Making a positive difference
for energy consumers

To all licensed energy suppliers

Date: 4th February 2022

Email: retailpriceregulation@ofgem.gov.uk

Guidance on treatment of reasonable risk management practices in future default tariff cap proposals

Dear suppliers,

Today we are launching a package of changes to the default tariff cap (the 'cap') to ensure the design of the cap is more resilient to highly volatile wholesale energy market conditions. Our view is that a market where suppliers can recover their efficient costs is in the long-term interests of all customers. We want suppliers to have the right incentives to adopt prudent risk management practices, increase efficiency and provide a better quality of service to their customers.

This letter sets out a summary of announcements being implemented for cap period eight (April – September 2022), the changes we are consulting on for implementation in cap period nine (October 2022 – March 2023) and guidance for suppliers to support them in making prudent risk management decisions during the consultation.

We are allowing suppliers to recover their efficient cost increases from cap period seven and are implementing temporary measures to reduce the risk of further systemic costs from period eight, in the interests of protecting current and future domestic customers.

We have also launched a consultation on changes to the cap for cap period nine, but we recognise that this increases regulatory uncertainty at a time when suppliers are having to make decisions that affect their costs for this period and beyond. This letter provides guidance on how we intend to treat costs incurred for future periods to provide reassurance that suppliers who take a prudent approach to risk management will not be penalised.

Summary of changes from cap period eight

We have decided to allow suppliers to recover £59[1] over cap periods eight and nine in respect of the extra costs they have incurred in cap period seven relating to unexpected SVT demand, backwardation, and shaping and imbalance costs.[2]

We are further introducing the ability for us to amend the cap outside of our routine six-monthly cycle. 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, we consider that by defining a clear set of criteria, that ordinarily we would expect a situation to meet before we trigger an in-period adjustment, stakeholders will appreciate that there is a high threshold for making such an adjustment, and will be able to understand the situations when we would consider using this tool, reducing risk overall.[3]

Consultation on changes from cap period nine

The changes introduced in cap period eight will benefit customers by reducing systemic risks for suppliers, but we recognise that we need further changes from the start of the next cap period in October 2022. Our consultation process ensures that we work with industry and customer stakeholders, such that any changes are implemented in the best way to protect customers.

[1] At current Typical Domestic Consumption Values (TDCV), or £61 at cap benchmark consumption levels
[2] 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
[3] Ofgem (2022), Decision on the process for updating the Default Tariff Cap methodology and setting maximum charges. https://www.ofgem.gov.uk/publications/price-cap-decision-process-updating-default-tariff-cap-methodology-and-setting-maximum-charges

We have today published a Consultation on Medium Term Changes to the Price Cap Methodology[4] following on from our call for input in December. This consultation covers three further ways we might reduce systemic risk in the current market:

- changing the cap methodology to either a quarterly update (our currently preferred option), a price cap contract (previously called the fixed term default contract), or strengthening the current six-monthly update with other protections;
- adding a backwardation allowance to allow suppliers to recover any exceptional costs of the seasonal basis risk inherent in the current cap methodology; and
- reducing the implementation period of the cap from two months to one.

Given these potential changes, we recognise that suppliers who hedge in line with the current price cap methodology may be uncertain what approach to take from 1 February, which marks the beginning of the next observation period.

Guidance for suppliers on treatment of reasonable risk management practices

We encourage suppliers to adopt robust risk management strategies – this is the primary means of protecting against market volatility. We want suppliers to have the right incentives to adopt prudent risk management practices, increase efficiency and provide a better quality of service to their customers.

Our changes are designed to give suppliers greater confidence to hedge in such a way as to support their financial resilience, to the ultimate benefit of customers. While it is for suppliers to determine their own risk management strategies in line with their corporate objectives and risk appetite, we want to be clear about the actions we will take to recognise suppliers' reasonable risk management actions in our future decisions.

Our consultation on introducing a backwardation allowance in the cap to allow suppliers to recover costs associated with systemic backwardation risk from October 2022, sets out options to reduce exposure to the current exceptionally wide spread between winter 22/23 and summer 23. We still expect suppliers to prudently manage their exposure and will seek to incentivise this behaviour in our choice of mechanism, for instance by compensating suppliers based on the weighted average supplier backwardation cost.

If we change the indexation period, by either reducing the implementation period or changing the cap methodology, we will allow for the costs or benefits faced by a supplier on

[4] 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

a nominal hedging strategy consistent with the current cap, up to the point that Ofgem is clear about the changes it intends to make

We have published our decision today on the potential impact of increased wholesale volatility on the default tariff cap. In our decision, we note a wide variance in demand forecasting and hedging strategies designed to manage the risk of greater numbers of fixed priced contract customers defaulting onto the cap than forecast. We decided not to adjust the allowance for the effectiveness of these strategies, as the market circumstances were unprecedented. Going forward, we expect suppliers to respond to the now-known risks of customer demand variance and will take that into account if we make a future allowance for unexpected customer demand.

Our ability to modify the price cap within the current six-monthly cycle is constrained by our five tests, including that the circumstances leading to the intervention are externally caused and not reasonably avoidable. 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.

We welcome engagement with suppliers and other interested stakeholders on these issues, as we have a shared objective to reduce the systemic risk of the cap in volatile wholesale markets for the ultimate benefit of customers. in volatile wholesale markets for the ultimate benefit of customers.

Yours sincerely,

Neil Lawrence
Director - Retail

The Office of Gas and Electricity Markets
10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000
www.ofgem.gov.uk