To all licensed energy suppliers

Date: 15th March 2022

Email: retailpriceregulation@ofgem.gov.uk

Updated guidance on treatment of price indexation in future default tariff cap proposals

Dear suppliers,

This letter is to provide updated guidance to domestic energy suppliers on the treatment of wholesale prices observed during the transitional period to a new cap mechanism, due to start in October 2022. It is intended to help inform their prudent risk management strategies pending publication of our decision on a new mechanism.

We published a letter on 4th February to provide guidance to suppliers on Ofgem's intended treatment of suppliers' reasonable costs of risk management under the default tariff cap[1], based on the decisions made in cap period eight (April – September 2022) and the changes we consulted[2] on for implementation in cap period nine (October 2022 – March 2023).

[1] Domestic Gas and Electricity (Tariff Cap) Act 2018 (legislation.gov.uk)
[2] Consultation on Medium Term Changes to the Price Cap Methodology | Ofgem

In that letter we stated, '*If we change the indexation period* [for cap period nine]*, by either reducing the implementation period or changing the cap methodology, we will allow for the costs or benefits faced by a supplier on a nominal hedging strategy consistent with the current cap, up to the point that Ofgem is clear about the changes it intends to make.'*

The consultation closed on 4th March. We are analysing responses to determine the most effective way to systemically reduce the risk that suppliers bear on unexpected SVT demand and backwardation costs in highly volatile market conditions. However, we have sufficient certainty in our upcoming changes to make a contingency decision to shorten the implementation period[3] and provide updated guidance on our treatment of price indexation for cap period nine.

We also consulted on the introduction of a backwardation allowance to allow suppliers to recover the excess costs of seasonal price differentials in the cap and potentially changing the cap methodology to a quarterly update. For clarity, we are providing guidance for the Winter 22 six-month cap period only at this point.

Contingency decision to shorten the implementation period from two months to one month

We have reviewed suppliers' and other stakeholders' responses to our policy consultation and there is significant support for a reduction in the notice period, albeit there are a number of practical issues to work through. Combined with our other proposals, which would also have the effect of pushing the observation window to later in the year, we have sufficient certainty to make a contingency decision to delay the price observation window. This is in line with our policy objective of shortening the period between price observation and delivery to reduce the volume risk faced by suppliers.

This would mean that, absent any other policy decisions on the cap mechanism, the price observation window would be from 1st March to 31st August for the winter period, one month later than the current observation window. The other policy decisions currently under consideration would push the observation window even later in the year.

We will issue a statutory consultation in due course with the detailed changes necessary to implement this policy and will consider feedback before making our final decision.

[3] The implementation period is the time between announcement of the new cap level and this level applying to suppliers' prices. Under the existing cap mechanism, it would be from 5th August to 30th September 2022 for cap period nine.

Delaying the observation window by reducing the weighting of prices observed over a two-month period

Based on our previous guidance, prices observed from 1st February 2022 will be used to calculate the cap for period nine. We committed not to retrospectively change this guidance, so to move to a later observation period we need to make a forward-looking change to the price observation profile.

We are aware that changes to the cap observation window could affect wholesale market liquidity, so rather than stopping price observations for a period, we will reduce the weighting of prices to transition more slowly towards the target observation window. Further changes to the cap methodology may push the target observation window even later, so it is prudent to make a change to guidance as soon as possible, to avoid the need for deeper reductions later in the period.

To delay the price observation window by one month we will apply a 50% weighting to prices observed over a two-month window, from 16th March to 19th May inclusive. Absent of any other changes, we would then resume a 100% weighting for prices observed between 20th May and 31st August inclusive[4]. If we do not go ahead with our contingency decision to shorten the implementation period, then we would consult on increasing the weighting of price observations to 30th July to make up for the shortfall[5].

We intend to publish our statutory consultation on further changes to the price cap methodology in early May, at which point we will provide further guidance on the treatment of prices observed for the remainder of the observation window.

Impact of this guidance on other policy areas

We are aware that this updated guidance will have knock-on impacts on other polices that are dependent on the price cap indexation. We will also reflect this in our ongoing work on any backwardation allowance required under the new cap methodology, the market stabilisation charge and in the calculation of commodity costs in Annex 2 of the eventual price cap decision.

[4] Extending the price observation period to end on 31st August adds 22 trading days. In order to maintain the weighting of prices observed to date we need to apply the 50% weighting to 44 trading days from 16th March to 19th May, inclusive.

[5] The increase in this scenario would be to 145% of the existing cap weighting for the remaining 49 trading days

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 default tariff customers.

Yours sincerely,

Neil Lawrence
Director - Retail