Decision

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Decision on the Contract for Difference (CfD) allowance methodology in the default tariff cap

Subject	Details
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We consulted in April 2022 on a proposal to amend the CfD allowance to better reflect cost and benefits faced by suppliers. This document sets out our decision to proceed with the proposed amendment.

We have considered suppliers responses and set out our considerations and rationale in this document. 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 23 million households on standard variable and default tariffs (which we refer to collectively as "default tariffs").

The Contracts for Difference (CfD) scheme is the government's main mechanism for supporting low-carbon electricity generation. Under the CfD scheme, renewable generators receive a fixed price for their energy. Suppliers incur costs or benefits from the CfD scheme depending on whether there is a positive or negative difference between the wholesale price and this fixed price, leading to CfD generators making or receiving payments.

As with other levies and obligations on suppliers, the cap sets an allowance for CfD costs incurred by suppliers. Since the introduction of the cap, CfD costs have represented £25 per customer at typical consumption, around 2% of the total cap value.

The cap allowance is currently based on the Interim Levy Rate (ILR) used to collect advance payments from suppliers and fund the costs of the CfD scheme. The ILR is based on the Low Carbon Contract Company's (LCCC) forecast of the cost of the scheme.

The ILR has typically been a positive value, reflecting higher prices paid to 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, as suppliers are expected to receive payments, rather than make them. However, the ILR has a floor of £0/MWh.[1] This means that our methodology would not currently reflect these negative CfD costs in the cap for cap period nine.

In April 2022, we consulted on options for amending the CfD allowance in the cap from cap period nine onwards. We proposed to replace the ILR with an expected levy payment that can be negative based on the latest available LCCC forecasts at the time the cap is set. We considered this approach better balanced simplicity of implementation with ensuring customers pay a price that more accurately reflects supplier costs/benefits. In our consultation we forecast that with this amendment, for cap period nine, the cap would be

[1] Under the regulations governing the CfD, LCCC cannot set an ILR lower than £0/MWh. The purpose of this floor was to ensure LCCC does not make payments to suppliers in advance and has sufficient funds to cover the cost of the CfD scheme. Any payments due to suppliers will be made following a reconciliation process carried out by LCCC after the relevant quarter.

£12.51/customer lower. Based on the latest LCCC forecasts, we now estimate the figure at £11.44/customer.

When we developed the cap in 2018, we allowed suppliers to recover the costs incurred due to the CfD scheme, as set out in our 2018 decision.[2] We also set out to only make changes where there are clear material and systematic impacts on the costs of supplying default tariff customers that are not appropriately accounted for by the existing cap methodology.

We have decided **to remove the £0/MWh floor from the CfD price cap allowance** by replacing the LCCC's published ILR in our methodology with an expected levy payment, calculated using LCCC CfD payments forecasts and energy demand. We have also decided **to not introduce** a reconciliation of the CfD allowance against outturn costs.

We consider not removing the £0/MWh floor could lead to material and systematic impacts.

All suppliers agreed that the current methodology should be changed to be more cost-reflective. The main concern raised was whether we should introduce a reconciliation mechanism. When setting the cap in 2018, we stated we would not include a mechanism in the cap for correcting previous forecast errors – whether or not they benefit suppliers.[3]

We have considered the arguments raised by suppliers on a reconciliation mechanism. We have concluded the issues underpinning these arguments are not resulting in material and systematic impacts and therefore we do not consider a reconciliation appropriate.

Next steps

This document sets out the methodology that will be used when setting the CfD allowance in the next cap update. This document is not setting the value of the CfD allowance. The new CfD allowance methodology will apply from 1 October 2022 onwards. A decision on how frequently this allowance will be updated will be taken following feedback on our statutory consultation on changes to the wholesale methodology.[4]

[2] Ofgem (2018), Decision – default tariff cap – Appendix 5 – policy and network costs. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[3] Ofgem (2018), Decision – default tariff cap – Paragraph 3.17. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[4] Ofgem (2022), Consultation – default tariff cap -statutory consultation on changes to the wholesale methodology

1. Introduction

Subject of this decision

1.1. This document sets out our decision to amend the Contracts for Difference (CfD) allowance methodology in the default tariff cap to ensure it remains reflective of the CfD related costs (and benefits) suppliers face.

1.2. As outlined in the consultation, our initial view was that the current methodology does not accurately reflect supplier costs in instances where CfD costs are negative. Not addressing this issue could lead to material and systematic impacts.

Scope of this decision

1.3. This decision refers to the methodology we follow to set the allowance for the CfD scheme in the price cap. Proposing amendments to or commenting on the workings of the CfD scheme and agents involved in the scheme is not within our scope.

1.4. This decision does not set the allowance for CfD, but sets out the methodology that will be used to calculate it in the next cap period.

What are our decisions?

1.5. Remove the £0/MWh floor from the CfD price cap allowance by replacing the Low Carbon Contracts Company's (LCCC) published Interim Levy Rate (ILR) in our methodology with an expected levy payment, calculated using LCCC CfD payments forecasts and energy demand.

1.6. Not to introduce a reconciliation of the CfD allowance against outturn costs.

Structure of this decision document

1.7. This decision document has the following structure:

- chapter 1: introduction
- chapter 2: decision-making process
- chapter 3: CfD allowance methodology

The default tariff cap

1.8. 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.[5]

a. the need to create incentives for holders of supply licences to improve their efficiency;

b. the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;

c. the need to maintain incentives for domestic customers to switch to different domestic supply contracts; and

d. the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

1.9. The requirement to have regard to the four matters identified in section 1(6) of the Domestic Gas and Electricity (Tariff Cap) Act 2018 (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.

1.10. In setting the cap, we may not make different provisions for different holders of supply licences.[6] This means that we must set one cap level for all suppliers.

[5] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). http://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted
[6] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

Context

1.11. The 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 LCCC, a government-owned company.

1.12. 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.

1.13. To fund the Supplier Obligation, suppliers must make two payments. At a high level, the 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.

1.14. In addition, 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.

1.15. The ILR is the 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.

1.16. The Interim Levy Rate has a floor of £0/MWh. 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.

CfD allowance in the price cap

1.17. Since the start of the cap, wholesale prices have not been typically higher than the CfD strike prices agreed for renewable generation projects for a sustained period, so the ILR forecast has been a positive value. However, when wholesale prices are higher than the CfD strike price for an extended duration, suppliers will receive a payment from generators via the LCCC, rather than suppliers paying generators when wholesale prices are below the strike price.

1.18. As with other levies and obligations on suppliers, the cap sets an allowance for CfD costs incurred by suppliers. Under the policy cost allowance, the cap ensures that suppliers can recover the additional costs related to their obligations under different government environmental and social programmes.

1.19. Following recent wholesale price increases, the agreed strike prices for projects have been lower than forecast wholesale prices. This has led to generators making payments to the LCCC, with the latter then refunding levy payments to suppliers. Due to the ILR's £0/MWh floor, the cap cannot currently account for this additional revenue for suppliers and decrease prices for customers.

1.20. 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 CfD financial year (April to March) within which the cap period falls. For the summer price cap, this is based on forecast interim levy rates for April-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.

1.21. 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.

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

1.23. In our 4 February 2022 decision, we estimated suppliers would receive a benefit in cap period eight (April 2022-September 2022) 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.[7] We did not propose to adjust this benefit to suppliers for cap period eight through a negative adjustment as this issue was not raised in our original

[7] In the 4 February 2022 decision we quoted this figure as an annualised value ~£7 per customer. Ofgem (2022), Decision – 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

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.[8]

1.24. In the consultation, we estimated that suppliers will receive a benefit of £12.51 per customer in cap period nine (October 2022-March 2023) if the CfD cap methodology is not amended and suppliers hedge in line with the interim levy rate forecast.[9] LCCC updated its forecast for Q2 2022 on 12 May. We have recalculated the benefit as £11.44, taking into account this forecast.[10,11]

1.25. We therefore consulted 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.

1.26. When we developed the cap in 2018, we allowed suppliers to recover the costs incurred due to the CfD scheme, as set out in our 2018 decision.[12] We also set out to only make changes where there are clear material and systematic impacts on the costs of supplying default tariff customers that are not appropriately accounted for by the existing cap methodology.

1.27. At a high level, systematic impacts are either those that lead cap allowances consistently overrepresent or those that consistently underrepresent suppliers efficient

[8] Ofgem (2022), Decision – 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

[9] 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.

[10] To note this document is not setting the value of the CfD allowance, but the methodology we will use to calculate it from the next cap update. This number is subject to change depending on the latest LCCC forecasts at the time of setting the cap.

[11] It is worth noting these estimates are for a six-monthly cap. See Appendix 2 for how estimates would be calculated on a quarterly basis if we move to updating the cap and CfD allowance quarterly, as outlined in our statutory consultation on changes to the wholesale methodology

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

costs. Similarly, at a high level, the materiality condition is applied to ensure only significant impacts are considered, keeping the cap methodology stable and proportionate.

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

2. Decision-making process

Consultation stages

April 2022 consultation

2.1. We published a consultation in April 2022 that set out our proposals on how we would amend the CfD allowance from cap period nine onwards. We consulted on how we would remove the existing £0/MWh floor in the methodology to allow the allowance to lower customer bills if CfD benefits for suppliers are expected. We proposed to use the latest available information from LCCC on the CfD scheme costs at the time we set the cap.[13] Suppliers provided responses in May 2022.

June 2022 decision

2.2. This decision document sets out our decisions on how to determine the allowances for the CfD scheme in the cap for cap period nine onwards.

2.3. We will update the allowance for each subsequent cap period.

Related publications

2.4. The main documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted
- Default Tariff Cap Decision: https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

2.5. The main documents relating to reviewing and amending the CfD methodology in the default tariff cap are:

- Price Cap April 2022 - Consultation on amending the methodology for setting the Contracts for Difference (CfD) cap allowance:

[13] Ofgem (2022), Consultation – Consultation on amending the methodology for setting the Contracts for Difference (CfD) cap allowance: https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-contracts-difference-cfd-cap-allowance

https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-contracts-difference-cfd-cap-allowance

- Price Cap November 2021 – 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 February 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

- Price Cap May 2022 – Statutory consultation on changes to the wholesale methodology: https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology

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

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

General feedback

2.6. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this report. We would 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.

3. CfD allowance methodology

Section summary

This chapter sets out our decision to amend the CfD allowance to remove the £0/MWh floor and not to introduce a reconciliation into the methodology. We discuss our rationale behind the policy, options considered and considerations following consultation responses from suppliers.

Context

3.1. When we developed the cap in 2018, we allowed suppliers to recover the costs incurred due to the CfD scheme, as set out in our 2018 decision.[14] We also set out to only make changes where there are clear material and systematic impacts on the costs of supplying default tariff customers that are not appropriately accounted for by the existing cap methodology.

3.2. In the 2018 decision, we also stated that we will not include a mechanism in the cap for correcting previous forecast errors, noting that in the long run, non-systematic forecast errors should net out.[15]

3.3. In the consultation we outlined three options we had considered:

- option 1: status quo
- option 2 (preferred option): remove the £0/MWh floor by replacing the LCCC's published ILR with an expected levy payment based on LCCC data
- option 3: remove the £0/MWh floor by replacing the LCCC's published ILR with an expected levy payment based on LCCC data and reconcile actuals vs forecast

3.4. All of these options relate to how we would set the CfD cap allowance and do not change or amend how the CfD scheme operates.

[14] Ofgem (2018), Decision – default tariff cap – Paragraph 3.14
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[15] Ofgem (2018), Decision – default tariff cap – Paragraph 3.17
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

Decisions

3.5. Remove the £0/MWh floor from the CfD price cap allowance by replacing the LCCC's published ILR in our methodology with an expected levy payment, calculated using LCCC CfD payments forecasts and energy demand.

3.6. Not to introduce a reconciliation of the CfD allowance against outturn costs.

Overview of responses

3.7. In response to our April 2022 consultation, we received responses from five suppliers.

3.8. All suppliers agreed the methodology should be amended to be more cost reflective.

3.9. Out of the responses received, 3 suppliers disagreed with our preferred option, and 2 supported it.

3.10. Those who disagreed noted concerns on the accuracy of forecasts that underpin the CfD cap allowance in our proposal. They also noted concerns on the impact our allowance would have on their cash flow, as suppliers would not receive payments back from the LCCC until it carries out its reconciliation so our methodology would lower prices ahead of suppliers receiving the payments. Suppliers also noted concerns around needing to continue hedging for CfD costs.

3.11. Suppliers who agreed with our proposal raised different views on the cash flow and hedging impact and the incentives a reconciliation would place on customers.

Considerations

3.12. In this section, we set out our overall views on suppliers' comments and provide our detailed rationale for our decisions. We mainly focus on the arguments raised by suppliers around whether a reconciliation should be built into the CfD price cap allowance methodology. This is because this area was the key focus of most responses received and the key one where there are differing supplier views.

3.13. The purpose of a reconciliation would be to adjust the CfD allowance of a future cap period to account for the difference between our CfD allowance and actual CfD costs for a prior cap period.

3.14. We address supplier comments raised on other areas in Appendix 1.

Overall consideration

3.15. We consider that if we do not remove the £0/MWh floor there will be material and systematic impacts, as customers would not see lower bills when suppliers are forecast to experience negative CfD costs.

3.16. Having reviewed supplier concerns, we do not consider the issues underpinning the key arguments for a reconciliation are having a material and systematic impact on suppliers' costs. Therefore, we do not consider a reconciliation is appropriate for the CfD allowance methodology.

3.17. We also consider that our CfD methodology mitigates to some extent the concerns raised by suppliers on the allowance being based on forecast scheme costs. This is because (as described in Chapter 1) for the winter cap, our methodology incorporates reconciled levy rates for the first months of the CfD year (if available). However, it maintains the benefit that cap customers face the costs and benefits of the CfD scheme within the relevant cap period. If we were to move to a quarterly cap, more frequent updates would allow our methodology to pick up reconciled values into the allowance more frequently.[16]

3.18. In addition, the current CfD cap allowance is bound at £0/MWh and there is a negative payments profile forecast for cap period eight overall. We expect that there is currently a one-off benefit that suppliers could be receiving that is not accounted for in the allowance and which could net off cost increase concerns for cap period eight.[17]

3.19. We also consider that the price charged to default tariff customers should reflect current costs to suppliers. A reconciliation would mean future customers may experience benefits or costs that should have been reflected in the price of current customers.

[16] Ofgem (2022), Consultation – default tariff cap. https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology
[17] For the period between April – September 2022, LCCC forecasts show total CfD payments expected to be negative: https://www.lowcarboncontracts.uk/index.php/dashboards/cfd/levy-dashboards/interim-levy-rate-and-total-reserve-amount

Accuracy of LCCC forecasts that underpin the CfD cap allowance

3.20. There are three key sources of uncertainty when forecasting CfD payments. Market prices, volume of energy generated and generator start dates. Suppliers raised issues pertaining to risk of capturing generator delays and price risk in the LCCC forecasts, and in turn the CfD cap allowance.

Capturing generator delays

3.21. Two suppliers said that two generators, which were due to start participating in the CfD scheme, have taken the commercial decision to defer their entry into the scheme. This is in response to current market conditions, where the CfD scheme is resulting in payments from generators to the LCCC. Suppliers also noted that generators due to come online over the next few years would likely take this decision if current market conditions persisted.

3.22. The delay in generators taking part in the scheme will change the cost / benefit of the CfD scheme for suppliers, who are responsible for funding the scheme.

3.23. Suppliers argued that LCCC forecasts, which the cap uses as a key data point to set the allowance, will not pick up the impact of these delays until the LCCC is formally notified by the relevant generator, even though this behaviour from the generators should be predictable given market incentives. Suppliers argued that LCCC forecasts, on which the cap is based, are therefore unlikely to materialise, leading to suppliers under recovering on their efficient costs for cap period eight.

3.24. We acknowledge that there may be some systematic aspects in regard to CfD generator delays onto the scheme as, under the current market conditions, it could be expected for generators to delay their entry into the scheme until their contract long-stop date. However, we consider that there is uncertainty regarding the extent to which this risk will materialise. The materiality of any generator delays on the CfD allowance will depend on:

- when the generator was due to start operating as a CfD
- when that is communicated to the LCCC
- the capacity of the generator
- incentives to delay continue to be present

- when the next cap update will happen
- volume and price changes

3.25. Two suppliers submitted evidence suggesting that currently, confirmed generator delays will result in a £2.5-£4 per customer additional cost impact in cap period eight, reducing existing negative CfD cost forecasts. We acknowledge the recent generator delays will likely increase supplier costs over cap period eight. However, future cap allowance updates from cap period nine onwards will capture the increased costs as a result of these previously notified delays given that the LCCC will be aware of them ahead of publishing its forecasts.

3.26. In addition, between now and 2023, there is only one more generator due to start in the CfD scheme who has not communicated their intention to delay, reducing the risk of potential immediate material impacts due to this issue.

3.27. Overall, we do not consider this issue to be both material and systematic going forward. This is because the potential materiality of this issue in future cap periods is uncertain and will depend on the factors noted above.

3.28. In addition, pending the outcome of our work on changes to the wholesale methodology, should the price cap move to a quarterly update as currently proposed, the impact of CfD generator delays on LCCC forecasts would be more easily captured in the cap. This would reduce the impact to suppliers if LCCC forecasts fail to materialise, as the next cap update, which would incorporate any unaccounted-for changes in the previous cap, would be closer than under the current model. However, this will not be a reconciliation of previous allowance deviations.

LCCC price forecast accuracy

3.29. One supplier highlighted that LCCC's forecast will overstate intermittent reference prices due to the dampening price effect of increased renewable output displacing more expensive generation, leading to a consistent over-forecast of CfD costs.

3.30. Our cap methodology relies on LCCC forecasts as they will offer the latest view of CfD scheme costs and workings. The LCCC produce the best publicly available forecast of CfD costs and are best placed to produce these as they manage the CfD scheme. The LCCC are continuously improving their processes and forecasting to ensure it best reflects expected CfD scheme costs.

3.31. In response to supplier comments, we have compared the ILRs we used to set the CfD allowance in previous cap periods in our Annex 4 – Policy cost model, based on the available forecasts at the time, with LCCC reconciled levy rates.[18] Historically, differences between the ILRs we used and reconciled ILRs have been small. Moreover, this gap would represent an upper bound given that suppliers can take hedging actions to minimise the impact of differences between forecasted and actual wholesale prices. We would welcome evidence from stakeholders if in the future they consider that our approach for setting CfD allowances is no longer appropriate.

3.32. One supplier has said that suppliers are exposed to the price risk between the allowance being set and the actual CfD cost/benefit being incurred/received. We consider deviations in this time period are likely due to non-systematic forecasting errors such as price movement and volume risk.

Cash flows

3.33. Two suppliers noted that the proposed option could create a cash flow burden in instances where negative CfD payments are forecast. This is because suppliers, as a result of the design of the CfD scheme, only receive payments back from the LCCC after its reconciliation of costs for a particular CfD quarter. Suppliers argue the cap allowance will require suppliers to reduce their default tariff customer prices before the LCCC reconciliation process takes place.

3.34. One of the suppliers who raised concerns around cash flows argued that a variation of one of our options considered would be needed in order to solve this issue. The option proposed would keep the expected levy payment in our methodology at £0/MWh when negative payments are forecast but include a reconciliation when data on actuals became available. The supplier argued this mimics the way in which the CfD scheme operates and avoids having to pass on savings to customers before suppliers experience them.

3.35. However, one supplier noted that the time lag described above is manageable.

[18] Based on latest settlement data available at: Reconciled Daily Levy Rates | Low Carbon Contracts Company

3.36. Another supplier, who agreed with the preferred option, raised another issue that introducing a reconciliation into the cap methodology could create a cash flow risk where changes to the price cap to account for current costs take place in future cap periods.

3.37. We acknowledge the time lag between the CfD price cap allowance and the receipt of payments from the LCCC to suppliers when negative CfD payments are forecast. We consider this is a result of the CfD scheme design rather than the cap allowance, which will affect both customers on the cap and fixed term contracts.

3.38. The cap is not designed to exactly match suppliers' cash flows. When wholesale prices are above the strike price, we consider that suppliers will have the tools to manage temporary cashflow in the normal course of business.

3.39. We also note that LCCC starts its reconciliation process within the six-month cap period for the first quarter of the cap period, partially mitigating cash flow concerns. If we were to move to a quarterly cap, more frequent cap updates would further reduce cash flow concerns.[19]

3.40. In light of differing views across suppliers and the above considerations, we do not consider we need to amend the allowance to account for this consideration.

Supplier hedging

3.41. Two suppliers argued that introducing a reconciliation would remove the need to hedge against CfD costs for default tariff customers. Suppliers noted it is challenging to hedge against this scheme given volatility and the cost associated with hedging.

3.42. One supplier expressed a preference not to have a reconciliation to keep its current hedging approach.

3.43. One supplier also noted that under our preferred option in the consultation, suppliers are exposed to price risk between the allowance being set and CfD actual costs/benefits being incurred/receive. This is because LCCC publish the power prices used

[19] Ofgem (2022), Consultation – default tariff cap. https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology

to set the ILR a few weeks after setting the ILR, so suppliers would need to assume these in order to hedge.

3.44. As stated at the beginning of this chapter, in line with our 2018 decision, we do not include mechanisms in the cap for correcting previous forecast errors, particularly if these are non-systematic. We consider that deviations of CfD costs from their forecasts will largely be due to changes in wholesale prices and volume generation which are difficult to predict and non-systematic. Suppliers can also hedge against the former. Given the differing supplier views on this issue, and the fact that differences between outturn and forecasts are not considered to be a systematic issue, we do not consider this to be a sufficient argument to trigger the need to introduce a reconciliation.

3.45. We also consider hedging to be prudent risk management behaviour and did not receive evidence from suppliers suggesting this activity was having a material impact on their costs.

3.46. We also note that suppliers will need to hedge CfDs for fixed tariff customers, so this issue could not be avoided entirely, even if a reconciliation for default tariff customers is introduced.

Accuracy of price paid by customers

3.47. All suppliers agreed the methodology should be amended to be more cost reflective, with four out of five suppliers agreeing with our proposal to remove the £0/MWh floor.

3.48. One supplier suggested maintaining the floor but introducing a reconciliation. See the cash flow section for the argument raised and our consideration.

3.49. In our consultation, we noted that *"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."*[20]

[20] Ofgem (2022), Consultation – Paragraph 4.17 Consultation on amending the methodology for setting the Contracts for Difference (CfD) cap allowance | Ofgem

3.50. One supplier argued the gain in accuracy we noted would outweigh any potential volatility or uncertainty customers could experience.

3.51. We consider that while a reconciliation could potentially ensure greater accuracy over time, changes in SVT customer numbers would also erode accuracy of a reconciliation. A reconciliation would also mean that default tariff cap customers would be subject to a CfD allowance based on past costs that would not reflect the costs incurred by customers in that cap period.

3.52. In addition, we consider that non-systematic forecast errors in forecasts should net out in the long-run, as per our 2018 decision on the price cap.[21]

3.53. We do not consider potential changes to the accuracy of the price paid by customers are material and systematic. Therefore, this is not a sufficient reason to introduce a reconciliation into the methodology.

Customer reflexivity

3.54. One supplier argued that if a reconciliation were to lead to a benefit for customers, it could incentivise customers to switch to the default tariff, or vice versa. This would add uncertainty to expectations around default tariff customer numbers.

3.55. We note the point raised, but do not consider the scale of potential reconciliations would be material enough to incentivise customers, or a significant proportion of them, to switch tariffs given the size of the CfD scheme compared to the total cap allowance. We also do not consider this issue to be of a systematic nature, as reconciliations will be caused by non-systematic forecast errors, as outlined in sections above.

[21] Ofgem (2018), Decision – default tariff cap, paragraph 3.17 Default Tariff Cap - Overview Document (ofgem.gov.uk)

Appendices

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Appendix 1- Considerations of additional supplier comments

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

CfD scheme administration

1.2 One supplier has said that there is a material imbalance between suppliers and generators in current market conditions as suppliers face a cash flow burden because of the way the scheme is administered. Another supplier has also asked whether our minded-to position would change to how payments to suppliers are received. The design and workings of the CfD scheme are a matter for government. We are not currently proposing to change the workings of the CfD scheme. We will instead focus on how we reflect the scheme in the CfD cap allowance for it to be more cost reflective.

1.3 One supplier has said that if we are to proceed with our minded-to position, the LCCC should publish the eligible demand as this is not currently provided on the LCCC dashboard for cap periods beyond the front two quarters. We consider this issue to be outside the scope of our allowance-setting process.

CfD allowance methodology in price cap

1.4 One supplier has said that CfD allowance is an outlier in the cap methodology as most other non-energy cost rates use historical data to set their allowances. Although the costs associated to the CfD scheme may be subject to volatility, we consider that non-systematic forecast errors in forecasts should net out in the long run, as per our 2018 decision on the price cap.

1.5 One supplier has asked that we inform suppliers of the date used to calculate the CfD allowance, so that suppliers can hedge the price risk. When calculating the CfD allowance, we will use the latest publicly available LCCC data when setting the cap. We consider this to be an existing area for suppliers to manage rather than an issue raised due to the new CfD methodology.

Green Excluded Electricity cap

1.6 One supplier raised that, in any option Ofgem pursues, the existing assumption that the Green Excluded Electricity (GEE) cap will be met when wholesale prices are above CfD strike prices needs to be removed as there will be no value in suppliers submitting Guarantee of Origin certificates to reduce market share should Ofgem pursue option 2 or 3.

1.7 We acknowledge the incentive for suppliers not to reduce their share via the GEE when wholesale prices are above CfD strike prices. However, the GEE uplift is a small percentage of the total allowance and do not consider proportionate to increase the complexity of the allowance methodology to cater for this potential impact.

Timing of CfD allowance methodology change

1.8 One supplier said the decision on whether to amend the CfD allowance methodology should be made in early June to allow suppliers to finish their current hedging decisions.

1.9 In line with supplier feedback received, this decision will apply from cap period nine onwards and has been published in June.

Timing risk

1.10 One supplier noted that currently, the wholesale allowance is calculated using an average wholesale price offered during the historic observation window, whereas the CfD allowance uses LCCC forward looking forecasts for future levy costs at the point in time that the cap is set. The supplier argued this presents an inconsistency between how the wholesale price and CfD allowances are calculated in the cap, and therefore introduces inherent timing risk into the price cap.

1.11 The cap provides allowances using different methodologies to a number of costs incurred by suppliers to serve customers, including direct wholesale costs and CfD costs. We do not consider that there is an interaction between those cost areas.

Adopting an ex-post approach

1.12 One supplier has suggested that the CfD allowance methodology could adopt the use of historical rates in a similar way to how BSUoS costs are recovered in the cap methodology. This is because they believe CfD costs are volatile and difficult to predict.

1.13 Our cap methodology relies on LCCC forecasts as they will offer the latest view of CfD scheme costs and workings. The LCCC are best placed to produce forecasts and monitor the scheme and are continuously improving their processes. We consider appropriate to rely on these forecasts in order to ensure that bills are cost reflective of customer costs for that cap period.

Appendix 2- Calculating the cap allowance

2.1 In the consultation, we noted that we would calculate the expected levy by:

- dividing forecast CfD payments for each quarter of the CfD year by expected eligible demand for the same quarter to calculate an expected levy payment per quarter
- the four quarterly expected levy payments would then be multiplied by the share of energy demand of their relevant quarter and summed to produce an annual expected levy payment
- this calculation would then be uplifted by energy in scope of the green energy exemption. An uplift for losses would also be applied
- to convert from a £/MWh estimate to £/customer, benchmark consumption values of 3.1MWh per customer per year are applied[22]

2.2 This decision confirms this will be the methodology used in order to set the CfD allowance from cap period nine onwards.

2.3 Currently, the CfD allowance is based on a quarterly levy, but set for a six-month period. Should our proposals to update the cap quarterly be taken forward, we would update inputs to the allowance on a quarterly basis and move CfD costs from Annex 4 – policy cost model, to Annex 2 – wholesale cost model. This will allow us to contain all components for the quarterly update within one annex and limit the number of changes we make to the models.[23]

[22] Ofgem (2022), Consultation - Consultation on amending the methodology for setting the Contracts for Difference (CfD) cap allowance – Footnote 11 https://www.ofgem.gov.uk/publications/consultation-amending-methodology-setting-contracts-difference-cfd-cap-allowance

[23] Ofgem (2022), Consultation - Statutory consultation on changes to the wholesale methodology | Ofgem- Table 3.2 and paragraph 3.14