Consultation

Price Cap – Consultation on amending the methodology for setting the Contracts for Difference (CfD) allowance

Subject	Details
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We are consulting on amending how the CfD allowance is calculated to ensure it remains reflective of the CfD related costs (and benefits) suppliers face. We would like views from people with an interest in the level of the default tariff cap. We particularly welcome responses from domestic energy suppliers and consumer groups. 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

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.

This consultation sets out the options considered for amending the Contracts for Difference (CfD) allowance in the cap from cap period nine (October 2022 – March 2023) onwards.

The CfD scheme is the government's main mechanism for supporting low-carbon electricity generation. Under the CfDs, when the market price for electricity generated by a CfD Generator (the reference price) is below the Strike Price set out in the contract, payments are made by Low Carbon Contracts Company (LCCC) to the CfD generator to make up the difference. When the reference price is above the Strike Price, the LCCC receives payments from the CfD generator.

Suppliers incur costs or benefits from CfD depending on whether LCCC makes or receives payments from CfD generators. When wholesale prices are overall higher than the CfD strike for a given quarter, suppliers will receive a payment from generators via the LCCC, while suppliers fund CfD costs when wholesale prices are below the strike price. This either increases or decreases the cost to serve default tariff customers.

The price cap sets an allowance for CfD costs incurred by suppliers, as with other levies and obligations on suppliers. The cap allowance is based on the interim levy rate (ILR) set by the LCCC each quarter.

The ILR has typically been a positive value, reflecting higher costs of CfD generators compared to wholesale prices. For cap period nine, LCCC has forecast negative payments from suppliers, reflecting increases in wholesale prices. This would imply a negative ILR, reflecting suppliers are expected to receive payments, rather than make them. However, the ILR has a floor of £0/MWh.[1] This means that we cannot currently reflect these negative CfD costs in the cap for cap period nine.

[1] The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (legislation.gov.uk)

From LCCC forecasts, we estimate that, for cap period nine, suppliers would receive a benefit of £12.51 per customer compared to the allowance they would receive if the ILR could be negative.[2]

We are proposing to amend the CfD allowance methodology to better reflect the costs faced by suppliers in all instances.

We are proposing to replace the ILR with an expected levy payment that can be negative. We consider that it betters balances simplicity of implementation with ensuring customers pay a price that more accurately reflects supplier costs/benefits. We are also proposing that this is based on the latest available LCCC forecasts at the time the cap is set.

We are proposing to apply this new CfD allowance methodology from cap period nine onwards.

The changes to CfDs we are consulting on do not preclude any potential proposals as a result of the medium-term reform work.[3]

Next steps

We are requesting responses by 17 May 2022 and responses to this consultation can be submitted to Ofgem by emailing RetailPriceRegulation@ofgem.gov.uk. We intend to issue a decision to this consultation in June 2022 so that any changes may come into effect from 01 October 2022 (cap period nine) and give suppliers sufficient notice.

[2] LCCC levy forecast - Interim Levy Rate and Total Reserve Amount | Low Carbon Contracts Company
[3] Consultation on Medium Term Changes to the Price Cap Methodology

1. Consultation Process

What are we consulting on?

1.1 This consultation sets out our proposal on whether, and how, to update the CfD allowance methodology in the price cap to ensure it remains reflective of the CfD related costs (and benefits) suppliers face and to ensure the CfD allowance is robust to wholesale market volatility.

1.2 This document is split into four chapters:

- Chapter 1: consultation process;
- Chapter 2: introduction;
- Chapter 3: case for change; and
- Chapter 4: options to amend cap methodology.

Context and related publications

1.3 The main documents relating to reviewing the CfD methodology in the default tariff cap are:

- Price Cap – Consultation 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

- Price Cap - 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

- Default tariff cap: decision – overview: https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

- The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014: The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (legislation.gov.uk)

- Supplier CfD Payments EMRS Guidance: G16 - Supplier CfD Payments (emrsettlement.co.uk)

Consultation stages

1.4 This consultation sets out further detail on the rationale for reviewing the CfD allowance methodology, the options we are considering and our minded to position. We invite stakeholders to submit comments on any aspect of this consultation on or before by 17 May 2022.

1.5 Responses to this consultation, and any supporting evidence, can be submitted to Ofgem by emailing RetailPriceRegulation@ofgem.gov.uk. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

1.6 The LCCC is expected to publish their determination for October-December 2022 in June, and we understand this information drives suppliers' hedging strategies for CfD costs. We intend to issue a decision to this consultation in June 2022 following this consultation, so that any changes may come into effect from 1 October 2022 (cap period nine) and give suppliers sufficient notice.

How to respond

1.7 We want to hear from anyone interested in this consultation. Please send your response to RetailPriceRegulation@ofgem.gov.uk.

1.8 We do not ask specific questions in this document. Rather, we welcome views on any of the matters discussed in this consultation.

Your response, data, and confidentiality

1.9 You can ask us to keep your response, or parts of your response, confidential. We will 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.

1.10 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 will 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.

1.11 If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), 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 2.

1.12 If you wish to respond confidentially, we will keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We will not 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

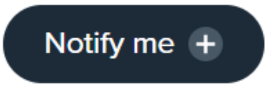
1.13 We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:

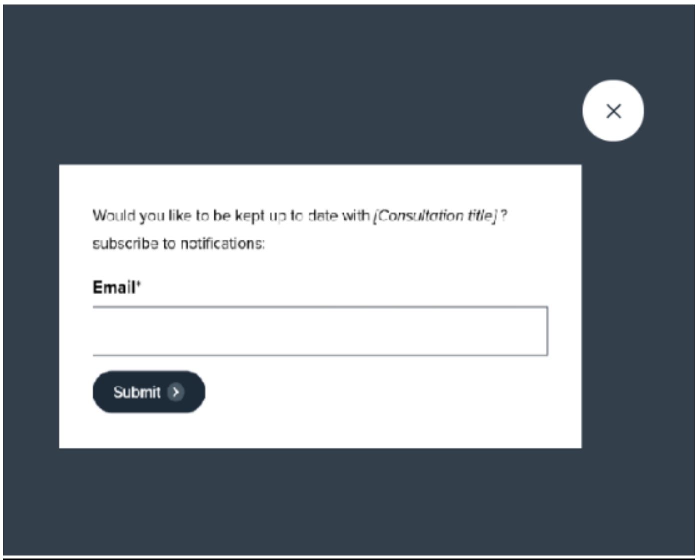
1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6.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

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

How to track the progress of the consultation

1.15 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.





1.16 Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:

Upcoming ► Open ► Closed (awaiting decision) ► Closed (with decision)

2. Introduction

Section summary

This chapter sets out in further the detail the Contracts for Difference (CfD) scheme including how the scheme works, the scheme's funding mechanisms and how it is accounted for in the price cap as part of the CfD allowance.

The default tariff cap

2.1 We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('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 matters.[4]

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts; and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

2.2 The requirement to have regard to the four matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future consumers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often a balance must be struck between competing considerations.

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

2.3 In setting the cap, we may not make different provisions for different holders of supply licences.[5] This means that we must set one cap level for all suppliers.

Contracts for Difference (CfD)

2.4 The Contracts for Difference (CfD) scheme is the government's main mechanism for supporting low-carbon electricity generation. A CfD is a private law contract between a low carbon electricity generator and the Low Carbon Contracts Company (LCCC), a government-owned company.

Funding the cost of CfDs

2.5 Payments made by the LCCC to generators participating in the CfD scheme are funded by a statutory levy on all UK-based licensed electricity suppliers called the Supplier Obligation levy.

2.6 To fund the Supplier Obligation, suppliers must make two payments. At a high level, the Interim Levy Rate (ILR) funds the expected costs of the scheme, while the Total Reserve Amount (TRA) ensures that LCCC is still able to make payments to generators if costs vary from expectations. Both are set on a quarterly basis, three months in advance of the relevant quarter. We provide further detail on these payments below.

2.7 **ILR** - Unit cost fixed 'Interim Levy Rate' chargeable as a £/MWh rate on eligible demand daily. The purpose of the ILR is to fund the day-to-day CfD payments to generators

2.8 The Interim Levy Rate has a lower bound of £0/MWh.[6] This ensures the LCCC is not making daily payments to suppliers when wholesale prices are above the strike price, ie, the agreed price at which the CfD generator will provide energy. In a period where generators make net payments to the LCCC, the relevant cash flow to suppliers occurs through reconciliation following the end of the quarter.

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[5] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[6] As per, The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (legislation.gov.uk)

2.9 As a result, when wholesale prices are materially higher than the CfD strike price for an extended duration, suppliers will receive a payment from generators via the LCCC.

2.10 **TRA** – a lump sum paid by individual suppliers at the start of each quarterly obligation period. These payments serve as a contingency to ensure a 19 in 20 (95%) probability that LCCC can fund the day-to-day CfD payments to generators in a given quarter.[7]

2.11 The TRA rates depend on the LCCC's existing reserve amount; timing of payments made and received by the LCCC; uncertainties associated with generation, market reference prices and other factors; and suppliers recent market share.

2.12 The LCCC's operational costs are funded by suppliers via an operational cost levy. This levy is invoiced daily and is based on a supplier's gross eligible demand.

LCCC reconciliation process

2.13 Following the end of each quarter, an exercise is undertaken to set 'reconciled' daily levy rates, which represent the ratio between the actual CfD to/from generators and the actual daily demand.

2.14 At the end of each quarter the ILR is reconciled over the ten preceding quarters.

CfD allowance in the price cap

2.15 The cap sets an allowance for CfD costs incurred by suppliers as with other levies and obligations on suppliers. The cap includes a policy cost allowance to ensure that suppliers can recover the additional costs related to their obligations under different government environmental and social programmes.

2.16 The allowance within the price cap is currently calculated at the time the cap is set, based on the latest LCCC forecasts of levy rates for the financial year within which the cap period falls. For the summer price cap, this is based on forecast interim levy rates for April-

[7] The Contracts for Difference (Electricity Supplier Obligations) Regulations 2014 (legislation.gov.uk) section 10 (5)

March. For the winter cap, this is based on reconciled levy rates for April-June (if available in August) and forecast interim levy rates for July-March.

2.17 The allowance is then calculated using a weighted average of the quarterly interim levy rates for the financial year, considering seasonal demand, CfD scheme exclusions and transmission losses.

3. Case for Change

Section summary

This chapter sets out further detail on the overarching considerations for this consultation and the issues with the current CfD allowance methodology.

We welcome stakeholders' views on our consideration of the issues.

Context

3.1 When we developed the cap in 2018 we allowed suppliers to recover the costs incurred due to CfD, as set out in our 2018 decision.[8] We also set out to only make changes where there are clear and material systematic impacts on the costs of supplying default tariff customers that are not appropriately accounted for by the existing cap methodology.

Issues with the current CfD allowance methodology

3.2 The Interim Levy Rate (ILR), which is used to determine the CfD allowance in the price cap, has a floor of £0/MWh.

3.3 When wholesale prices are materially higher than the CfD strike price for an extended duration, suppliers will receive a payment from generators via the Low Carbon Contracts Company (LCCC), rather than suppliers paying generators when wholesale prices are below the strike price. Since the start of the cap, wholesale prices have not been typically higher than the CfD strike prices agreed for each renewables project for a sustained period, so the ILR forecast has typically been a positive value.

3.4 Following recent wholesale price increases, the agreed strike prices for projects have been lower than forecast wholesale prices, triggering generators to pay the LCCC, with the latter then refunding levy payments to suppliers. This implies supplier levy payments to

[8] Ofgem (2018), Decision – default tariff cap – Appendix 5 – policy and network costs. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

LCCC are forecast to be negative. Due to the ILR's £0/MWh floor, the cap cannot currently account for this additional revenue for suppliers and decrease prices for customers.

3.5 In our 4 February 2022 decision, we estimated suppliers will receive a benefit in cap period eight if they hedge in line with the ILR forecast. This benefit was worth £3.11 per customer and was based on the latest figures from the LCCC at the time.[9] We did not propose to adjust this benefit to suppliers for period eight through a negative adjustment as this issue was not raised in our original consultation. We also considered this potential benefit may offset other additional and uncertain costs which suppliers may incur during period eight related to wholesale market volatility.[10]

3.6 Going forward, we estimate that suppliers will receive a benefit of £12.51 per customer in cap period nine if the CfD cap methodology is not amended and suppliers hedge in line with the interim levy rate forecast.[11] This is based on the latest LCCC forecasts. We are therefore consulting on amending the CfD allowance methodology to ensure it remains reflective of the CfD-related costs (and benefits) suppliers face, and to ensure the CfD allowance is robust to wholesale market volatility. The new CfD allowance methodology would apply from cap period nine onwards (October 2022 onwards) and will be based on the latest LCCC forecasts available when setting the cap.

3.7 We consider that, if not fixed, this issue could lead to material and systematic impacts. The current methodology will not be able to lower the price cap whenever negative CfD payments are forecast at the time of setting the cap.

[9] In the 4th February 2022 decision we quoted this figure as an annualised value ~£7 per customer. Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, section 2: https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

[10] Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, section 6: https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

[11] Expected CfD levy payments by suppliers for each quarter are divided by expected eligible demand for the same quarter to calculate an expected levy payment per quarter. The four quarterly expected levy payments are then multiplied by the share of energy demand of their relevant quarter and summed to produce an annual expected levy payment. This calculation is then uplifted by energy in scope of the green energy exemption. An uplift for losses is also applied. To convert from a £/Mwh estimate to £/customer, benchmark consumption values of 3.1Mwh per customer. In order to apportion this annual value to a six-monthly cap period, the demand weights for the two relevant quarters are summed and used to apportion.

4. Options to amend cap methodology

Section summary

This chapter sets out the options we are considering to allow an adjustment to the CfD cap methodology (if appropriate) and our minded to position.

We welcome stakeholders' views on our options and minded to position.

4.1 As outlined in previous sections, our initial view is that the current methodology does not accurately reflect supplier costs in instances where CfD costs are negative.

4.2 We have considered the following three options for amending the CfD allowance methodology.

Table 1 – Summary of price cap amendment options considered

Option	Minded to position	Description of option
Option 1: Status quo	No	Keep existing approach with a zero bound ILR.
Option 2: Replace LCCC published ILR with an expected levy payment based on LCCC data	Yes	Replace the ILR as the key input to the policy cost model, with the total forecast of CfD payments published by the LCCC divided by expected eligible demand to calculate an expected levy payment that can be negative. The latest forecast figures from the LCCC will be used when setting the allowance.
Option 3: Replace LCCC published ILR with an expected levy payment based on LCCC data and reconcile actuals vs forecast	No	Same as option 2, with a reconciliation. Given volatility of CfD costs within cap periods, a reconciliation of the difference between forecast and outturn would be conducted and affect future period allowances. The latest forecast figures from the LCCC will be used when setting the allowance.

Assessment criteria

4.3 The options have been assessed against three criteria:

- **Feasibility**: ease of application of the methodology and clarity to stakeholders.
- **Supplier impact**: cost impact on suppliers and exposure to volatility.
- **Customer impact**: customer price impact.

Minded to position

4.4 **We are minded to implement option 2 - Replace LCCC published ILR with an expected levy payment based on LCCC data, from cap period nine onwards.**

4.5 Option 2 was chosen as the minded-to position option as it balances simplicity of implementation with ensuring customers pay a price that more accurately reflects supplier costs/benefits.

Feasibility

4.6 The methodology change proposed is a minor change. It uses similar data points as the existing methodology, but removes the zero floor, allowing the CfD allowance to be negative.

Supplier impact

4.7 In terms of supplier impact, this methodology allows for pass-through of supplier benefits to customers, as the new expected levy payment will consider expected negative CfD payments and pass this on to customers as lower prices.

Customer impact

4.8 This methodology addresses the ILR's lower bound, allowing the price to decrease for cap periods where CfD payments are forecast to be negative.

Alternative options we have considered

4.9 **Option 1 – Status quo:** we are minded not to progress the current methodology as an option as it does not address the ILR lower zero bound issue, which has a negative impact on customers.

Feasibility

4.10 No feasibility concerns as this option retains current approach.

Supplier impact

4.11 No supplier impact concerns as this option retains current approach.

Customer impact

4.12 Keeping the existing methodology would not address the zero lower bound ILR issue discussed.

4.13 **Option 3-Replace LCCC published ILR with an expected levy payment based on LCCC data and reconcile actuals vs forecast:** We are also minded not to progress this option as we do not believe it is viable due to feasibility and customer impact issues.

Feasibility

4.14 This option has a similar benefit to option 2 as it also replaces the ILR with an expected levy payment based on LCCC data. The main issue posed by this option is the reconciliation process as it is difficult to implement. This is because there will be a time lag associated with the reconciliation process as the LCCC publishes the first set of reconciled actuals data approximately 16 working days after the settlement day.[12] This means that a reconciliation for a quarter can only occur two quarters after the relevant period. It would not be possible to apply it to the CfD allowance until then. In turn, this option may cause

[12] Overview of EMR Settlement – EMRS working practice (Page 10 - Table 3: BSCCo Settlement Runs): https://www.emrsettlement.co.uk/document/working-practice/wp1-overview-of-emr-settlement/

cashflow issues for suppliers as well as increase the risk that individual suppliers experience gain/losses, given that supplier's default tariff customer numbers may change over time.

Supplier impact

4.15 This methodology allows for pass-through of supplier benefits to customers, as the new expected levy payment will consider expected negative CfD payments and pass this on to customers as lower prices. This means that it will remove any windfall benefits currently experienced by suppliers.

4.16 With Option 3, suppliers would not be able to hedge against this methodology so will be exposed to any differences between initial allowance and actuals up until the point the reconciliation completes. However, the reconciliation may expose suppliers to more volatility.

Customer impact

4.17 The reconciliation process in option 3 ensures customers pay a more accurate price but potentially exposes them to more volatility and uncertainty. This is because the shortfall or excess from the calculated adjustments would be included in the CfD allowance two quarters after the relevant period. It also means that the difference could potentially be paid by a different cohort of customers rather than those that incurred the cost/benefit.

Appendices

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Appendix 1 – Detailed model modifications: Annex 4

1.1. We summarise in this appendix the modifications to 'Annex 4 – Policy cost allowance methodology' of SLC 28AD of the gas standard supply licence conditions based on our proposals in Chapters 3 and 4.

1.2. We have published alongside this consultation a revised Annex 4 that would come into effect for cap period nine. We invite stakeholders' views on this. A summary of the modifications can be found below.

1.3. Updated cells are highlighted in yellow in the models published alongside this consultation.

Model updates

Tab '3c CfD'

1.4. Cells B17:AB20: added CfD payments forecasts as input to calculate the new expected levy payment. This is published by the LCCC on a quarterly basis.

1.5. Cells B31:AB34: updated with the expected levy payment for each quarter in £/MWh.

1.6. Cells Z38:AB39: use cells Z31:AB34 as an input for the calculations, sourcing the relevant cap period data.

Appendix 2 – 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, ie a consultation.

4. With whom we will be sharing your personal data

We may share consultation responses with BEIS.

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

Your personal data will be held for six months after the project, including subsequent projects or legal proceedings regarding a decision based on this consultation, is closed.

6. 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.

7. Your personal data will not be sent overseas.

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

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

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