Making a positive difference
for energy consumers

To all market participants and interested parties

Email: retailpriceregulation@ofgem.gov.uk
Date: 16 May 2022

Dear colleagues,

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

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.

This follows the guidance issued on 15 March 2022[1] in line with the preceding letter we issued on 04 February 2022.[2]

Statutory consultation on proposal to move to quarterly updates with a reduced notice period and include backwardation costs

Today we have published the statutory consultation on medium term reforms to the price Cap detailing the changes we propose to implement for October 2022.[3] In summary, these proposals are to move to quarterly updates with a reduced notice period – the index will be

[1] Ofgem (2022), Updated guidance on treatment of price indexation in future default tariff cap proposals https://www.ofgem.gov.uk/publications/updated-guidance-treatment-price-indexation-future-default-tariff-cap-proposals
[2] Ofgem (2022), Price Cap - Guidance on treatment of reasonable risk management practices in future default tariff cap proposals https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals
[3] Ofgem (2022), Price Cap – Statutory Consultation on to wholesale methodology https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology

3-1.5-12 [3].[4] We are also proposing to change the wholesale methodology to include backwardation costs. This would follow a transitional period for the period 9 cap – this is detailed below.

We will consider feedback on the proposals before making our final decision. But we recognise the decisions suppliers need to make in the meantime, so this guidance sets out our approach in allowing for reasonable risk management activities.

Transition to quarterly updates

On 15 March 2022, we published an Indexation Guidance Letter[5] for suppliers. In our letter we outlined that we would apply a 50% weighting to prices observed between 16 March 2022 and 19 May 2022 (inclusive). Additionally, we announced that from 20 May 2022 we would apply full weighting to observed prices. Thirdly, to maintain the same number of total trading days, we extended the observation window to 31 August 2022 (inclusive). This guidance transitioned the index from the 6-2-12 [6] to a non-linear 7-1-12 [6] approach which is the index we expect a nominal supplier to be currently following.

For transitioning to quarterly updates, the final day of observed prices under the 7-1-12 [6] will be 01 June 2022. At this point, we will be exactly halfway through the 124 weighted trading day observation window of the 7-1-12 [6] approach. We expect that a nominal supplier will have purchased 50% of its volumes for delivery over the winter season (October 2022 – March 2023).

Cap period 9a (01 October 2022 to 31 December 2022) indexation approach

We consider a nominal supplier will have bought half of their volumes for cap period 9a under the 7-1-12 [6] approach and therefore it will have to purchase the remaining 50% under a 3-1.5-12 [3] approach.[6]

In the proposed quarterly updates, the observation window closes 30 working days prior to the start of the cap period. This means the last trading day on which we will be observing prices will take place on 18 August 2022. The observation window for cap period 9a under

[4] We express the price cap formula in an index with the format X-Y-Z [A], where X is the price observation period, Y is the lag period between the end of the observation period and the start of the price cap period starting, Z is the length of forward contracts observed and A is the period for which the cap is in place, all in months. So a 3-1.5-12 [3] index for delivery starting 01 October 2023 means a 3 month observation period running from mid-May to mid-August where 12 month forward prices are observed. There is then a lag of 1.5 months from mid-August until the cap starts on the 01 October. And the cap runs for three months from 01 October to 31 December.
[5] Ofgem (2022), Updated guidance on treatment of price indexation in future default tariff cap proposals https://www.ofgem.gov.uk/publications/updated-guidance-treatment-price-indexation-future-default-tariff-cap-proposals
[6] Given we stop observing prices for 7-1-12 in early June, in practice the approach is more akin to 4-4-12 for cap period 9a and 4-7-12 for cap period 9b (reflecting a shorter observation window and longer lag). The observation period for cap period 9a is approximately 2.5 months so it's a 2.5-1.5-12 approach. For simplicity and terminology consistency, we continue to use 7-1-12 and 3-1.5-12.

the 3-1.5-12 [3] approach runs from 06 June 2022 to 18 August 2022 – there are 54 trading days within this period.

To ensure the total number of weighted trading days between the two approaches remains the same (62 each, 124 in total) and a nominal supplier can recover for the full volumes purchased, we uplift the weighting on the 3-1.5-12 [3] observed prices. The level of uplift is 14.81%, calculated as [50%*124]/54 (where 124 is the total number of trading days and 54 is the number of trading days under the 3-1.5-12 [3] approach for the period)[7]. An illustration of this can be found in Appendix 2 of the Price Cap – Statutory Consultation on changes to wholesale methodology.

Cap period 9b (01 January 2023 to 31 March 2023) indexation approach

A similar approach will be applied for the transition to cap period 9b. A nominal supplier will have bought half of its volumes for this quarter under the 7-1-12 [6] approach.

The observation window for cap period 9b under the 3-1.5-12 [3] approach would begin on 19 August 2022 and end on 16 November 2022 (inclusive). This is a total of 63 trading days over which we would expect a nominal supplier to buy the remaining 50% of their volumes for the quarter.

Similar to the transition for cap period 9a, we aim to keep the weighted total trading days equal (62 for each approach, 124 in total) and therefore adjust the weighting for the 3-1.5-12 [3] approach downwards by 1.59%. This is calculated as [50%*124]/63. Again, this is illustrated in Appendix 2 of the statutory consultation.

The table below sets out the approaches for the different period.

Cap period	Index approach	Observation window start	Observation window end	Trading days	Weighting/ adjustment
9a & 9b	6-2-12 [6]	01/02/2022	15/03/2022	31	Full weight
9a & 9b	7-1-12 [6]	16/03/2022	19/05/2022	44 (22 weighted)	Half weight
9a & 9b	7-1-12 [6]	20/05/2022	01/06/2022	9	Full weight
9a	3-1.5-12 [3]	06/06/2022	18/08/2022	54 (62 adjusted)	c.15% increase
9b	3-1.5-12 [3]	19/08/2022	16/11/2022	63 (62 adjusted)	c.1% decrease

[7] Additionally, we apply some minor adjustments to reflect the shift from seasonal to quarterly electricity demand weights. For instance and for Profile Class 1, adjustments are worth -0.25% and +0.21% for cap period 9a and 9b respectively. More info can be found in Appendix 2 of the statutory consultation.

Impact of this guidance on other policy areas

We are aware that this updated guidance will have knock-on impacts on other policies that are dependent on the price cap indexation. We will also reflect this in our ongoing work on any wholesale allowances for backwardation costs required under the new cap methodology and the Market Stabilisation Charge.

Approach if we do not implement quarterly updates

Following consultation, should we decide not to proceed to a 3-1.5-12 [3] index, we will issue further price indexation guidance in time for suppliers to adjust their positions.

We welcome engagement from suppliers and other interested stakeholders on these issues. We share the same objective of reducing the systemic risk of the cap in volatile wholesale markets for the ultimate benefit of default tariff customers.

Yours sincerely,

Neil Lawrence
Director - Retail