. For example, if suppliers carried out efficiency saving measures, we would not seek to use this mechanism to adjust the cap for the savings.

2.55. If suppliers take what is considered an overly risky strategy compared to the rest of the market, resulting in potential supplier exit without an in-period adjustment, we would not consider the situation to be externally caused. For example, a supplier using a risky strategy which results in it having a cost above what is provided by the cap and is

subsequently unable to recover costs to avoid market exit without an in-period cap adjustment, will not pass this test. Conversely, an event external to supplier actions, such as a government policy change or intervention would typically be considered to meet this test.

2.56. For avoidance of doubt, a situation caused by the actions of a single supplier that impacts the result of the market would likely be considered as externally caused to the rest of the market.

Not reasonably avoidable

2.57. **Definition**: When even suppliers who have taken reasonable steps to mitigate the impact of the event have limited or no success and face unavoidable changes to their costs.

2.58. Two suppliers raised concerns that an in-period adjustment would incentivise suppliers to carry out riskier behaviour and reduce risk mitigation practices. We will use this test to check whether reasonable steps were taken to mitigate the impact. If we found more reasonable steps could have been taken, the test would not be met.

2.59. If the impact of an exceptional event could have been reasonably mitigated, the test may not apply. For example, a sudden and significant change in energy demand could substantially increase energy demand and costs (above the cap), and suppliers may argue that reasonable mitigations could not have accounted for the scale of the event. Assuming that other tests are met, Ofgem would expect to see energy purchase cost hedging as well as active risk management, using an *ex-ante* point of view to determine what is reasonable.

2.60. In general, we do not intend to use an in-period adjustment to enable suppliers to recover costs caused by risky behaviour or poor risk management strategies. This would lead to customers bearing the associated costs and would not meet our objective of protecting customers. Given there are five separate strict tests we expect an exceptional circumstance to meet, we consider there is less incentive for suppliers to adopt riskier strategies with the expectation that Ofgem will amend the cap should they go wrong.

2.61. Risk management and mitigation practices should continue to be put in place by suppliers, as this test will check whether the impact of the exceptional circumstances could have been reasonably avoided through different practices (for example pricing decisions or hedging strategies).

2.62. It is important to note that this test will be taken with a view of what was considered as reasonable mitigation or protection before the exceptional circumstances occurred, rather than identifying what would have been the best strategy with hindsight.

2.63. In general, we would seek to assess mitigating actions across the market. We may use quantitative data on a case-by-case basis dependent on the wider context of the situation. We may consider supplier data to assess whether reasonable mitigations were carried out. For example, we may consider supplier hedging data to consider risk mitigation against extreme price changes. We do note that the use of quantitative data may be limited by speed of collection, quality and availability.

2.64. There may be some situations where mitigations may not necessarily be applicable. For example, an exogenous shock may result in sudden and material change in network costs that may increase or reduce a cost that suppliers usually pass on directly to customers. As network costs are typically stable across a ~15-month time period and are typically a pass-through cost from network companies to customers via suppliers, there may not be any mitigation actions suppliers can take.

2.65. However, some exogenous shocks will require some form of mitigation action from suppliers before the impacts can be considered not reasonably avoidable. For example, volatility in wholesale costs should typically be planned against. Therefore, reasonable mitigating actions need to be taken by suppliers before a situation can be considered not reasonably avoidable.

2.66. Mitigation actions may be limited by many factors, such as the speed of impact, understanding of impact and probability of event occurrence, which vary situation to situation. There may be instances where we consider mitigation actions unreasonable for a supplier to have carried out. For example, if the action is very costly to mitigate a very unlikely risk.

Appropriate

2.67. **Definition**: The event impacts the efficient costs of supply.

2.68. Given this policy is specific to adjusting the cap level, we consider it important to ensure that a situation has an impact on the efficient costs of supply.

2.69. A situation which impacts the efficient costs of supply in either direction, upwards or downwards, will be considered within this test. This ensures the policy has the flexibility to

adjust the cap in both directions to protect both customers and suppliers where necessary. For example, an emergency government intervention could either raise or lower prices depending on the nature of the change.

2.70. When considering an in-period adjustment, we would consider the impact of any other policy measures on the situation (if applicable). This would ensure we do not double count any impacts that are captured through other policies when setting an allowance in the cap and minimise the risk of over/under funding suppliers.

2.71. The use of quantitative data to assess this criterion will be mixed. There will be some cases where we rely more heavily on data sources to consider whether the situation has an impact on efficient costs of supplying energy. Whereas in other cases, the link may be clear without the need for data (eg changes in wholesale prices). Scale of impact on efficient costs of supply are not included within this test but will be captured in the fifth test (Requires urgent action).

2.72. A change in the efficient cost of supply may or may not already be captured within the cap cost components. For example, changes in budget to existing environmental / social obligation costs could be considered as appropriate and would be captured by the cap components. Whereas a policy change to how employers provide support to their employees could increase the operating costs for a supplier but may not be captured within the cap.

Requires urgent action

2.73. **Definition**: Urgent action by Ofgem is deemed necessary within the remaining cap period, to mitigate otherwise potential long-term and/or enduring impacts on the market and customers.

2.74. This test will check whether waiting for the next point at which a change could be implemented as part of a scheduled update could have high and/or enduring impacts on the market and customers, that could be avoided by acting now. For example, if inaction before the next cap period could lead to a significant number of efficient suppliers exiting the market, it could be considered a situation which requires urgent action.

2.75. In addition, the proximity of an event to the next scheduled cap update will impact whether urgent action is required. If a situation occurs close to the next cap update, it may be possible to wait for the scheduled update.

2.76. An urgent change to the cap through the in-period adjustment could be downward or upward. In the case of an upward adjustment, the immediate action may prevent potential long-term harm to the market and customers (for example by reducing the risk of supplier failures and the associated costs). A downward adjustment may reduce enduring customer harm by helping them to manage their energy bills (for example, it may reduce the risk of debt build up or self-rationing).

2.77. Setting a specific threshold for scale of change or impact could restrict use of the adjustment when required. Therefore, scale of impact will be considered on a case-by-case basis, looking historically and assessing the potential long-term impacts where appropriate. Supplier financial data may also be used to understand any immediate impacts on resilience. We may also use quantitative data on customers to assess the immediate impacts on customer affordability (eg self-rationing statistics).

2.78. An example of a situation that may require urgent action is if there was a significant shift in supplier cost. For example, if efficient suppliers are not resilient to a large disruption in energy costs, we may consider it as requiring urgent action, depending on supplier resilience.

2.79. Conversely, if government introduced an emergency policy to reduce any immediate consumer harms, we may consider this to require urgent actions so customers see an immediate benefit rather than waiting until the next cap period. An immediate benefit could help ease situations such as any constraints on the cost of living.

2.80. A major disruption could be significant in impact but not require urgent action if it occurs close enough to the next cap review, if the impacts won't be felt prior to the next cap period, or if suppliers or customers are able to adequately manage the impacts.

Using the power

Process timings

2.81. Ten stakeholders commented on how we propose using the power. A key concern raised by stakeholders is that consultation and implementation periods applied when using the power could limit the speed at which any adjustment could be made, therefore reducing the usefulness of the power. One stakeholder mentioned that an in-period adjustment would need to adhere to current statutory timeframes on a 28 day consultation and a 56 day implementation period.

2.82. A few stakeholders noted the amount of time it may take Ofgem to use an in-period adjustment. This ranged from estimates of six weeks to up to twelve weeks. They included steps such as Ofgem assessing a situation against the framework, suppliers updating supplier pricing systems, and issuing customer price change notifications.

2.83. One stakeholder stated that for prepay customers in particular, there are greater price change risks, which increase with short notice changes. In particular, it raised concerns around the process to apply tariff changes to PPM meters failing when trying to make quick changes.

2.84. The same supplier raised concerns that there are risk asymmetries faced by suppliers in terms of compliance and enforcement. This is particularly the case if a downward adjustment is enforced immediately, but an upward adjustment means a supplier is compliant even if the implementation takes longer. We expect suppliers to be compliant with the cap at all times. In the event that a supplier fails to comply, we would take all the circumstances of the case into account when making a decision on what, if any, action to take. This would include exceptional circumstances that would trigger an in-period adjustment.

2.85. We deem that process timings may require consideration on a case-by-case basis depending on the exceptional circumstance in question and the proposed adjustment. If we consider that the threshold set by the test framework is passed, the process timings may depend on factors such as the adjustment required, the materiality of that adjustment and the time required for that adjustment to take effect.

2.86. When deciding on an appropriate consultation period, we will consider a reasonable timeframe for stakeholders to consider and respond to our proposals. In doing so, we will also take into account the nature of the exceptional circumstance and the need to act quickly. For considering an appropriate implementation time, we will consider any relevant licence conditions and the points raised by stakeholders, and this may include accounting for differences in meter types and payment methods. We will also have regard to public law principles on consultations and our own published guidance on consultations.[18]

2.87. We aim to reflect a balance between having a reasonable consultation period with informed stakeholder representations and practical implementation timeframes whilst also

[18] Ofgem (2002), Ofgem's consultation policy, https://www.ofgem.gov.uk/publications/ofgems-consultation-policy

addressing exceptional circumstances in a sufficient amount of time to ensure that the cap reflects efficiently incurred costs. While we would consult on any use of an in-period adjustment and allow an appropriate implementation period for suppliers to give effect to any change in the price cap level, this power would allow us to respond more quickly to significant developments than would be the case for licence modifications, for example.

2.88. If we deem that an exceptional circumstance occurs too close to the period in which we set the next cap level, we may choose to not use an in-period adjustment given the process timings required. In these cases, it would be quicker to utilise the existing review period.

Upwards and downwards adjustments

2.89. Some stakeholders commented whether an in-period adjustment would be used asymmetrically in favour of upwards adjustments. They questioned the likelihood of this policy being triggered for an exceptional circumstance requiring a downwards adjustment.

2.90. The test framework has been designed to be agnostic to whether an exceptional circumstance would require an upwards or downward adjustment. We will apply the test framework in an unbiased way when considering such circumstances, so we can objectively determine the direction of any adjustment that would be required if the criteria set by our test framework are met. In the test framework section, we have provided examples of how each of the criteria of the framework can be considered for an upward or downward adjustment.

2.91. One stakeholder commented that implementing an upwards adjustment to reflect cost recovery on the wholesale spot market may erode the degree to which customers are protected from large wholesale price movements.

2.92. The objective of the cap is to protect existing and future domestic customers who are pay the standard variable and default rates. In applying any in-period adjustments we would do so with regards to this objective. Where this policy leads to upwards adjustments, this may be introduced to mitigate longer-term cost increases for customers (for example the mutualisation costs of supplier failure). For a downward adjustment, customers would see an immediate benefit. This may help to lessen issues such as self-rationing or debt build-up.

Forward looking adjustments

2.93. Most respondents did not respond to this in particular but of those who did, one agreed with the proposal, noting retrospective changes would add more uncertainty. One respondent disagreed, noting that it is not possible to make the adjustment without it having a retrospective effect, as the observation window for each cap window closes in advance of that cap period.

2.94. We have decided that in-period adjustments would be forward looking only when setting the cap level. This means if we made an in-period adjustment to the cap, the updated cap level would only apply for the remainder of the existing cap period. It would not be retrospectively applied to the period before the implementation date for the updated cap level. For example, to consider a cap period from 01 April to 30 September; if we implemented an adjusted cap level on 01 July, this would apply from 01 July to 30 September and would not apply between 01 April and 30 June.

2.95. However, when setting an in-period adjustment, we may consider additional costs and benefits suppliers have experienced prior to the in-period adjustment taking effect. This is provided that historic costs and benefits are not accounted for by the current cap methodology and are covered by the exceptional circumstance we define through our test framework. In such cases, this would be covered by an in-period adjustment that applied from the date in which it takes effect. In addition, we would consider the impact any adjustment has before setting it. This includes, for example, any interaction with the observation window that relates to an adjustment to wholesale costs. However, we note that an in-period adjustment would not be limited to exceptional circumstances relating to changes in wholesale costs only, providing the criteria set by our test framework are met.

2.96. SLC 28AD.1 states that suppliers must be compliant in relation to each relevant 28AD customer at all times within the cap period. This means that suppliers would be obliged to comply with the new cap level that is set for the remainder of the existing cap period, if we made an in-period adjustment.

2.97. For the avoidance of doubt, we would assess compliance at each point in time against the cap level which applied at that point in time. We would not assess compliance for the whole cap period against the latest cap level. This means that, in the event of an upward in-period adjustment, a supplier would not be able to charge more than the cap level in the second part of the cap period and offset this against the lower amount charged in the first part of the cap period.

Appendices

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Appendix 1 – Considerations of additional stakeholder comments

1.1. This appendix contains our consideration of additional stakeholder comments not directly addressed in the main decision document.

Self-modification provisions

1.2. One stakeholder commented the Default Tariff Cap Act 2018 ('the Act') does not have specific provisions for self-modification. It stated that the Act did not grant us powers to amend the Standard Licence Conditions (SLCs) to introduce self-modification processes, such as the one we proposed to enable us to amend the cap outside of the current six-monthly cycle.

1.3. We consider that both, SLC28.AD.21A and SLC 28AD.20A in the electricity and gas supply licences respectively, constitutes a self-modification licence condition (that is to say, a licence condition that falls within the scope of s.7(5) EA89, as incorporated into the Act by s.2(1)(g)) such that statutory timescales may not apply.

Post adjustment review

1.4. One stakeholder suggested that Ofgem should review any in-period cap adjustment made within twelve months of implementation.

1.5. We recognise the importance of transparency across the decision-making process given significant potential consequences involved with an in-period cap adjustment. When setting an in-period adjustment, we will seek to provide as much clarity as possible on the decision-making process and the factors that led to our decision.

Seasonal considerations

1.6. Two stakeholders commented on the timings for considering this policy, where one suggested that an in-period adjustment should not be applied during the coldest months to increase consumer protection.

1.7. We recognise consumer protection is the key objective of the cap. Any in-period adjustment would be subject to the test framework (outlined in Chapter 2) and be carried out with both immediate and longer-term consumer protection in mind.

Double counting of impacts

1.8. One stakeholder noted that if a price spike occurred and triggered an in-period adjustment, customers prices would likely increase in both the existing period and the next cap period, as wholesale prices would be averaged out over six-monthly periods.

1.9. When setting an in-period adjustment to the cap, we would consider any interactions with other components within the cap. We would seek to avoid double counting of costs to ensure customers do not pay more than the efficient cost of energy.

1.10. To note, the possibility of an in-cap adjustment is not limited to exceptional circumstances that drive changes to wholesale costs. There may be circumstances that impact other costs within the cap.

Defining good or bad suppliers

1.11. One stakeholder expressed a concern that assessments on the efficiency of suppliers and their hedging and risk management strategies would mean Ofgem asserting a distinction between good and bad suppliers.

1.12. Ultimately it is a supplier's judgement based on their own circumstances on how they decide to mitigate against certain risks. Our focus is on applying the test framework, through the 'not reasonably avoidable' criterion (discussed in the test framework section in Chapter 2), when assessing whether exceptional circumstances could have been reasonably avoided through the different practices taken by suppliers. In doing so, we do not necessarily consider that our assessments would make distinctions between good and bad suppliers in terms of efficiency and/or their risk management practices.

1.13. Supplier practices and behaviours may vary due to a variety of factors. This may include, but is not limited to, differences in supplier business models, customer portfolios and their tariff offerings for example.

1.14. Depending on the situation itself, there may be also instances where we consider mitigation actions are unreasonable for a supplier to have carried out (eg if the action is comes at a significant cost to completely mitigate against a very unlikely risk). There may also be some situations where mitigations may not necessarily be applicable.

1.15. Overall, when assessing a situation, we would consider the typical case for mitigating actions that reflects the market. Individual suppliers may differ from the typical case for the reasons stated above. We discuss how we would consider each criterion in more detail in the Test Framework section in Chapter 2.

Scope of costs

1.16. Some stakeholders noted a number of increases in the cost of supply that they considered were not accounted for in the cap. They noted costs such as mutualisation costs, industry costs, shaping costs and working capital costs and contributions towards operating codes.

1.17. We consider the point raised is out of scope for this decision. We have discussed some of these costs in our decision on the potential impact of increased wholesale volatility on the default tariff cap.[19] For example mutualisation costs and shaping costs.

Using policy in summer 2022

1.18. One stakeholder stated concerns that suppliers would be unable to recover efficiently incurred costs in a volatile wholesale market in summer 2022. It commented that the sector's exposure to the cap diverging would be much higher compared to winter 2021. It forecasted standard variable tariffs to be materially below fixed prices for the summer 2022 cap period. As a result, they suggested that we should trigger an in-period adjustment in summer 2022.

1.19. In our decision on the potential impact of the increased wholesale volatility on the cap, we set out our intention to consult on further targeted changes to the cap in summer 2022 to ensure the cap is more robust to the risks associated with market volatility. This includes consulting on reforms of how the cap accounts for both Contracts for Difference (CfD) costs and shaping and imbalance costs. In this decision, we also note that we would conduct a further cost review during the summer of 2022 if we consider that wholesale market volatility has caused the cap to depart from the efficient cost benchmark. If so, we may make further changes to the level of the cap from 1 October 2022 (cap period 9) if it is appropriate to do so.[20]

[19] Ofgem (2022), Decision on the potential impact of increased wholesale volatility on the default tariff cap, https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

[20] Please see the decision document for further information. Ofgem (2022), Decision on the potential impact of increased wholesale volatility on the default tariff cap, chapter 7. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

1.20. In addition, we have also published our 'Consultation on Medium Term Changes to the Price Cap Methodology'.[21] We will continue to progress wider cap reform options to be implemented for October 2022, to ensure that the cap is more resilient to extreme commodity price volatility whilst continuing to protect customers.

1.21. Our package of reforms does not stop us using an in-period adjustment when the appropriate tests have been met.

[21] Ofgem (2022), Consultation on Medium Term Changes to the Price Cap Methodology, https://www.ofgem.gov.uk/publications/consultation-medium-term-changes-price-cap-methodology