Decision

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Price Cap – Decision on possible wholesale costs adjustment

Subject	Details
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We consulted in May 2022 on whether suppliers are incurring additional efficient wholesale costs and whether any adjustment is necessary to the default tariff cap. We have carefully considered all evidence and representations provided by stakeholders.

This document sets out our decision to introduce an adjustment for the costs of unexpected Standard Variable Tariff demand relating to cap period eight (April to September 2022). This adjustment will take effect from 1 October 2022, for 12 months.

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Executive summary

We introduced the default tariff cap ('cap') on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures that default tariff customers pay a price for their energy that reflects its reasonable underlying costs. Customers who are disengaged or in vulnerable situations have been more likely to be on default tariffs than customers in general, so the cap plays a particular role in protecting these customers.

Potential additional costs

As a result of Russia's actions, the volatility in the energy markets that we experienced last winter has lasted much longer, with much higher prices than ever before. As a result of the market conditions we continue to see, the cap will automatically increase to reflect those costs. This situation has the potential to create further costs – beyond those already included in the cap – for suppliers in two areas.

- Suppliers may incur **unexpected standard variable tariff (SVT) demand costs** when more customers than expected move to or remain on SVTs, to the extent that they need to buy additional energy at a cost above the cap wholesale allowance. These costs have historically (before winter 2021) been low and covered by existing uncertainty mechanisms – but this might no longer be the case due to the scale of wholesale price increases.
- Suppliers **incur shaping and imbalance costs** from refining their hedged positions to meet customers' demand. This activity occurs close to the time of consumption, and is affected by wholesale prices at that time. While we include an allowance in the cap for shaping and imbalance costs, wholesale price increases could push costs above it.

In February 2022, we decided to introduce an adjustment to the cap for these two areas (and backwardation) in relation to costs for cap period seven. (Backwardation costs are a result of the difference between the index used to set the cap level and the way suppliers are able to purchase energy for their cap customers). In May 2022, we consulted on whether to introduce an adjustment for the two areas for costs relating to cap periods eight (April 2022 – September 2022) and nine (October 2022 – March 2023), pending enduring changes to the cap being fully implemented. This document sets out our decisions following evidence and responses submitted in response to the consultation.

We have also adjusted our calculation of backwardation costs in cap period seven (October 2021 – March 2022), leading to an uplift of £6 per dual fuel customer. We have addressed

future backwardation costs separately through our decision 'Price cap - Decision on changes to the wholesale methodology'.

Unexpected SVT demand costs for cap period eight

We have decided to apply an adjustment to the cap for non-prepayment meter (non-PPM) customers to account for unexpected SVT demand costs incurred by suppliers over cap period eight.

We have carefully balanced the immediate impact on bills with customers' wider interests and we consider that an allowance intended for efficient costs is in customers' long-term interests. In particular, it should reduce the risk that customers have to pay for the mutualised costs of supplier failures as a result of efficient suppliers being unable to recover their costs. These mutualised costs can be very significant – as an illustration, by December 2021 we had consented to Suppliers of Last Resort making initial levy claims totalling £1.83bn. Our assessment of the financial risk of supplier failure this winter suggest that costs could be significantly higher than last winter if we did not implement measures to stabilise the market. As well as costs, supplier failures would risk creating disruption and worry for customers. We are conscious of the impact that this adjustment will have on customers already facing severe cost of living pressures, including some of most vulnerable and disengaged. The same general trade-off applies in relation to these customers – but our assessment is that making an adjustment is still in their interests. The Government has announced support measures for households, and we will keep working with them, with consumer groups and with energy companies on what further help may be needed with higher prices, including as a result of this adjustment.

We calculated unexpected SVT demand costs using the lower quartile of the figures received as evidence from suppliers. We consider this is the most appropriate benchmarking approach in these circumstances to protect customers. We did not offset unexpected SVT demand costs against other changes to costs as a result of higher wholesale prices, as we did not have sufficient confidence to do so. We consider that the resulting costs are material and systematic – our test for adjustments to the cap. However, we have assessed these costs using a more stringent benchmark than in our February 2022 decision, as we expect suppliers to have responded to now-known risks.

The adjustment will be applied from 1 October 2022 over a 12 month period. The adjustment is worth £41 per typical dual fuel non-PPM customer at cap benchmark consumption. We considered PPM and non-PPM customers separately. We do not consider that an adjustment is justified for PPM customers as the costs are not material for that

payment type. This decision helps PPM customers, who are more likely on average to be in vulnerable situations than non-PPM customers.

Other costs

We have decided not to adjust the cap for unexpected SVT costs relating to cap period nine, or for shaping and imbalance costs relating to cap periods eight and nine. We did not find evidence of material cost changes relative to the existing cap allowance for shaping and imbalance in cap period eight. We consider there is insufficient evidence on whether suppliers are incurring material additional costs in cap period nine, and the data submitted is subject to significant uncertainty. We consider that it would be up to stakeholders to make the case for any future reviews of these areas.

1. Introduction

Subject of this decision

1.1. Following an increase in wholesale price volatility over recent months, we have considered whether suppliers are incurring increased wholesale costs, which are not reflected in the default tariff cap ('cap') methodology and which ought to be.[1] We are considering costs for cap period eight (April to September 2022) and cap period nine (October 2022 to March 2023).[2]

1.2. This document sets out our considerations and decision on whether to adjust the cap from 1 October 2022 to account for potential additional wholesale costs incurred by suppliers in cap periods eight and nine.

1.3. Specifically, this decision focuses on costs incurred across two areas.

- **Unexpected standard variable tariff (SVT) demand:** increases in wholesale prices may erode or eliminate the savings available on fixed-term contracts (FTC) relative to SVTs. This may increase the number of customers on SVTs, beyond the number that suppliers expected and hedged for. Suppliers may therefore need to buy energy to meet this unexpected SVT demand at prices above those used to set the cap level.

- **Shaping and imbalance costs:** while suppliers buy energy in the forward markets, they incur further costs to refine their positions close to delivery. These costs are likely to depend on the prevailing wholesale prices, and so may increase with them.

1.4. We provide further information on these areas in Chapters 3 and 4, respectively.

[1] We note that the relevant legislation requires us to protect default tariff customers and to have regard to the need to provide incentives for suppliers to improve their efficiency. See the 'Statutory framework' section below.
[2] We have published a separate decision on the wholesale methodology. This will implement a quarterly cap update from 1 October 2022. In this document, we refer to 'cap period nine' as the overarching term for the two quarterly cap periods in winter 2022. We consider this six month period because this aligns to the data we hold.

Our key decisions

Unexpected SVT demand costs for cap period eight

1.5. **Adjustment:** we will apply an adjustment of approximately £41 per typical dual fuel customer to the cap in order to account for additional costs incurred by suppliers over cap period eight.[3]

1.6. **Benchmarking:** we have calculated unexpected SVT demand costs using the lower quartile of supplier figures received.

1.7. **Offsets:** we have decided not to apply any offsets (for other changes to costs as a result of higher wholesale prices) to the unexpected SVT demand costs.

1.8. **Implementation:** we will apply the adjustment from 1 October 2022 over a 12 month period. The adjustment will be a fixed amount, rather than being subject to a subsequent true-up.

1.9. Appendix 1 shows the cost values that we have decided to include in the relevant cap model. The adjustment allowance cap model published alongside this decision shows the final values of the adjustment.

Other costs

1.10. We will not introduce an adjustment for unexpected SVT costs relating to cap period nine or for shaping and imbalance costs relating to cap periods eight and nine.

Structure of this decision document

1.11. This decision document has the following structure:

- Chapter 1 sets out the scope of our decision and provides context.

[3] This comprises approximately £17 per typical electricity customer and approximately £24 per typical gas customer. All these values are at the benchmark annual consumption values used to set the cap (3,100kWh electricity and 12,000kWh gas). These are higher than the current typical domestic consumption values (2,900kWh electricity and 12,000kWh gas).

- Chapter 2 explains our decision-making process.
- Chapter 3 covers our decision on unexpected SVT demand costs, including decisions on benchmarking and offsets.
- Chapter 4 covers our decision on shaping and imbalance costs, including decisions on benchmarking and offsets.
- Chapter 5 sets out our decisions on implementing an adjustment.

The default tariff cap

The cap

1.12. We introduced the cap on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying costs.

Statutory framework

1.13. We set the cap with reference to the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('the Act'). The Act requires us to put in place and maintain the licence conditions which give effect to the cap.[4] 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:

- 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;

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

- 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.[5]

1.14. 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.

1.15. 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.

Approach to considering adjustments to the cap

1.16. In our 2018 decision, we said that: "if in the future we consider there are material systematic issues that require correction, we might modify the licence. This would allow us to make any changes required to correct how the cap was updated, if it systematically and materially departed from an efficient level of costs". We also said that: "The type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes".[7]

1.17. We have applied this test when considering changes to the cap. As set out in our November 2021 wholesale consultation: "We broadly consider the case for amending the cap methodology against the test of whether a change in the costs facing suppliers is material and systematic, considering the market as a whole".[8]

[5] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). https://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[6] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[7] Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[8] Ofgem (2021), Price Cap – Consultation on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 4.16. https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap

Context

Wholesale cost allowances in the cap

1.18. Wholesale costs account for the largest portion of a customer's bill. There are currently[9] three parts to our assessment of wholesale costs in the cap.

- **Core direct fuel allowance:** we estimate the majority of wholesale costs based on forward contracts for electricity and gas. We measure the prices of these contracts over a period of time before a cap period, which we refer to as an observation window.

- **Additional direct fuel allowances:** we uplift the core direct fuel allowance by an additional set percentage. This percentage reflects the expected costs of converting less granular forward contracts to more granular contracts closer to delivery, forecast error and imbalance. The percentage also reflects transaction costs. It also includes an uplift for additional risks ('additional risk allowance'), which we set at 1% in our 2018 decision. We apply this uplift because wholesale costs are a volatile and uncertain element of suppliers' costs, and this uncertainty could lead to additional costs which are not covered by the other wholesale allowances. We also apply regional electricity losses and unidentified gas[10] before calculating the final direct fuel allowance.

- **Capacity market payments:** we also provide an allowance for the capacity market (CM) scheme, designed to ensure electricity security of supply.

1.19. Under the existing cap methodology, we calculate and update the core direct fuel allowance and CM allowance each time we update the cap. This means that unexpected changes in direct fuel costs and CM costs are reflected in the cap level each time it is updated.[11]

[9] Through our decision on changes to the wholesale methodology, we have decided to add a backwardation allowance as a new element to the wholesale cost allowance. We have also decided to move the Contracts for Difference allowance from the policy cost model to the wholesale cost model.
[10] Unidentified gas is a charge to suppliers reflecting gas losses, eg due to theft or leaking pipes.
[11] In future, we will continue to update the CM allowance twice-yearly, even when we update certain other components more frequently.

1.20. The additional direct fuel allowances are indexed as a fixed percentage of direct fuel costs, rather than calculated. At the time we introduced the cap, we estimated the costs associated with shaping, forecast error and imbalance costs, based on historical cost data. Table 1 includes a summary of the additional direct fuel allowances. We set out more detail on how we calculated these additional direct fuel allowances in Appendix 4 to our 2018 decision.[12]

Table 1: Summary of additional direct fuel allowances for electricity and gas (as a percentage of the core direct fuel allowance)

Allowance	Electricity (single rate and multi-register)	Gas
Shaping, forecast error and imbalance costs	6.0%	4.3%
Transaction costs	0.4%	0.3%
Additional risk and uncertainty	1.0%	1.0%
Total	**7.4%**	**5.6%**

February 2022 wholesale decision

1.21. Our February 2022 wholesale decision[13] sets out that suppliers' efficient costs materially departed from the cap allowances during cap period seven (October 2021 to March 2022). We concluded that a cap level increase of £61 per customer in cap periods eight and nine was required to ensure suppliers could recover their efficient costs related to cap period seven.

1.22. We implemented this adjustment through a change to the additional risk allowance. We changed the value so as to recover the adjustment, in addition to the original 1% value.

[12] Ofgem (2018), Default tariff cap: Decision – overview. Appendix 4 – Wholesale. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[13] Ofgem (2022), 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

1.23. We did not make an upfront adjustment for costs relating to cap period eight. At a high level, this reflected the uncertainty about future costs. Our February 2022 wholesale decision sets out our considerations in detail.[14]

1.24. Alongside our February 2022 wholesale decision, we published the February 2022 guidance letter.[15] This sets out guidance for suppliers to support them in making prudent risk management decisions. We noted that, in our February 2022 wholesale decision, we had not adjusted the allowance for the effectiveness of suppliers' demand forecasting and hedging strategies, "as the market circumstances were unprecedented". However, we said: "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".[16]

Recent wholesale price movements

1.25. Wholesale prices increased during summer 2021, followed by a significant acceleration in September 2021. Prices increased further in December 2021.

1.26. These price increases provided the context for our February 2022 wholesale decision on costs relating to cap period seven. However, these price increases also affect cap period eight. Suppliers will have started to incur wholesale costs for cap period eight from the start of the observation window in August 2021.

1.27. Since our February 2022 wholesale decision, wholesale gas price volatility has increased further. At a high level, we can highlight three main developments:

- an increase in both near-term and forward prices in spring 2022;

[14] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraphs 2.29 to 2.30. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

[15] 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

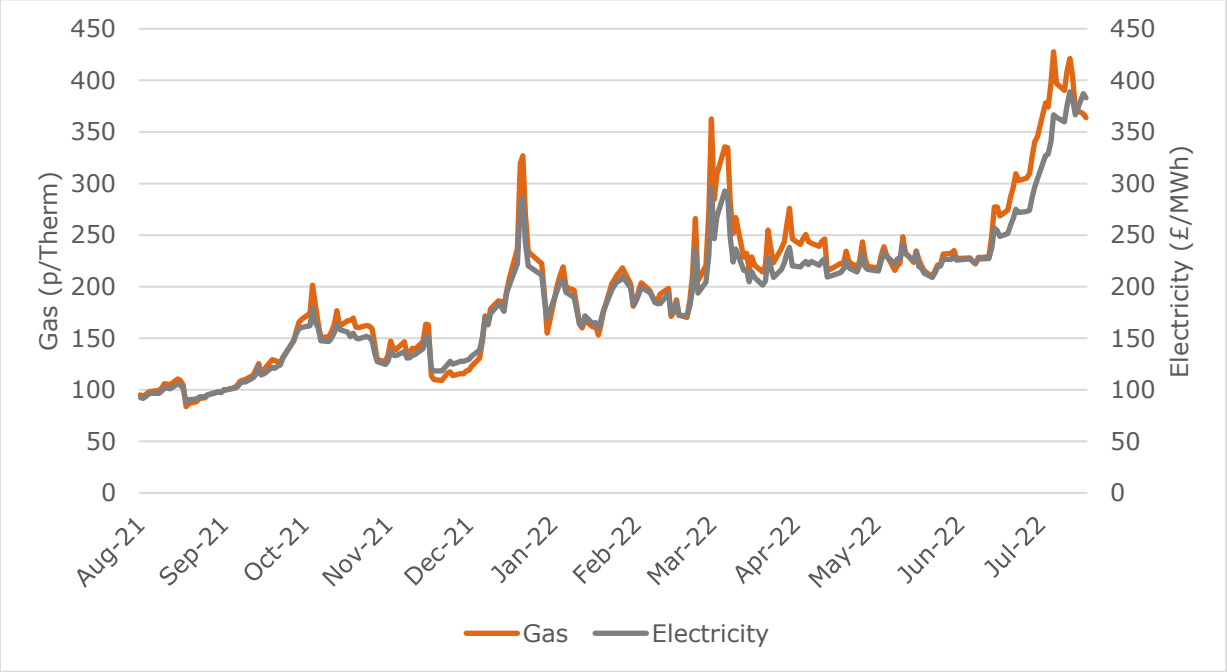
[16] Ofgem (2022), Price Cap - Guidance on treatment of reasonable risk management practices in future default tariff cap proposals, p4. https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals

- a stabilisation in forward prices and a reduction in near-term prices in the first months of cap period eight; and

- a recent increase, particularly focussed on forward prices but also impacting near-term prices, from mid-June 2022.

1.28. As a broad illustration of price movements, Figure 1 below shows the evolution of forward prices under the quarterly wholesale indexation approach we have adopted in our August 2022 wholesale methodology decision (referred to as 3-1.5-12).[17] This does not show movements in prices once a season has started delivery, or movements in near-term prices.

Figure 1: Gas and Electricity forward prices under the 3-1.5-12 quarterly wholesale indexation approach – August 2021 to July 2022



Line graph showing forward prices under the cap from the start of the cap period eight indexation period (ie August 2021). The overall trend is rising since August 2021. Spikes at the end of 2021 and around March 2022, as well as a sharp increase since mid-June 2021.

[17] This means a three month period over which we average wholesale prices ('observation period'), a 1.5 month lag between the end of the observation period and the start of the cap period ('notice period') and looking at contracts for delivery over 12 months ('forward view period'). For more information on these concepts, please see the August 2022 wholesale methodology decision.

Source: Ofgem analysis. **Note:** At each date, the chart shows the index value that would have applied for the next cap period, if this quarterly wholesale indexation approach had been in place. The chart therefore does not show prices for a single cap period.

1.29. These further changes in wholesale prices could affect wholesale costs for the current cap period (ie cap period eight). They are likely to affect wholesale costs for cap period nine, where the observation window started in February 2022.

Cap period seven backwardation review

1.30. In our February 2022 wholesale decision, we set out our decision to allow for costs related to wholesale market volatility (incurred during cap period seven) that were not already accounted for under the existing cap methodology.

1.31. We concluded that a cap level increase of £61 per customer in cap periods eight and nine was required to ensure suppliers could recover their efficient costs related to cap period seven. More specifically, backwardation related costs were calculated at £8 per customer, which reflected the weighted average cost level of the evidence submitted (£24), minus a deadband of £16.

1.32. After engagement with suppliers following publication of this decision, we have conducted a further detailed review of the evidence provided in response to November 2021 wholesale consultation which informed this decision. The outcome of this review concludes that the weighted average cost level should have been £6 per customer higher than we originally calculated. We therefore consider that a £6 upwards adjustment to the cap level is required for a 12-month period to ensure the cap level reflects the correct weighted average cost level as intended in the February 2022 wholesale decision. We have not considered any evidence as part of this review other than the cost evidence originally provided as part of the November 2021 wholesale consultation. Although the outcome of this review results in a further marginal increase to the cap level, we think it is the right adjustment to make in light of the evidence and the existing customer protections within the cap mechanism.

1.33. The £6 adjustment to the cap level to reflect cap period seven backwardation costs will take effect from cap period nine (1 October 2022) and will be in place for 12 months.

To align with additional wholesale costs allowed for as part of this decision,[18] we will account for this adjustment through the adjustment allowance rather than amending the indexed additional risk allowance.

[18] See Chapter 5 for our rationale for the model that we use to make the adjustment.

2. Decision making process

Our decision making process

May 2022 consultation

2.1. We published a consultation in May 2022 ('May 2022 consultation') to seek views and evidence on whether suppliers are incurring additional wholesale costs, beyond existing allowances in the cap. This consultation followed a request for information (RFI) in March 2022. We issued this RFI to monitor the potential impact of increasing wholesale prices on suppliers' wholesale costs.

2.2. We did not set out a minded to position in the May 2022 consultation. However, we set out our initial view on the importance of different cost areas.

- We said that, at that stage, the area with the most (although inconclusive) evidence of material additional costs was unexpected SVT demand costs for cap period eight. This was therefore the main subject of the May 2022 consultation.
- There were three areas covered in the RFI where we did not consider that there was sufficient evidence that suppliers are incurring material additional costs. These were shaping and imbalance costs for cap period eight, and both cost areas for cap period nine.

2.3. We received nine responses to this consultation, all from suppliers. We have published non-confidential responses on our website.

2.4. We respond to supplier comments through the main body of this decision document and the appendices. Appendix 2 contains responses to supplier comments which we do not address elsewhere.

August 2022 decision

2.5. This document sets out our decisions on whether to make an adjustment from 1 October 2022 for additional wholesale costs relating to cap periods eight and nine.

Approach to considering impacts, including equalities impacts

2.6. The Act does not specifically require the same Impact Assessment (IA) requirements as the Electricity Act 1989 and Gas Act 1986. However, as part of our 2018 decision, we conducted an extensive IA. This included an equalities assessment. We have since continued to consider the impact of our decisions on customers and suppliers. When considering the impact on customers, we have paid particular attention to the impact on customers in vulnerable situations. By doing so, we have taken into account the impact on protected groups where customers are more likely than average to be in vulnerable situations.

2.7. As a general point, the cap has a particular benefit for customers in vulnerable situations, as these customers are less likely on average to engage in the energy market and therefore more likely than average to be on a default tariff covered by the cap.

2.8. We have taken different approaches to considering impacts in our publications, reflecting the circumstances in each case. During the May 2022 wholesale methodology consultation on a possible wholesale adjustment ('May 2022 wholesale methodology consultation'), we published analysis on the distributional impacts of our proposals in that consultation.[19] We carried out this analysis because those proposals involved significant changes to the cap methodology. In contrast, our work on a possible wholesale adjustment has a much narrower focus.

Related publications

2.9. The main general documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: http://www.legislation.gov.uk/ukpga/2018/21/contents/enacted

[19] Ofgem (2022), Price Cap – Changes to the wholesale methodology – Distributional impacts. https://www.ofgem.gov.uk/publications/price-cap-changes-wholesale-methodology-distributional-impacts

- 2018 decision on the cap methodology ('2018 decision'): https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview.

2.10. The main documents relating to this decision are:

- November 2021 consultation on additional wholesale costs for cap period seven ('November 2021 wholesale consultation'): https://www.ofgem.gov.uk/publications/price-cap-consultation-potential-impact-increased-wholesale-volatility-default-tariff-cap

- February 2022 decision on additional wholesale costs for cap period seven ('February 2022 wholesale decision'): https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

- February 2022 guidance on treatment of reasonable risk management practices in future default tariff cap proposals ('February 2022 guidance letter'): https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals

- May 2022 consultation on a possible wholesale adjustment ('May 2022 consultation'): https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

- May 2022 statutory consultation on changes to the wholesale methodology ('May 2022 wholesale methodology consultation'): https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology

- August 2022 decision on changes to the wholesale methodology ('August 2022 wholesale methodology decision'): https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

2.11. The scope of this decision and the August 2022 wholesale methodology decision are different. This decision considers unexpected SVT demand costs and shaping and imbalance costs, for cap periods eight and nine. The August 2022 wholesale methodology decision

contains decisions on changes to our wholesale methodology in relation to the frequency of cap updates, the notice period for cap updates, and backwardation.

General feedback

2.12. We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this decision. We'd 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. Unexpected SVT demand

Section summary

We explain unexpected SVT demand costs, how these have arisen and how we gathered data to consider these. We set out our decision on benchmarking suppliers' costs. We set out suppliers' reported costs. We set out our decisions on offsetting against other allowances. We set out our decisions on whether an adjustment is needed.

Context

3.1. Suppliers may incur unexpected SVT demand costs when they need to buy additional energy for SVT customers, which are unexpected and unhedged. Below we explain both these concepts in general terms.

3.2. In this decision, we consider unexpected SVT demand costs from rising wholesale prices. Suppliers can also incur costs from falling wholesale prices. However, the Market Stabilisation Charge (MSC) already responds to the risk of falling wholesale prices.

Unexpected

3.3. To align with the core direct fuel cost methodology for a given cap period, a supplier would need to purchase energy for SVT customers over the observation window for that cap period. To achieve this, a supplier would need to have a forecast – from the start of the observation window – of its expected SVT customer numbers over the course of that cap period. We would expect that such forecasts would take into account the expected number of customers moving from FTC to SVT, and of customers leaving the SVT (for a new FTC or to switch to another supplier).

3.4. However, SVT customer number forecasts may change between the start of the observation window and the end of the cap period. One particular driver that can cause changes to SVT demand is changes in wholesale prices.

3.5. Changes in relative prices of FTCs and SVTs, due to changes in wholesale prices, can affect how customers move between these tariffs. For instance, increases in wholesale prices may erode or eliminate the savings available on FTCs. This may make it more likely that customers will end up on SVTs, through two effects. First, FTC customers may be more likely to default onto the SVT when their existing contracts expire. Second, SVT customers may be less likely to consider moving to FTCs or switching supplier.

3.6. This increase in SVT customers would be unexpected, given that suppliers cannot reliably predict future changes in wholesale prices. The risk of unexpected SVT demand has been small historically (before cap period seven). However, given the recent scale of wholesale price increases, the volume of unexpected SVT demand has risen significantly.

3.7. It is worth noting that the unexpected movement is measured relative to the tariff a supplier expected a customer to be on, rather than a customer's current tariff. This means that, in principle, there could be several rounds of unexpected SVT demand over time, even if many customers have already moved to SVTs.

Unhedged

3.8. When a supplier's forecasts change, it is unable to buy more energy at historical prices to reflect its revised forecast. If wholesale prices have increased, then a supplier might need to buy additional energy at a price higher than used to set the cap. This would be the case if it had not bought energy for its expected FTC customers – for example, if it did not buy energy for FTC customers until this demand is considered 'firm' (eg at the point of contract).

3.9. However, a supplier does not necessarily need to buy additional energy. In some cases, a supplier may have already started to buy energy for its expected FTC customers. Any such hedging would mitigate the impact of increased wholesale prices, as a supplier would be able to net off its under-hedged SVT position with an over-hedged FTC position.

February 2022 decision

3.10. In our February 2022 decision, we decided to include an allowance for unexpected SVT demand costs of £41 per dual fuel customer.[20] This additional allowance reflected the additional unexpected SVT demand costs incurred by suppliers for cap period seven. We set this adjustment based on data suppliers provided in response to the November 2021 wholesale consultation.[21]

[20] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraphs 3.0 to 3.2.
https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[21] Ofgem (2021), 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

Information considered

3.11. This section covers the information we considered in relation to unexpected SVT demand. However, much of this section is also relevant to our data gathering process for shaping and imbalance costs (which we discuss in Chapter 4).

Rationale for gathering data

3.12. As explained in Chapter 1 wholesale prices have increased significantly since September 2021. Beyond the impact on cap period seven, which we covered in our February 2022 decision, the rise in wholesale prices is also relevant to both cap period eight (where the observation window began on 1 August 2021) and cap period nine (where the observation window began on 1 February 2022).

3.13. Alongside this decision, we have published our August 2022 wholesale methodology decision to move to quarterly cap updates. Updating the wholesale cost allowance more frequently will reduce the risks from changing wholesale prices. However, these changes will not affect cap period eight, and cap period nine will be a transitional period.

3.14. The increase in wholesale prices created the possibility that suppliers have incurred unexpected SVT demand costs in relation to cap periods eight and nine, for the reasons set out in the previous section. Given the scale and pace of wholesale price increases (and the increased associated uncertainty around future prices), it was possible that the costs were material.

3.15. To help us understand the situation further, we therefore decided to issue a RFI to suppliers. This was to gather evidence on the potential impact on suppliers' wholesale costs, enabling us to monitor these impacts.

March 2022 RFI: Specific wholesale cost components

RFI process

3.16. The RFI covered two specific wholesale costs: unexpected SVT demand costs (covered in this chapter) and shaping and imbalance costs (covered in Chapter 4). We asked about costs that suppliers expect to face during cap periods eight and nine.

3.17. By asking about expectations, we recognised that the data would reflect a mixture of incurred and expected costs. The precise balance would differ between cap periods eight and nine, as a greater proportion of cap period nine costs would be forecasts.

3.18. We issued the RFI as a mandatory RFI, to suppliers with over 100,000 domestic default tariff customers.[22] This was a total of 11 suppliers. We considered that issuing a mandatory RFI would support the completeness and consistency of our evidence base.

Supplier feedback on the RFI process

3.19. One supplier disagreed with the scope of our RFI. It said we had excluded suppliers whose SVT customer numbers had started below the customer number threshold but had increased significantly. It said we could have issued the RFI on a voluntary basis to allow suppliers the choice of whether to respond.

3.20. We issued our RFI to suppliers with more than 100,000 domestic default tariff customers as we considered this to be the appropriate approach to understand the costs suppliers were facing, while also reducing the workload for suppliers to submit data. However, as part of our May 2022 consultation, we invited all suppliers who did not receive the RFI to contact us to obtain a copy of the template, to allow them to submit data.[23] One additional supplier did submit data following the May 2022 consultation. We therefore do not consider that the coverage of our RFI has affected our results.

3.21. We will consider whether to issue future cap RFIs to additional suppliers on a voluntary basis (while still issuing RFIs on a mandatory basis to larger suppliers).

Additional evidence from the May 2022 consultation

3.22. In our May 2022 consultation, we encouraged suppliers to submit updated cost estimates as part of their responses.[24] We recognised that the RFI response period was short. We therefore said that a further opportunity to submit data would give suppliers time to prepare more evidence and refine their estimates accordingly.[25]

3.23. Submitting updated evidence would also have allowed suppliers to reflect the impact of changing wholesale prices on their costs. Suppliers would have been able to make

[22] We used data from the Customer Account and Tariff RFI. The latest version available was from October 2021. This data therefore did not include subsequent movements of customers from FTCs to SVTs.
[23] Ofgem (2022), Price Cap – Consultation on possible wholesale cost adjustment, footnote 32. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[24] Ofgem (2022), Price Cap – Consultation on possible wholesale cost adjustment, paragraph 3.94. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[25] Ofgem (2022), Price Cap – Consultation on possible wholesale cost adjustment, paragraph 3.96. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

greater use of incurred cost data and would have been able to update their forecast costs. This was particularly relevant for cap period nine unexpected SVT demand costs – as noted in the May 2022 consultation, we requested data at an early point in the observation window.[26]

3.24. In response to our May 2022 consultation, two suppliers resubmitted their RFI data. One supplier provided updated values due to changes in costs incurred and customer number forecasts.[27] The other supplier's resubmission was to provide more accurate payment method splits. We also received data in the RFI template from one additional supplier. All this data related to unexpected SVT demand only.

3.25. During the May 2022 consultation, we also specifically engaged with representatives from consumer groups and charities to cover this consultation and the May 2022 wholesale methodology consultation.

Evidence provided

3.26. We discuss the evidence provided in Appendix 4. In summary, the data included in our analysis has good coverage, for both cap periods eight and nine.

3.27. However, there are inherent uncertainties around the estimates. We cover these uncertainties in the section 'Reported unexpected SVT demand costs' below.

Benchmarking suppliers' costs

Context

3.28. The aim of carrying out benchmarking is to help assess what notionally efficient costs may be, while recognising the uncertainty around whether particular costs have or have not been efficiently incurred. The stringency of the benchmark is therefore a key issue. We could set the benchmark at different levels:

- a **frontier benchmark** would use the supplier with the lowest costs;

[26] Ofgem (2022), Price Cap – Consultation on possible wholesale cost adjustment, paragraph 3.91. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[27] In response to the May 2022 consultation, another supplier also said that its SVT customer numbers had increased since the RFI, but did not provide resubmitted data.

- we generally use a benchmark at or near the **lower quartile** in the cap.[28] This is the cost of the supplier that is halfway (in number of suppliers) between the suppliers with the lowest and median (ie midpoint) costs; and

- we could select an average benchmark, such as a **weighted average**. This would consider costs across suppliers, and therefore incorporate each of their circumstances into the calculation. If some suppliers have higher costs or lower costs, due to factors outside their control, the weighted average will reflect the average situation across all suppliers.

3.29. These general options are available for benchmarking unexpected SVT demand costs. However, these mechanistic benchmarks are not the only way of addressing efficiency. In principle, we could exclude cost estimates provided by suppliers where we consider them to be outliers. We could also apply a discount (in percentage or absolute terms) to one of the benchmarks above, reflecting a judgement about the relative impact of efficiency and non-efficiency factors.

3.30. When comparing benchmarking options, we were interested in the potential reasons for differences in costs between suppliers. Common factors could increase suppliers' costs. However, to the extent that these affect suppliers equally, they would not affect the impact of different benchmark choices.

Decision

3.31. We have decided to use a lower quartile benchmark for unexpected SVT demand costs. We consider that this is the most appropriate approach to protect default tariff customers, recognising that efficiency factors will to some extent impact on suppliers' unexpected SVT demand costs. Using a lower quartile benchmark is in line with our general approach to setting the cap. This decision also takes into account our position in the February 2022 guidance letter about expecting suppliers "to respond to the now-known risks of customer demand variance", and the wider context of the interventions we have made to support market stability.

[28] For example, we set the operating cost benchmark at the lower quartile minus £5. We also used a lower quartile to set the payment method uplift.

Overview of responses

3.32. Suppliers generally agreed with our comments on non-efficiency factors in the May 2022 consultation. Suppliers' additional comments on non-efficiency factors focussed in particular on the role of chance in determining which suppliers had lower costs in a given cap period. Some suppliers also provided comments to explain why they considered their own approaches to be efficient, and commented on our characterisation of efficiency in the May 2022 consultation. Most suppliers who responded therefore supported a weighted average benchmark.

Considerations

3.33. In this section, we describe the non-efficiency and efficiency factors that may affect unexpected SVT demand costs. We then set out our decision on the balance between these factors. We cover some stakeholder feedback here, and additional points in Appendix 3.

Non-efficiency factors for unexpected SVT demand costs

3.34. Non-efficiency factors would affect suppliers' costs, but would be outside (or largely outside) suppliers' control.

3.35. The main non-efficiency factor we have identified is **a supplier's starting proportion of FTC customers** (ie before a wholesale price shock). All else being equal, a supplier with a greater proportion of FTC customers would have incurred higher unexpected SVT demand costs (than a supplier with a lower proportion). This is because it would have more customers moving unexpectedly between FTCs and SVTs as a result of rising wholesale prices. Our analysis of suppliers' costs suggests that this pattern is observed in practice.

3.36. A supplier would have been unable to change its starting proportion of FTC customers in response to a wholesale price shock, so this factor is outside a supplier's control in the short-term. We recognise that a supplier's starting proportion of FTC customers will reflect business decisions that it has made over a sustained period, so it is not entirely outside its control. However, we consider that having a high proportion of FTC

customers is at least a neutral feature of a supplier's business rather than a sign of pre-existing inefficiency.[29]

3.37. Several suppliers agreed that a supplier's starting proportion of SVT customers was an important or relevant non-efficiency factor.

3.38. The **level of engagement of a supplier's customer base** may also impact its unexpected SVT demand costs, by affecting the expected flow of customers from SVTs to FTCs in normal circumstances. Engaged customers might be more likely to spend a short amount of time on an SVT than less engaged customers (when FTCs are cheaper than SVTs). We might therefore expect suppliers with a more engaged customer base to have expected a larger proportion of their starting stock of SVT customers to move away from SVTs in normal circumstances (compared to suppliers with a less engaged customer base). After a wholesale price shock, the change in expected customer flows could increase the amount of unexpected SVT demand.

3.39. Several suppliers agreed that customer engagement was a relevant non-efficiency factor. One of these suppliers said that it was an important factor.

3.40. While we are using data provided in response to an RFI (and in the same template following the May 2022 consultation), there may be **methodological differences** in how suppliers have prepared their estimates. This reflects the challenge of determining whether additional SVT demand was unexpected and unhedged. In principle, we would not want to select a more stringent benchmark when this reflected suppliers underestimating costs, rather than genuine cost variations. We do not consider that this is an important non-efficiency factor for cap period eight unexpected SVT demand costs, because suppliers' evidence largely relates to costs which they have already incurred. This reduces the need for suppliers to develop a methodology to estimate these costs. Methodological differences may be more significant for cap period nine, where costs depend on forecasts. One supplier agreed that methodological differences are unlikely to be an important non-efficiency factor, at least for cap period eight.

[29] We do not consider that having a high proportion of FTC customers is by definition a desirable feature of a supplier's business. We recognise that there has been sustained interest from Ofgem in encouraging suppliers to engage their customer bases, including by moving to FTCs. However, an individual supplier's proportion of FTC customers will also reflect the extent to which it has chosen to acquire customers (which until recently would have largely been through FTCs).

3.41. We also recognise that there may be some **natural variation** in suppliers' costs. Some natural variation may be particularly likely in the context of an uncertain environment with rapidly changing wholesale prices. For example, small differences in the timing of suppliers purchasing additional volumes could affect the costs incurred if wholesale prices changed. The financial impact of natural variation is therefore likely to be greater under volatile wholesale prices than in normal circumstances. This could increase the risk that a supplier's costs were low due to natural variation, rather than efficiency.

3.42. In response to the May 2022 consultation, suppliers made several comments about the role of chance, relating to a number of areas.

- One supplier said that there was substantial noise around suppliers' customer number forecasts, meaning that it was random chance that a supplier's forecast was close to the outcome, rather than this being a matter of accuracy. Relatedly, another supplier said that it was challenging to model how customers' demand would change in response to higher prices.

- Two suppliers said that there was a risk of hindsight bias from considering the outcome of different hedging strategies, even if they could have all been reasonable or prudent attempts to mitigate wholesale risks. One of these suppliers said that lucky or unlucky hedging decisions were similar to natural variation in costs.

3.43. We do not agree with the characterisation of customer number forecasting as depending on random chance. We recognise that the degree of uncertainty around forecasting is greater when market conditions move beyond historical data, and that forecasting models will perform less well in such conditions. However, suppliers allocate resources to carry out forecasting and refine their processes over time to improve accuracy. Several suppliers' evidence shows that they have refined their forecasting approaches in response to recent market conditions. We therefore consider that suppliers' actions show there are aspects within their control, beyond the impacts of chance.

3.44. We are not seeking to apply hindsight bias, and do not consider that this is what we have done. We recognise that wholesale prices have been volatile, and this will magnify the impact of making different hedging decisions. However, suppliers' hedging decisions will include choices about the extent to which they mitigate their risks in volatile market conditions. If a supplier had lower costs (than other suppliers) under rising wholesale prices because it may have acted more prudently to mitigate its risks, then we may not consider that this cost difference is equivalent to natural variation.

Efficiency factors for unexpected SVT demand costs

3.45. Efficiency factors would affect suppliers' costs, and would be within (or largely within) a supplier's control. As with any business activity, when a cost is controllable, efficient suppliers would be expected to incur lower costs.

3.46. We consider that efficiency has a particular interpretation in the context of considering whether to provide an adjustment to the cap. Suppliers may adopt approaches with different degrees of riskiness. Some behaviours may or may not be inefficient in the sense of having higher expected costs in the long run, but may still increase the variability of outturn costs. Suppliers are subject to the cap, and we expect suppliers to manage risks prudently in this context. We do not consider that it would protect default tariff customers to compensate suppliers through an adjustment for incurring high costs as a result of risky strategies.[30]

3.47. We expect that an efficient supplier would **update its customer number forecasts frequently**, and would consider forecasting more frequently in volatile market conditions to better manage risks. Frequent forecasting would increase the likelihood that its forecasts are more accurate. In response to the RFI and the May 2022 consultation, we did not identify any particular concerns about suppliers' approaches in this area. There was some evidence of suppliers acting more quickly in current market circumstances. In response to the May 2022 consultation, one supplier said it was less sure that more frequent forecasting aids accuracy, but did not provide evidence to support this.

3.48. We also expect that an efficient supplier would **adjust its traded position reasonably frequently** in response to changes in forecast customer numbers. However, we recognise that a supplier may also want to avoid the risk of 'over-trading' (eg due to transaction costs or the risk of making losses on market fluctuations).[31] Again, we did not identify particular concerns about suppliers' approaches based on the RFI data and May 2022 consultation responses. Some suppliers said that market liquidity was a factor affecting the speed of their adjustments. We accept that suppliers will consider liquidity

[30] We discuss this further in Appendix 3, when responding to a supplier comment on the equivalent paragraph from the May 2022 consultation.
[31] Trading frequency may also differ between suppliers of different sizes, given the constraint of needing to meet the minimum volumes which are commonly traded in the wholesale market (known as clip sizes).

when executing trades, though suppliers have to manage the competing aims of achieving the best possible prices and mitigating risks promptly.

3.49. In the May 2022 consultation, we said that we expected an efficient supplier would **aim to hedge for its expected SVT customer numbers**. We said that not doing so could be a sign of inefficiency, unless there was a clear justification. One supplier disagreed with this view. Another supplier said that a supplier would need to take a view on the optimal hedge position, for example given its expectations for what MSC arrangements would be in place.

3.50. After further consideration, we consider the situation to be more nuanced than we had suggested in the May 2022 consultation. Suppliers had to hedge in a context where they could incur costs in a rising or a falling market – and the impacts may not have been symmetrical. Suppliers may have sought to manage these risks through deciding what proportion of their expected demand to hedge. We do not consider that moving away from hedging for expected SVT customer numbers is necessarily inefficient, although the decisions suppliers made could still involve different degrees of efficiency. (We explain our reasoning further in Appendix 3). However, for the avoidance of doubt, we still encourage suppliers to adopt robust and prudent risk management strategies, as set out in the February 2022 guidance letter.[32]

3.51. In the current market circumstances, we expect an efficient supplier to have at least considered whether to **adjust its hedging strategy for FTC customers**, so as to more closely align with the cap wholesale indexation methodology, or to change their assumptions on the likelihood of customers moving onto (or staying on) the SVT. This would reduce the impact of unexpected SVT demand. We recognise that suppliers' hedging strategies for FTCs will also be affected by competitive dynamics. We also recognise that historically some suppliers may have aimed to buy energy close to the point of sale, so as to ensure a competitive offering.

3.52. In response to the May 2022 consultation, one supplier said that it was unclear why FTC hedging was relevant, as any adjustment should focus on the costs of serving default

[32] Ofgem (2022), Guidance on treatment of reasonable risk management practices in future default tariff cap proposals, p3. https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals

tariff customers. Similarly, one supplier said that the only rationale for hedging ahead for FTC customers would be if they were expected to default to SVT.

3.53. A supplier might face uncertainty about whether customers would move to an SVT or not at the expiry of an existing FTC product (and uncertainty about whether existing SVT customers would move to FTCs). In principle, a supplier might therefore consider adjusting its FTC hedging strategy to reduce unexpected SVT demand costs in the scenario where wholesale prices remain high and customers move onto (or unexpectedly remain on) an SVT, even if this would make its (new) FTCs less competitive in other scenarios (where wholesale prices fall). A supplier's FTC hedging approach is therefore relevant to the unexpected SVT demand costs it incurs.

3.54. The efficiency factors above are not exhaustive. Forecasting demand and purchasing energy as a consequence are core activities for a supplier. Even where suppliers have similar strategies, there may be differences in **delivery efficiency** – ie efficiency in the detailed implementation of suppliers' strategies.[33] For example, suppliers may vary in how accurately they forecast demand. Differences in delivery efficiency may affect suppliers' costs.

3.55. In response to the May 2022 consultation, one supplier said that delivery efficiency is likely to not be a material consideration. It also said that delivery efficiency is likely to affect the variability of costs, rather than the expected level.

3.56. As generally, we want to ensure that our benchmark reflects the impacts of efficiency factors. This includes any impacts from delivery efficiency.

3.57. We also expect that suppliers would have considered ways to improve their efficiency in response to wholesale price increases. For example, one supplier explained how it was seeking to refine its approach to forecasting SVT customer numbers. Another supplier said that it had been able to make some process improvements in response to the experience of previous price spikes.

[33] For the avoidance of doubt, we are not using the term 'delivery efficiency' to specify a particular time period – we are not referring solely to efficiency during the period when energy is being delivered.

Choice of benchmark

Supplier feedback

3.58. Several suppliers supported a weighted average benchmark. Two of these suppliers said that non-efficiency factors would be more important than efficiency factors in determining suppliers' costs. One supplier did not give a preferred benchmarking approach, but did make points which would be in support of a weighted average.

3.59. No suppliers expressed support for a lower quartile benchmark. However, one supplier said that it would not be efficient for suppliers to incur unexpected SVT demand costs, and that suppliers should have adjusted their pricing and hedging to take into account this risk. It also said that making an adjustment provided suppliers with a free option, meaning that customers would underwrite their risk.

Would an efficient supplier incur any costs?

3.60. We consider that an efficient supplier (who offers FTCs) would have incurred some unexpected SVT demand costs in cap period eight.[34] Unexpected SVT demand costs are a consequence of having FTC customers – we do not consider that offering FTCs was itself inefficient. A supplier would also not have been able to reflect the experience of unexpected SVT demand costs in the prices of its existing FTCs. This is because, where FTCs expire during cap period eight, these tariffs would have been set before the wholesale price increases in autumn 2021. After these wholesale price increases, suppliers could not then increase the prices of existing[35] FTCs to reflect these risks.

Narrowing down options

3.61. We have decided to discard the option of a frontier benchmark, in line with what we proposed in the May 2022 consultation.[36] Non-efficiency factors are likely to affect suppliers' costs to some extent, particularly the starting proportion of FTC customers. A frontier benchmark would therefore be likely to underestimate suppliers' efficient costs. Under the Act, we must have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

[34] An efficient supplier who did not offer FTCs would not have incurred unexpected SVT demand costs.
[35] Ie tariffs which had already been sold to customers.
[36] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.39. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

3.62. In the May 2022 consultation, we noted the option of setting an intermediate benchmark between a lower quartile and a weighted average. We said that one of the possible ways of achieving this would be by excluding cost estimates provided by suppliers where we consider them to be outliers. We have decided to discard this option. We have not identified clear concerns that individual suppliers have incurred costs which are so inefficiently high that this would provide a basis for excluding them. This would still leave the other way of setting an intermediate benchmark which we discussed in the May 2022 consultation – applying a discount to the weighted average.

3.63. The remaining benchmarking options set out in our May 2022 consultation were therefore a lower quartile, a weighted average or an intermediate value which applies a discount to the weighted average.

Rationale for decision

3.64. We have decided to use a lower quartile benchmark, based on the considerations summarised below.

3.65. First, we consider that a lower quartile benchmark is appropriate because it takes into account the impact of potential efficiency factors.

3.66. A lower quartile benchmark allows room for both non-efficiency and efficiency factors which may occur to affect suppliers' costs. In contrast, a weighted average benchmark would incorporate an average level of efficiency, implying that suppliers were efficient in aggregate.

3.67. We consider that non-efficiency factors, in particular the starting proportion of FTC customers, may affect unexpected SVT demand costs. However, unexpected SVT demand costs may also depend on suppliers' actions, and so there is room for suppliers to be more or less efficient. While we do not have strong concerns about individual efficiency factors, the overarching point remains that suppliers may act in a more or less efficient manner, and this may impact on unexpected SVT demand costs.

3.68. We do not have a definitive answer on the balance between non-efficiency and efficiency factors – there is unavoidable uncertainty. As we do not consider that we can finely assess this balance, we have decided to discard the option of setting an intermediate value by applying a discount to the weighted average.

3.69. However, in the context of this uncertainty, and having given the matter very careful consideration, we have concluded that a lower quartile benchmark better protects default tariff customers than a weighted average, as it reduces the risk of them paying for inefficient costs. We consider that reducing the risk of customers overpaying is especially important given the cost of living pressures which they are facing.

3.70. For the avoidance of doubt, our decision to use a lower quartile does not reflect a view that non-efficiency and efficiency factors are likely to have the same impact on unexpected SVT demand costs in cap period eight. Instead, it reflects uncertainty.

3.71. Second, we generally use a lower quartile benchmark within the cap. We consider that this approach remains appropriate in this case and do not see a strong reason to deviate from this position. We have reached this view as a result of our consideration of the likely relative impact of non-efficiency and efficiency factors under the first point.

3.72. Third, a lower quartile benchmark is consistent with the February 2022 guidance letter. In that letter, we said that we expect suppliers to respond to now-known risks of customer demand variance,[37] and that we would take this into account in any future allowance for unexpected SVT demand. A lower quartile benchmark therefore recognises that this is the second time that we have considered an adjustment for unexpected SVT demand costs. We consider that a more stringent benchmark approach is appropriate in this context.

3.73. We are not suggesting (through the February 2022 guidance letter or this decision) that suppliers can eliminate unexpected SVT demand costs. However, we expect suppliers to have done what they could to mitigate these costs. We note that some suppliers said that they had made changes to their approaches in response to market conditions.

3.74. We consider that implementing a more stringent benchmark approach is important to support the aim of encouraging suppliers to hedge prudently. Consistently providing adjustments at the weighted average level would change the balance of risks that suppliers face from unexpected SVT demand, potentially discouraging them from hedging as prudently as they would do otherwise.

[37] Our statement in the February 2022 guidance letter about the risks of customer demand variance should be interpreted in a general sense. While the specific causes of wholesale price volatility after that letter were unpredictable, suppliers were on notice about the general risks.

3.75. Fourth, we are making the decision to adopt a lower quartile benchmark in the context of our wider interventions to support market stability. These interventions support suppliers and protect the long-term interests of customers. Among the key interventions, we have:

- introduced the MSC, and consulted on extending this for a further six months;
- introduced the ban on acquisition-only tariffs, and consulted on extending this for a further six months;
- paused assessment of new supply licences, while we updated our guidance and assessments to reflect the increasingly volatile conditions, and introduced milestone assessments;[38] and
- consulted on a range of measures to improve suppliers' financial resilience.

3.76. These interventions make it less likely that, in the short term, customers will switch away from SVTs, even in a falling wholesale market (either by switching tariff or supplier). This is because they reduce the risk of suppliers pricing FTCs at a particularly low level to attract customers away from SVTs. Under these interventions, future FTCs are more likely to reflect some of the costs incurred by suppliers who have hedged for SVT customers. We recognise that competition may still impose constraints on suppliers' ability to price in historical costs in the competitive FTC segment, especially where suppliers would have incurred different levels of these costs – but our interventions should improve suppliers' ability to price in such costs by reducing the risk of having to compete against particularly low-priced FTCs. Therefore, once implemented, suppliers should have taken these interventions into account in their risk management decisions.

3.77. We have also made further interventions which support market stability by allowing suppliers to recover efficient costs. We have:

- made changes to the cap methodology, including an ex ante backwardation allowance as part of our move to quarterly cap updates; and

[38] Ofgem (2021), Rising wholesale energy prices and implications for the regulatory framework, p4. https://www.ofgem.gov.uk/publications/rising-wholesale-energy-prices-and-implications-regulatory-framework

- made an adjustment to the cap through our February 2022 wholesale decision to allow recovery of costs relating to cap period seven.

3.78. While we must have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence, we consider that our benchmarking decision needs to be seen within this wider context of interventions which provide significant support to suppliers. In the round, we consider that we are having regard to financeability to a sufficient extent, while protecting default tariff customers, in line with the objective of the Act. We discuss our wider support for customers in the 'Whether to adjust for unexpected SVT costs' section below.

3.79. For further information on our lower quartile methodology and the related calculations, please refer to Appendix 4.

3.80. We consider benchmarking for shaping and imbalance costs separately in Chapter 4. Please see that chapter for an explanation of the approach we have taken in that case, and the rationale for why this is different than for unexpected SVT demand.

Reported unexpected SVT demand costs

3.81. We have conducted analysis of the cost of unexpected and unhedged SVT demand. We have produced this using the information provided by suppliers in response to the RFI and our May 2022 consultation.

3.82. We consider that this data is sufficiently accurate to set an adjustment. However, the figures are subject to a number of risks and uncertainties. These include:

- part of the data being forecasts, and therefore subject to change as a result of wholesale price fluctuations and potential changes in customers' consumption patterns;[39]

- differences in suppliers' methodologies for preparing their data, including differences in forecasting approaches; and

[39] In response to the May 2022 consultation, one supplier said that changes in consumption behaviour were uncertain due to prices being above historical levels and due to the impact of government support schemes.

- differences in the level of information suppliers provided to allow us to validate their estimates.

3.83. We have provided details on how we conducted the calculations for both a weighted average and lower quartile benchmark in Appendix 4.

Cap period eight

3.84. Based on suppliers' reported data, the lower quartile expected cost per dual fuel customer at benchmark consumption[40] for cap period eight is approximately £0 for prepayment meters (PPM) and £39 for non-PPM. These figures are before taking into account the impact of electricity losses and unidentified gas. Table 2 sets out our summary of the reported unexpected SVT demand cost impact facing suppliers for cap period eight by fuel and payment type.

Table 2: Reported unexpected SVT demand costs in cap period eight (lower quartile) – pounds per SVT customer during cap period eight

Fuel	Estimate of additional impact for PPM	Estimate of additional impact for non-PPM
Gas	£0.00	£23.38
Electricity	£0.00	£15.57
Dual fuel	**£0.00**	**£38.95**

Notes: Figures at benchmark consumption levels. Figures are costs over six months, rather than annualised costs. Non-PPM includes both direct debit and standard credit. Figures may not sum exactly due to rounding.

3.85. Based on the available data, unexpected demand costs are larger for non-PPM customers than PPM customers. This aligns with what we would expect. Very few PPM customers are on FTCs, which significantly reduces the number of customers who could unexpectedly move to SVTs. However, we note that there were data quality issues affecting the allocation of costs between PPM and non-PPM customers – see Appendix 4.

Cap period nine

3.86. Based on suppliers' reported data, the lower quartile expected cost per dual fuel customer at benchmark consumption for cap period nine is approximately £0 for PPM and

[40] We use the term benchmark consumption to refer to the average annual consumption values we use when setting the cap (3,100kWh for single rate electricity and 12,000kWh for gas).

£1 for non-PPM. Table 3 sets out our summary of the potential unexpected SVT demand cost impact facing suppliers for cap period nine by fuel and payment type.

Table 3: Reported unexpected SVT demand costs in cap period nine (lower quartile) – pounds per SVT customer during cap period nine

Fuel	Estimate of additional impact for PPM	Estimate of additional impact for non-PPM
Gas	£0.00	£0.78
Electricity	£0.00	£0.00
Dual fuel	**£0.00**	**£0.78**

Note: Figures at benchmark consumption levels. Figures are costs over six months, rather than annualised costs. Non-PPM includes both direct debit and standard credit. Figures may not sum exactly due to rounding.

3.87. Reported unexpected SVT demand costs are significantly lower for cap period nine than for cap period eight. There are two reasons for this.

- Costs are likely to be low. Many customers have already moved from FTC to SVT, reducing the potential additional movement of customers from FTCs. While wholesale price increases in spring 2022 may have created unexpected SVT demand, the wholesale price increases occurred at an early stage of the observation window for cap period nine. This means that suppliers would still largely be able to purchase in line with the core direct fuel cost allowance methodology for any unexpected SVT demand. We recognise that there have also been recent increases in wholesale prices, but we do not have sufficient data on the impact of these on unexpected SVT demand costs.

- Current estimates will also be low because suppliers do not know how wholesale prices will move in future. By their nature, unexpected SVT demand costs are driven by changes in wholesale prices, which cannot be reliably predicted.

3.88. As for cap period eight, reported unexpected SVT demand costs are lower for PPM than for non-PPM customers. Again, this would be due to the small proportion of FTC customers for PPM.

Existing specific allowances

3.89. Suppliers have always faced the risk of incurring unexpected SVT demand costs from needing to buy more energy for SVT customers when wholesale prices rise.[41] However, these costs have been small historically (before cap period seven) and likely to be captured within existing uncertainty mechanisms in the cap.

3.90. In particular, we took the potential for unexpected SVT demand into account when setting the headroom allowance in the cap. In our 2018 decision, we noted that suppliers "face a demand volume risk when purchasing their energy wholesale in advance of delivery". We referred to this as "a relatively small upward uncertain cost pressure", noting a supplier's estimate of this cost.[42] We also gave regard to this issue when setting the additional risk allowance.[43]

3.91. Given the scale of the cost, in our 2018 decision we took unexpected SVT demand into account through uncertainty allowances,[44] rather than by creating a specific allowance.

3.92. Given the recent size of wholesale price increases, unexpected SVT demand costs are likely to be higher than historically. Therefore, a significant proportion of the costs reported above will be incremental, as these costs may not be covered by the uncertainty allowances. However, this is before consideration of any offsetting costs, which we discuss in the next section.

Offsets

3.93. This section on offsets is primarily relevant to unexpected SVT demand, given our May 2022 consultation position to consider offsets in relation to this cost area. However, as

[41] We are referring to the impact of wholesale price changes on the amount of energy suppliers need to buy. Suppliers' demand forecasts may change for other reasons which do not depend on wholesale prices. Demand changes for other reasons may or may not be a cost to suppliers (relative to the amount they are able to charge) – the impact would depend on whether wholesale prices had increased or decreased.
[42] Ofgem (2018), Default tariff cap: decision – Appendix 2 – Cap level analysis and headroom, paragraph 3.72.
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[43] Ofgem (2018), Default tariff cap: decision – Appendix 4 – Wholesale costs, paragraph 3.106.
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[44] Ofgem (2018), Default tariff cap: decision – Appendix 2 – Cap level analysis and headroom, paragraph 3.72.
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
Ofgem (2018), Default tariff cap: decision – Appendix 4 – Wholesale costs, paragraph 3.106.
https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

this section explains the concept of offsets and discusses general supplier feedback on offsets, it is also relevant background for shaping and imbalance costs, which we discuss in Chapter 4.

Context

General context

3.94. We do not want to consider the impact of increased wholesale prices on suppliers' unexpected SVT demand costs in isolation. To understand whether suppliers' efficient costs have materially and systematically departed from the allowances in the cap,[45] we considered whether there have been any other changes as a result of increased wholesale prices, which could offset unexpected SVT demand costs. The overarching principle is to protect default tariff customers, by ensuring that the cap level does not exceed suppliers' efficient costs.

3.95. We specifically considered costs linked to higher wholesale prices. We are not re-examining the cap in its entirety. We do not consider that we need to reconsider all elements of the methodology when considering changes to one element. In the current circumstances, such an approach would also prevent us from making any kind of timely adjustment. We discuss our wider support for customers in the 'Whether to adjust for unexpected SVT costs' section below.

3.96. In the remainder of the context section, we provide context on each allowance that we have considered offsetting.

1% additional risk allowance

3.97. In our 2018 decision, we provided the additional wholesale risk allowance to account for additional uncertainty and volatility in suppliers' wholesale costs (beyond what is already provided for in the other wholesale allowances and headroom). In summary, we said that we had given regard to: specific risks identified by suppliers, the potential for unforeseen shocks, and the potential for errors in our modelling.[46]

[45] For cap period eight, we have already set the allowances in the cap, and so these are known. For cap period nine, we will determine the allowances based on the prescribed cap methodology (taking into account changes through our design decisions).
[46] Ofgem (2018), Default tariff cap: decision – overview. Appendix 4 – wholesale, paragraph 2.32. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

3.98. This 1% additional risk allowance is currently worth around £3 per dual fuel customer over the six months of cap period eight. Please see Appendix 5 for further information on how we have estimated this benefit. The benefit is higher in annualised terms (around £9 per dual fuel customer), but the actual amount received over the course of a year will depend on how the core direct fuel allowance changes for cap period nine.

Switching costs

3.99. Switching rates have fallen significantly, relative to historical levels. This is because the cap has been the cheapest tariff available for many customers, removing their financial incentive to switch suppliers.

3.100. Suppliers may therefore have seen reduced switching costs due to:

- lower commission paid to intermediaries on completion of a switch; and
- internal administrative costs savings – although these will depend on the extent to which staff and resources can be reallocated temporarily, as well as the knock-on consequences of reduced switching for other parts of suppliers' operations.

Contracts for Difference benefit

3.101. In the February 2022 wholesale decision, we noted that suppliers will receive a benefit in cap period eight from negative Contracts for Difference (CfD) costs, which are not currently reflected in the cap methodology.[47] This benefit will only occur in cap period eight, as we have published our June 2022 decision to amend the CfD methodology to ensure supplier CfD revenues forecast can reduce customer bills ('June 2022 CfD decision').[48]

[47] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 6.9.
https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[48] Ofgem (2022), Decision on amending the methodology for setting the Contracts for Difference (CfD) cap allowance.
https://www.ofgem.gov.uk/publications/decision-amending-methodology-setting-contracts-difference-cfd-cap-allowance

Other allowances

3.102. There are several allowances which are indexed based on other cap components. Increases in wholesale costs have therefore led to increases in these allowances. These are the payment method uplift (in part), Earnings Before Interest and Tax (EBIT) and headroom allowances.

Decision

3.103. We have decided not to offset unexpected SVT demand costs against a proportion of the 1% additional risk allowance. This is different from the proposal in our May 2022 consultation, which was to apply this offset. Given the small size of the potential benefit, it is hard to demonstrate that it has not been eliminated by current market circumstances. In other words, there may not be a value available to offset.

3.104. We have decided not to offset unexpected SVT demand costs against an estimate of the cost savings suppliers which have experienced from reduced switching as a consequence of higher wholesale prices. This is different from the proposal in our May 2022 consultation, which was to apply this offset. The residual benefit suppliers may have received is likely to be small and difficult to demonstrate.

3.105. We have decided not to consider the CfD benefit in the round when deciding whether an adjustment is required for cap period eight. This is a change from our May 2022 consultation. It reflects that we already considered the CfD benefit as part of our June 2022 CfD decision.[49]

3.106. There are other cap allowances (headroom, EBIT, and part of the payment method uplift) which scale with increased wholesale costs. We have decided not to offset unexpected SVT demand costs against these allowances at this time. There is no clear evidence to suggest that these costs have increased less quickly than the indexed allowances. We did not set out a proposal in this area in the May 2022 consultation, although we did seek input from stakeholders.

[49] Ofgem (2022), Decision on amending the methodology for setting the Contracts for Difference (CfD) cap allowance, paragraph 3.18. https://www.ofgem.gov.uk/publications/decision-amending-methodology-setting-contracts-difference-cfd-cap-allowance

Overview of responses

1% additional risk allowance

3.107. Most of the suppliers who commented on the 1% additional risk allowance disagreed with using this as an offset. The main reason given was that this allowance was already being fully utilised.

Switching costs

3.108. Suppliers who commented disagreed with using the switching benefit as an offset. The main reasons given were about the extent to which sales and marketing costs for default tariff customers were included in the 2018 operating cost benchmark, the likelihood of an increase in switching in future, and the costs of closing down sales teams.

CfD benefits

3.109. The main point from suppliers who commented was that there would be no CfD benefit.

Other allowances

3.110. The suppliers who commented disagreed with offsetting against other allowances. In general, this reflected an expectation that these costs would increase in line with the allowances, or that allowances were already fully utilised.

Considerations

1% additional risk allowance

3.111. We discuss the case in principle for offsetting against the 1% additional risk allowance, and how this affects the potential scale of any offset. We then consider suppliers' views that the allowance is fully utilised and set out our conclusion on whether to apply an offset against the 1% wholesale risk allowance. We cover other supplier feedback in Appendix 5.

Case in principle

3.112. In principle, we would not allow suppliers to benefit from an adjustment, to the extent that this duplicated the 1% additional risk allowance already included in the cap. There is clearly an overlap. Part of the rationale for the 1% additional risk allowance was the potential for unexpected shocks. An adjustment for unexpected SVT demand would

respond to unexpected increases in wholesale prices. The question is the extent of this overlap.

3.113. The additional risk allowance is intended to reflect costs over time, rather than costs in a specific cap period.[50] However, in the February 2022 wholesale decision, we decided not to take into account the 1% additional risk allowance from either cap periods one to six or cap period seven.[51] We are therefore considering only the 1% additional risk allowance for the cap periods where we are considering an adjustment.

3.114. Given the additional risk allowance is intended to reflect costs over time, the 1% additional risk allowance for a given cap period (eg cap period eight) can be seen as partly for risks in that cap period, but largely for risks in other cap periods.[52]

3.115. In our May 2022 consultation, we said that one possible approximation would be to consider the 1% additional risk allowance in a given cap period as relating to risks over the life of the cap (currently five years). We said that if we could broadly offset the risks for cap period eight (lasting six months), then this would provide a floor of offsetting 10% of the 1% additional risk allowance recovered during cap period eight.[53]

3.116. Under this methodology, the amount that could be offset against unexpected SVT demand costs would be £0.60/dual fuel customer over the six months of cap period eight.[54] Appendix 5 provides more detail on this calculation.

[50] Ofgem (2018), Default tariff cap: decision – overview. Appendix 4 – wholesale, paragraph 2.31. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[51] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraphs 2.24 and 2.29. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[52] For further detail, see: Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.68. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[53] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.69. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[54] This figure is before applying electricity losses and unidentified gas, for consistency with suppliers' reported unexpected SVT demand costs above. We would apply electricity losses and unidentified gas to this offset because we apply electricity losses and unidentified gas to the 1% additional risk allowance.

Utilisation of allowance

3.117. Four suppliers disagreed with using the additional risk allowance as an offset. One supplier did agree with using a proportion of the additional risk allowance as an offset, but only if we amended the shaping and imbalance allowances.

3.118. Three of the suppliers who disagreed said that this allowance is already being fully utilised and therefore is not suitable to use as an offset. One of these suppliers referred to its response to the November 2021 consultation, where it included data showing it had under-recovered its wholesale costs over the last few years. Another of these suppliers said that risks are already exceeding the 1% allowance. It said that this was due to increased risks in the current market environment (eg reduced wholesale market liquidity), as well as the impact of other Ofgem policies (eg applying a deadband to backwardation costs).

3.119. As set out above, the potential offset is small. Given this scale, it would only take a small increase in risk to eliminate this. This could be plausible in the current market circumstances – and it would be hard to demonstrate that the benefit has not been eliminated. On balance, we have therefore decided not to apply this offset.[55]

Switching costs

3.120. Given that the change in switching rates is linked to changes in wholesale costs, it seems appropriate to consider this as a potential offset.

3.121. In the May 2022 consultation, we developed an initial estimate for the switching benefit. We estimated that the reduction in switching costs over the six months of cap period eight could be roughly £1.90 to £2.70 per dual fuel customer.

3.122. Five suppliers disagreed with using the switching benefit as an offset.

3.123. Following consideration of supplier feedback, we have revised our estimated benefit to £0.48. There are two key reasons for the change in the estimated benefit. First, we now reflect the switching costs which we included in the operating cost benchmark for default tariff customers. Second, we now recognise that the current reduction in switching could

[55] Please note that this decision is not based on the impact of other Ofgem policies – see Appendix 5 for consideration of detailed stakeholder feedback.

partly be offset by a rebound in switching in future cap periods (above normal levels). For more detail on supplier responses and our revised calculations please see Appendix 5.

3.124. We have decided not to offset unexpected SVT demand costs against switching benefits. This is because the residual benefit suppliers may have received is small and difficult to demonstrate.

CfD benefits

3.125. Three suppliers said there would be no (or very little) CfD benefit. We disagree with this view. The CfD benefit results from the £0/MWh floor in the Interim Levy Rate (ILR) which we used to calculate the CfD allowance for cap period eight. Suppliers did not recognise this point in their responses.

3.126. In our February 2022 wholesale decision, we calculated this benefit at £7/dual fuel customer (annualised).[56] We have considered whether the size of this benefit would have changed since then.

3.127. Suppliers will no longer see a net benefit from cap period nine, given our decision to amend the CfD allowance methodology. We therefore focus on the benefit during cap period eight.

3.128. Based on previous supplier representations, we understand that many suppliers hedge CfD costs. In response to the May 2022 consultation, three suppliers said that efficient suppliers would hedge CfD costs. Hedged positions would help to mitigate the risk of changes in this benefit since our February 2022 wholesale decision due to wholesale price movements.

3.129. We recognise that achieved CfD costs will depend on other factors. In response to the May 2022 consultation, suppliers said that CfD costs during cap period eight had increased, especially as a result of generators delaying their CfD start dates. We recognise that it is harder to hedge for changes in CfD generation volumes (than for changes in

[56] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 2.29. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

wholesale prices). However, we still consider there is likely to be some benefit in cap period eight due to the £0/MWh ILR floor.[57]

3.130. In the February 2022 wholesale decision, we said that we did not propose to claw back this benefit to suppliers through a negative adjustment.[58] We have not changed this position. For the avoidance of doubt, the CfD benefit therefore does not affect the value of the adjustment for unexpected SVT demand costs.

3.131. In the February 2022 wholesale decision, our position at the time was that the CfD benefit was one of the factors to take into account when deciding not to make an ex ante adjustment for cap period eight costs.[59] In principle, we would use the same approach when deciding whether to make an adjustment for cap period eight. We would consider the CfD benefit alongside suppliers' reported cost increases and all factors covered in the sections above to understand whether there is a case for adjusting the cap. We consider that this approach would help to support the cap reflecting efficient costs, and therefore protect customers in line with the Act's objective.

3.132. In practice, we already considered the CfD benefit for cap period eight as part of our June 2022 CfD decision. We said that this could net off any cost increase concerns for cap period eight.[60] We have therefore decided not to consider the CfD benefit as part of our decision process for whether we adjust for unexpected SVT costs, to avoid double counting this benefit.

3.133. In any event, the reported unexpected SVT demand costs are much larger than any potential CfD benefit. Therefore, even if we had not already considered the CfD benefit in

[57] Ofgem (2022), Decision on amending the methodology for setting the Contracts for Difference (CfD) cap allowance, paragraph 3.18. https://www.ofgem.gov.uk/publications/decision-amending-methodology-setting-contracts-difference-cfd-cap-allowance
[58] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 6.11. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[59] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraphs 2.29 and 2.30. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[60] Ofgem (2022), Decision on amending the methodology for setting the Contracts for Difference (CfD) cap allowance, paragraph 3.18. https://www.ofgem.gov.uk/publications/decision-amending-methodology-setting-contracts-difference-cfd-cap-allowance

our June 2022 CfD decision, we consider that the case for adjusting for unexpected SVT demand costs would have been unaffected by the CfD benefit.[61]

Other allowances

3.134. Four suppliers disagreed with offsetting against other allowances. These responses reflected an expectation that costs had increased in line with the indexed allowances, or that these allowances were already fully utilised.

3.135. We have reviewed how costs might have changed relative to the indexed allowances. We have not identified any clear cases where costs were likely to increase more slowly than allowances. Appendix 5 provides information on our considerations and the detailed points raised by suppliers. In summary.

- The EBIT allowance in the cap increases at a single rate in response to changes in wholesale prices. This will overstate the growth of parts of the capital base and understate the growth of other parts. We would have needed detailed information on a supplier's capital base to demonstrate that the allowance had increased faster than costs. However, we do not have such evidence for this decision.

- The headroom allowance takes into account a wide range of cost and risk items, which we have considered on an individual basis. Overall, there is no clear evidence that there is a material difference between the growth in allowances and the growth in costs.

- The indexed part of the payment method uplift reflects bad debt and working capital costs. These costs relate to the bills that customers receive and we would therefore expect them to scale in line with the size of customers' bills.

[61] If the reported unexpected SVT demand costs had instead been similar to the CfD benefit (and we had not already considered the CfD benefit in our June 2022 CfD decision), then we might have concluded that the low net impact meant that no adjustment was needed.

Whether to adjust for unexpected SVT costs

Context

3.136. In this section, we set out our decision on whether to adjust from 1 October 2022 for additional unexpected SVT demand costs for cap periods eight and nine.

Decision

3.137. We have decided to adjust for additional unexpected SVT costs for cap period eight, for non-PPM customers only. We consider that the costs are material and systematic. We also consider that making this adjustment is overall in default tariff customers' interests. In the May 2022 consultation, we indicated that there was a possibility that suppliers were incurring material additional costs, but we did not indicate a minded-to position at that stage.

3.138. The amount of costs taken into account is £39/dual fuel customer. This value includes the impact of the decisions discussed earlier in this chapter on benchmarking and offsets. The size of the adjustment is £41/dual fuel customer, after taking into account the implementation decisions in Chapter 5 which apply electricity losses and unidentified gas to the calculated benchmark.[62]

3.139. We have decided not to apply an adjustment for PPM customers for unexpected SVT demand costs in cap period eight. In particular, this reflects that we do not consider that these costs are material.

3.140. We have decided not to adjust for unexpected SVT costs for cap period nine from 1 October 2022. This is unchanged from our initial view in the May 2022 consultation. We do not consider that the scale of reported costs is sufficient to consider an adjustment.

Overview of responses

3.141. One supplier said that an adjustment is required for unexpected SVT demand, without specifying whether this was for a specific cap period.

[62] We note that the single-rate and multi-register adjustment values will differ very slightly due to electricity losses.

3.142. For cap period eight, the majority of suppliers that responded to our consultation said that an adjustment is required for unexpected SVT demand costs in cap period eight.

3.143. For cap period nine, a couple of suppliers said that we should keep unexpected SVT demand costs under review. Another supplier said that unexpected SVT demand costs should be covered by the 1% additional risk allowance, provided that the MSC remained in place.

3.144. One supplier disagreed with the need for an adjustment for either cap period. It said that an efficient supplier should have the capability to deal with the costs of unexpected SVT demand. We consider this point in the 'Benchmarking' section above.

Considerations

Considerations for cap period eight

3.145. We consider that the reported costs for non-PPM customers – as assessed at a lower quartile benchmark – represent a material increase in suppliers' costs. As an illustrative comparison, the profit margin allowed in the cap over the six months of cap period eight is around £12, over three times lower than the extra cost incurred at the lower quartile level.

3.146. We consider that such costs would also be systematic. Although we expect these costs will be temporary, we would not expect suppliers to receive an offsetting benefit from unexpected SVT demand at any other point in time.

3.147. Furthermore, we consider that making an adjustment is in the interests of default tariff customers. We are conscious of the impact that an adjustment will have on customers facing cost of living pressures, but as set out in the February 2022 wholesale decision, "Our view is that a competitive market where suppliers can recover their efficient costs is in the long-term interests of all consumers".[63] A competitive market ensures suppliers have adequate incentives to become more efficient and provide a better quality of service to their customers. It will also promote innovation and deliver a greater range of products and choices for customers. It should reduce the risk that customers have to pay for the mutualised costs of supplier failures as a result of efficient suppliers being unable to

[63] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, p5.
https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

recover their costs. These mutualised costs can be very significant – as an illustration, by December 2021 we had consented to Suppliers of Last Resort making initial levy claims totalling £1.83bn.[64] Our assessment of the financial risk of supplier failure this winter suggest that costs could be significantly higher than last winter if we did not implement measures to stabilise the market.

3.148. We do not consider that an adjustment is needed for PPM customers. This is for four reasons.

- First, the reported costs are much lower for PPM than for non-PPM. These costs may therefore not be material.
- Second, most suppliers did not have PPM FTC customers, so would not incur unexpected SVT demand costs.
- Third, even for the few suppliers who plausibly had such costs, there is significant uncertainty about how to allocate costs between payment types. We therefore have limited confidence that the costs considered under the PPM payment type are an accurate reflection of the costs of serving PPM customers.[65]
- Fourth, we have taken into account that PPM customers are more likely on average to be in vulnerable situations than non-PPM customers.[66] This means that we would be particularly cautious about allowing suppliers to recover uncertain costs from these customers.

3.149. We therefore consider that there is a clear justification for reaching different conclusions about whether to adjust for the non-PPM and PPM payment types. These conclusions have been enabled by our approach of gathering data segmented by these payment types. Our analytical approach has therefore helped us to reach appropriate

[64] Ofgem (2022), Last resort levy claims true-up process consultation, paragraph 0.10. https://www.ofgem.gov.uk/publications/last-resort-levy-claims-true-process-consultation
[65] This is even after making analytical judgements about how to classify individual suppliers' costs – see Appendix 4.
[66] BEIS (2019), Fuel Poverty Factsheet, Slide 3. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/966_517/Fuel_Poverty_Factsheet_2019_data.pdf

decisions for these payment types, and helped us to protect PPM customers from paying more than necessary.

3.150. Given that PPM customers are more likely on average to be in vulnerable situations, this decision will have a particular benefit for these customers, especially at a time when other elements of the cap will be increasing.

Considerations for cap period nine

3.151. Suppliers have not reported significant costs for cap period nine. We therefore do not consider that an adjustment for cap period nine is necessary, as we do not consider that the costs are material.

3.152. Furthermore, the reported costs for cap period nine are uncertain. While we encouraged suppliers to provide us with updated evidence on unexpected SVT demand costs for cap period nine in the May 2022 consultation, we received little additional evidence. Suppliers' reported data is therefore largely based on forecasts from early in the observation window for cap period nine, which are subject to significant uncertainty. Any forecasts will also remain uncertain due to the potential for wholesale price changes during cap period nine. We therefore do not have sufficient confidence in the information available to make an adjustment. In response to the May 2022 consultation, one supplier said that market conditions remained too uncertain to provide an accurate estimate of costs for cap period nine. We recognise that the costs for cap period nine may change over time, as wholesale prices remain volatile.

3.153. We also need to bear in mind the impact of making a series of adjustments for unexpected SVT demand. Consistently providing allowances for unexpected SVT demand may affect suppliers' incentives to manage their risks appropriately in future (ie by creating moral hazard). Wholesale markets have experienced significant volatility for a sustained period of time and may continue to do so in the near future. However, through the adjustment for cap period eight costs and other interventions (see the 'Benchmarking' section), we have acted to manage the risks arising from wholesale price volatility. We therefore expect market volatility to be accounted for by our policies to a greater extent than historically, making future additional adjustments less likely. Once the transition to quarterly cap updates is complete (at the start of cap period ten, which runs from April to September 2023), we consider that the risk of making further adjustments for unexpected SVT demand is greatly reduced.

Wider customer impacts

3.154. Our decision to implement an adjustment will increase bills for non-PPM default tariff customers. While we consider that an adjustment is justified for the reasons above, we recognise that this bill impact will occur alongside the impact of high energy prices, as well as other cap decisions. We are acutely aware of the negative effects which high energy prices have on all customers, particularly those less able to afford it (who may be in vulnerable situations and/or part of particular protected groups).

3.155. Government has announced several support measures including a £400 grant towards households' energy bills this autumn. All households with a domestic electricity connection will be automatically eligible. Additionally, a £150 non-repayable council tax rebate being paid to households living in council tax bands A – D has been announced, with £144 million of discretionary funding for Local Authorities to support households who need it but are not eligible for the Council Tax reduction. Further support is available for those most in need,[67] this includes a:

- £650 one-off Cost of Living Payment for around eight million households on means tested benefits;
- £300 one-off Pensioner Cost of Living Payment for over eight million pensioner households to be paid alongside the Winter Fuel Payment;
- £150 one-off Disability Cost of Living Payment for around six million people across the UK who receive certain disability benefits; and
- £500 million increase and extension of the Household Support Fund available to councils to support vulnerable households with the cost of essentials such as food, utilities and clothing

3.156. We will continue working closely with our counterparts at the Department for Business, Energy and Industrial Strategy and HM Treasury to input into these types of measures with updated cap level forecasts and represent stakeholders' feedback received through our consultation process. Furthermore, we have consulted on moving the standing charge element of supplier of last resort (SoLR) charges to a volumetric charge and are

[67] https://www.gov.uk/government/news/400-energy-bills-discount-to-support-households-this-winter

considering responses. This policy could help lower consumption customers but there is a trade-off to be made against extra costs faced by vulnerable high consumption customers.

3.157. As always, we remain open to developing our policies and approach in the future. We welcome engagement from all customers and the groups who represent them.

4. Shaping and imbalance

Section summary

We explain the issue of shaping and imbalance costs and how we gathered data to consider this. We set out our decision on benchmarking suppliers' costs. We set out suppliers' reported costs. We set out our decision on whether an adjustment is needed.

Context

Defining shaping and imbalance costs

4.1. Suppliers purchase energy in forward markets using less granular products. The products which are largely traded involve a flat volume over a long period (a season or quarter). For electricity, the products available are generally either a flat volume across each day (baseload) or a flat volume across the daytime on weekdays (peak).

4.2. However, customers' demand varies over time – at monthly, weekly, daily and (for electricity only) half-hourly granularity. Suppliers need to buy energy to reflect the pattern of their customers' demand, or otherwise face imbalance charges.

4.3. Suppliers must therefore refine their hedged positions from less to more granular contracts. They incur shaping and imbalance costs in doing so.

Impact of wholesale price changes on shaping and imbalance costs

4.4. Suppliers generally carry out shaping much nearer to delivery than their hedging. This is when more granular products are available,[68] and when there is more clarity about their customers' likely demand. Given that shaping and imbalance occur near to delivery, the costs of these activities will depend on wholesale prices at this time.

4.5. Therefore, if wholesale prices increase, shaping and imbalance costs are also likely to increase.

[68] By "available", we mean that these products are traded to a degree in the market – ie that there is some liquidity. Liquidity is a measure of the ability to buy or sell a product without causing a major change in its price and without incurring significant transaction costs.

Existing allowances

4.6. As set out in Chapter 1, the cap includes existing allowances for shaping and imbalance. We define these in relation to the core direct fuel costs, which depend on wholesale prices during the observation window. Any increase in wholesale prices during or after the observation window could therefore mean that the prevailing wholesale price level at the point of shaping is higher than the wholesale price used to define the shaping allowance.

4.7. This situation is not unique to the cap. A supplier pricing an FTC would only be able to take into account its expectations of future shaping and imbalance costs when setting its tariffs. The outturn costs would depend on changes in wholesale prices. The outturn costs can also vary significantly based on short-term factors such as weather and generation outages. Suppliers would therefore face differences between the amount priced into their tariffs for shaping and imbalance costs and the outturn costs.

4.8. The shaping and imbalance allowances in the cap therefore do not attempt to match suppliers' outturn costs in any given cap period. Rather, they are intended to reflect (together with other wholesale allowances) the average costs over a longer period of time. We discussed our approach to considering whether the wholesale allowances were sufficient in our 2018 decision.[69]

Previous decision

4.9. In our February 2022 wholesale decision, we concluded that increased wholesale prices had caused electricity shaping and imbalance costs to be materially higher than the cap methodology had accounted for in cap period seven. We therefore decided to set an additional allowance of £12 for electricity shaping and imbalance costs, to be recovered across cap periods eight and nine.[70] We did not set an additional allowance for gas. Our decision was based on supplier-provided data in response to the November 2021 wholesale consultation.

[69] Ofgem (2018), Default tariff cap: decision. Appendix 4 – Wholesale costs, paragraph 2.31. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[70] Ofgem (2022), 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

4.10. There was particular volatility in short-term electricity prices in the second half of 2021 (ie the end of cap period six and the start of cap period seven). This could have caused shaping and imbalance costs to deviate from the underlying wholesale index. This exceptional circumstance supported a one-off intervention, rather than our usual position of considering that fluctuations in shaping and imbalance costs would be likely to average out over time.

Information considered

Rationale for gathering data

4.11. We decided to gather data because of increases in wholesale prices in spring 2022. The rationale is therefore equivalent to that set out for unexpected SVT demand in Chapter 3.

March 2022 RFI: Specific wholesale cost components

RFI process

4.12. This is the same as set out in Chapter 3.

Additional evidence from the May 2022 consultation

4.13. As set out in Chapter 3, in our May 2022 consultation we welcomed further evidence from suppliers.

4.14. In response to our May 2022 consultation, suppliers did not provide any resubmitted RFI data for shaping and imbalance costs.

4.15. As set out in Chapter 3, we also specifically engaged with representatives from consumer groups and charities on this issue.

Evidence provided

4.16. We discuss the evidence provided in Appendix 6. In summary, the data included in our analysis has modest coverage (as a proportion of SVT customers), for both cap periods eight and nine.

4.17. We consider that estimating shaping and imbalance costs is more challenging than estimating unexpected SVT demand costs. These costs are incurred close to delivery, so

most of the costs had not been incurred at the time of the RFI. Suppliers therefore had to forecast these forward-looking costs to a greater extent rather than reporting known costs.

4.18. This means that suppliers had to use methodologies to estimate their costs. These methodologies may vary between suppliers (in terms of scope and approach) and have different pros and cons. Therefore, the variation in reported costs between suppliers may reflect methodology differences, rather than necessarily genuine differences in costs. We explain some of the observed differences at a high level in Appendix 6.

4.19. This is not intended as a criticism of suppliers. It is inevitably challenging to forecast costs in a complex area. We also recognise that suppliers had to provide these estimates in a short period of time.

4.20. We cover further uncertainties around the estimates in the section 'Reported shaping and imbalance costs' below.

Benchmarking

Context

4.21. The same general benchmarking considerations apply as set out in Chapter 3.

Decision

4.22. Given the data available, we have decided to use a weighted average benchmark to assess suppliers' shaping and imbalance costs for this decision. This is because variation in the costs reported is likely to be driven by differences in the methodological approaches used to estimate the costs.

4.23. This decision is solely based on the data available. It does not mean that we would take the same approach for any future benchmarking of shaping and imbalance costs.

Overview of responses

4.24. Suppliers provided limited feedback on which benchmarking approach we should use specifically for shaping and imbalance costs. We discuss suppliers' general feedback on benchmarking in Chapter 3. Suppliers did comment on individual aspects of our considerations about non-efficiency and efficiency factors for shaping and imbalance costs.

Considerations

Non-efficiency factors for shaping and imbalance costs

4.25. The main non-efficiency factor is **methodological differences** in how suppliers have prepared their estimates when responding to the RFI. As set out above, we consider that these differences are potentially significant for shaping and imbalance costs, given the need to forecast costs.

4.26. One supplier agreed that methodological differences in forecasting mainly drive the differences in costs between suppliers. Another supplier said that calculating these costs is a complex matter, and approaches can differ among suppliers.

4.27. We also recognise that there may be some **natural variation** in suppliers' costs. For example, in a context of volatile spot prices, demand forecasting errors might be particularly expensive on certain days.

4.28. We have not identified reasons why a supplier's **customer base** would be a significant driver of its shaping and imbalance costs.

Efficiency factors for shaping and imbalance costs

4.29. Suppliers could reduce their shaping and imbalance costs by more **accurately forecasting customer demand**. An efficient supplier would be likely to make use of the information available to forecast and would consider the frequency of its forecasts. We consider this to be within a supplier's control. However, we received limited information on this area in response to the RFI.

4.30. Suppliers could also achieve efficiency through their **trading approaches**. An efficient supplier may make use of a number of markets (ie trading at different timeframes) to try to manage risks. Carrying out all shaping at a late stage (eg day-ahead) could be inefficient, especially in volatile market conditions. An efficient supplier may also trade more frequently – eg in response to revised forecasts. Information from the RFI and in response to the May 2022 consultation does not suggest evidence of manifestly inefficient approaches, and some suppliers show evidence of having adapted their approaches in response to recent market circumstances.

4.31. As a complex and ongoing activity, there will be a variety of other features of a supplier's business which affect its shaping and imbalance costs. These will affect its **delivery efficiency**.

4.32. There may also be specific common challenges in current market circumstances - suppliers have told us that product liquidity and uncertainty of customer demand are particular challenges at present which affect shaping costs. However, to the extent that these affect suppliers equally, they would not affect the impact of different benchmark choices. One supplier said liquidity risks primarily affect suppliers which are not vertically-integrated, as vertically-integrated suppliers benefit from internal transfer pricing. It is possible that individual suppliers may have different options available in the short-run for managing increased shaping and imbalance costs. However, we received several explanations from suppliers about strategies they use to mitigate any liquidity issues. We therefore do not consider that managing liquidity is fully outside a supplier's control.

Choice of benchmark

4.33. Managing shaping and imbalance risks is a core business activity for suppliers. We expect that there is the potential for some suppliers to deliver this activity more efficiently than others. In normal circumstances, we would therefore be likely to use a lower quartile, in line with our general approach in the cap.

4.34. However, given the methodological variations in the data, non-efficiency factors could have a significant impact on variation in costs. One supplier said that the non-efficiency factors outweigh efficiency factors in explaining the differences in cost between suppliers, and therefore said that a lower quartile benchmark would not be appropriate.

4.35. We consider that one of the main reasons for methodological differences in suppliers' forecasts is uncertainty. It is complex to estimate future shaping and imbalance costs, which depend on many factors. Suppliers will develop different approaches and assumptions to try to model this complexity – but this leaves room for the reported cost figures to differ based on methodological differences.

4.36. We have therefore decided to use a weighted average benchmark to assess shaping and imbalance costs. This decision is solely based on the data available. It does not mean that we would take the same approach for any future benchmarking of shaping and imbalance costs.[71]

[71] We discuss our approach to possible future adjustments in the section 'Future review of allowances' in Chapter 5.

4.37. This is a different decision than for unexpected SVT demand costs, where we decided to use a lower quartile benchmark. We consider it appropriate to use a different benchmarking approach for shaping and imbalance costs in this specific instance for the following reasons.

- The number of suppliers included in the analysis is smaller for shaping and imbalance costs than for unexpected SVT demand costs. This could increase the extent to which a lower quartile benchmark would be influenced by individual suppliers' reported costs, and therefore increase the impact of methodological differences.

- Methodological differences have a greater impact on suppliers' reported costs for shaping and imbalance costs than for unexpected SVT demand costs. This is particularly because suppliers had to make a greater use of forecasts for shaping and imbalance costs than for unexpected SVT demand costs, where more costs had already been incurred. While suppliers' reported costs included forecasts in both instances, the extent and complexity of forecasting were greater for shaping and imbalance costs.

Reported shaping and imbalance costs

4.38. We analysed shaping and imbalance costs using the information provided to us by suppliers through the RFI described above.

4.39. The reported figures are subject to a number of risks and uncertainties. These include:

- differences in suppliers' methodologies;[72]

- potential differences between suppliers' reported costs and the outturn costs, in particular driven by wholesale price fluctuations and near-term demand uncertainty; and

[72] We discuss this in the 'Benchmarking' section of this chapter.

- differences in the information provided to allow us to validate the estimates provided (ie differences in the quality of responses).

4.40. We note that the data used in the analysis represent less than half of the SVT customer base. We set out the reasons for this low coverage in Appendix 6.

4.41. We have provided details on how we conducted the calculations in Appendix 6. We report the weighted average benchmark figures below, as this is our chosen benchmark. We also present the lower quartile benchmark figures in Appendix 6.

Cap period eight

4.42. Based on suppliers' reported data, the weighted average expected cost per dual fuel customer at the benchmark level of consumption for cap period eight is approximately £23 for PPM and £16 for non-PPM. Table 4 sets out our summary of the potential shaping and imbalance cost impact facing suppliers for cap period eight by fuel for non-PPM customers.

4.43. Table 5 shows the equivalent information for PPM customers. The differences in the benchmarked PPM and non-PPM figures are due to differences in weighting across suppliers and not due to differences in the cost per customer figure for individual suppliers. We have explained this in Appendix 6.

Table 4: Reported shaping and imbalance costs in cap period eight (weighted average), shown against existing allowances – Non-PPM – pounds per customer during cap period eight

	Estimate of cost	Price cap allowance	Difference between estimated costs and price cap allowances
Gas	£5.86	£5.45	£0.41
Electricity	£10.49	£10.48	£0.00
Dual fuel	**£16.34**	**£15.93**	**£0.41**

Notes: Figures at benchmark consumption levels. Figures are costs over six months, rather than annualised costs.[73] Non-PPM includes both direct debit and standard credit. Figures may not sum

[73] In annualised terms the price cap allowance, for both payment types, would be £22 for gas and £24 for electricity.

exactly due to rounding. Some figures may have slightly changed from the reported cost in our May 2022 consultation due to changes in the weights explained in Appendix 6.

Table 5: Reported shaping and imbalance costs in cap period eight (weighted average), shown against existing allowances – PPM – pounds per customer during cap period eight

	Estimate of cost	Price cap allowance	Difference between estimated costs and price cap allowances
Gas	£6.33	£6.14	£0.20
Electricity	£16.67	£10.48	£6.19
Dual fuel	**£23.00**	**£16.62**	**£6.38**

Notes: Figures at benchmark consumption levels. Figures are costs over six months, rather than annualised costs. Figures may not sum exactly due to rounding. Some figures may have slightly changed from our May 2022 consultation due to changes in the weights explained in Appendix 6.

4.44. There is a small difference between the expected cost per customer and the allowance in the cap for cap period eight.[74] The expected cost is approximately £6 higher for PPM – but we discuss the caveats around this figure in our considerations below. There is very little difference between the expected costs per customer and the allowance for non-PPM.

Cap period nine

4.45. Based on suppliers' reported data, the weighted average expected cost per dual fuel customer at the benchmark level of consumption for cap period nine is approximately £75 for PPM and £66 for non-PPM. Table 6 sets out our summary of the potential shaping and imbalance cost impact facing suppliers for cap period nine by fuel for non-PPM customers. Table 7 shows the equivalent information for PPM customers.

[74] We included seasonal to monthly shaping, monthly peak/baseload to hourly shaping, rehedging day ahead and imbalance items within the additional wholesale allowances to calculate the allowance set for electricity shaping and imbalance costs for cap period eight. We included quarterly to monthly shaping, rehedging day ahead and imbalance items within the additional wholesale allowances to calculate the allowance set for gas shaping and imbalance costs for cap period eight.

4.46. We should treat these estimates with caution due to the limitations highlighted earlier in this chapter. In particular, suppliers' methodologies for forecasting costs have a significant impact on the reported costs.

4.47. We have not provided an estimated cap allowance for cap period nine. This is because the observation window is still open, meaning that the final value of the core direct fuel cost allowance is not known.

Table 6: Reported shaping and imbalance costs in cap period nine (weighted average) – Non-PPM - pounds per customer during cap period nine

	Estimate of cost
Gas	£40.85
Electricity	£24.80
Dual fuel	**£65.64**

Notes: Figures at benchmark consumption levels. Figures are costs over six months, rather than annualised costs. Non-PPM includes both direct debit and standard credit.

Table 7: Reported shaping and imbalance costs in cap period eight (weighted average) – PPM - pounds per customer during cap period nine

	Estimate of cost
Gas	£43.42
Electricity	£32.05
Dual fuel	**£75.47**

Notes: Figures at benchmark consumption levels. Figures are costs over six months, rather than annualised costs.

Existing specific allowances

4.48. We have considered whether suppliers have incurred additional costs above those covered by the shaping and imbalance allowance in the cap. We have therefore decided to deduct the shaping and imbalance allowance from the reported shaping and imbalance costs. This is to avoid duplication. We did not receive any responses from suppliers regarding this position.

Offsets

Context

4.49. Chapter 3 provides context on offsets.

Decision

4.50. We have decided not to offset other allowances against additional shaping and imbalance costs. This position is unchanged from May 2022 consultation. Our decision reflects that we considered offsets in relation to unexpected SVT demand costs and decided not to apply these – see Chapter 3.

Overview of responses

4.51. Stakeholders did not comment specifically on cost offsets for additional shaping and imbalance costs. Suppliers provided general feedback on offsets – we cover this in Chapter 3.

Considerations

4.52. In the May 2022 consultation, we proposed to use certain allowances to offset unexpected SVT demand costs. We therefore said that we did not consider it appropriate to offset additional shaping and imbalance costs against these allowances, to avoid double counting.[75]

4.53. As set out in Chapter 3, we have decided not to apply offsets to unexpected SVT demand costs. This removes the risk of double counting. However, the same considerations on offsets apply as in Chapter 3. For consistency, we have therefore decided to adopt the same position on offsets as in Chapter 3.

Whether to adjust for shaping and imbalance costs

Context

4.54. In this section, we set out our decision on whether to adjust for additional shaping and imbalance costs for cap periods eight and nine, from 1 October 2022.

[75] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 4.41. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

Decision

4.55. We have decided not to adjust from 1 October 2022 for shaping and imbalance costs for cap period eight.[76] This is because we consider that the additional costs reported by suppliers are not material and systematic, and are subject to uncertainty. We generally consider the sufficiency of the shaping and imbalance allowance in the round over time, rather than in a single cap period. Our position is unchanged from the initial view in our May 2022 consultation.

4.56. We have decided not to adjust from 1 October 2022 for shaping and imbalance costs for cap period nine. We consider there is too much uncertainty around market conditions and suppliers' estimates to justify an adjustment. Our position is unchanged from the initial view in our May 2022 consultation.

4.57. However, in each case, we are not ruling out a possible adjustment in the future (see section 'Future review of costs and allowances' in Chapter 5). In that section, we also discuss our approach to reviewing the enduring values of the shaping and imbalance allowance and transaction costs allowance.

Overview of responses

4.58. One supplier said that we should make an adjustment given material cost increases, but did not relate this to a specific cap period. Another supplier said that it had some sympathy for our consultation position (in relation to both cap periods), but said that we should review the shaping and imbalance allowances. We cover future reviews in the section on 'Future review of costs and allowances' in Chapter 5.

4.59. For cap period eight, two suppliers disagreed with our initial position and said that we should make an adjustment. Another supplier provided figures suggesting that suppliers have a shortfall[77] in cap eight but did not explicitly say that we should make an adjustment. One supplier said we should review once the cap period ends.

[76] We refer to 1 October 2022 because this is the point that an adjustment would have had effect – ie the start of cap period nine. This is separate from the period that the costs relate to – ie cap period eight.
[77] The supplier compared the allowances for shaping and imbalance costs for cap period eight and the result of applying the percentage allowance values to near-term wholesale prices during cap period eight.

4.60. For cap period nine, one supplier disagreed with our initial view and said that we should make an adjustment. Two suppliers proposed that we monitor the costs and adjust in future if needed.

Considerations

Considerations for cap period 8

4.61. While suppliers reported costs above the cap allowance, we do not consider that this difference is material. The difference for non-PPM is small. While the difference for PPM is slightly larger, there is uncertainty about the robustness of the difference – especially given that the higher reported cost for PPM than non-PPM is only driven by the weighting of suppliers' data (as described in the section on 'Reported shaping and imbalance costs'). One supplier said that its working view is that shaping and imbalance has a much smaller effect than unexpected SVT demand.

4.62. Given the small difference, we also do not consider that the impact is systematic, as variation in costs could balance out over time. We generally consider the sufficiency of the shaping and imbalance allowance in the round over time, rather than in a single cap period.

4.63. Furthermore, we do not have sufficient confidence in the reliability of the data to implement an adjustment. This is for three reasons.

- The reported costs are partly based on forecasts. Wholesale price volatility is likely to affect these forecasts and therefore there is significant uncertainty around the outturn costs.[78]

- We observed methodological differences between suppliers. These differences led to large variations in reported costs, creating uncertainty about what we would expect the costs to be. In response to the May 2022 consultation, two suppliers said that there is a high degree of uncertainty in the outturn costs for cap period eight.

[78] Some of the reported costs for unexpected SVT demand in cap period eight – where we have decided to make an adjustment – were based on forecasts. However, this would account for a smaller proportion of costs for unexpected SVT demand compared to shaping and imbalance.

- The included suppliers only cover a minority of SVT customers. This makes it difficult to obtain a reliable estimate of the market-wide expected costs for the period.

4.64. Our decision is about whether to make an adjustment from 1 October 2022. We discuss our approach for possible future adjustments in the 'Future review of costs and allowances' section in Chapter 5.

Considerations for cap period nine

4.65. The estimates for cap period nine are subject to a significant degree of uncertainty. There are also significant questions about the methodological consistency between suppliers. We therefore do not consider that the estimates for cap period nine are sufficiently reliable to set an adjustment.

4.66. We also consider that the degree of uncertainty around the reported costs is larger for cap period nine than for cap period eight. This is because a greater proportion of the cap period nine reported costs will be based on forecasts (than for cap period eight).

4.67. One supplier explained in detail why it considered that there would be additional shaping costs for cap period nine, although it said that the degree of confidence in any forecast of costs would be low. We appreciate the level of detail provided to help us understand the supplier's view of potential future costs. However, considering our evidence base in the round, we still do not have sufficient confidence to set an adjustment.

4.68. The supplier also said that we should ensure allowances cover incurred costs in the majority of scenarios. We discuss this point in the 'Nature of adjustment' section in Chapter 5.

5. Implementation

Section summary

We explain which cap model we have decided to adjust, the nature of the adjustment (ie through a fixed amount or a 'float and true-up'), and the duration over which we will apply the adjustment. We also consider other implementation issues raised by suppliers in response to the May 2022 consultation, and set out our position on future reviews of allowances.

5.1. In this chapter, we set out how we will implement the adjustment.

5.2. We cover the following issues:

- **the format of the adjustment** – ie which cap model we will adjust;
- **the nature of the adjustment** – ie whether this will be a fixed amount, or whether we will true it up later by making a further adjustment once more data became available;
- **the duration** over which to apply the adjustment;
- **other implementation issues** raised by suppliers in response to the May 2022 consultation; and
- **future reviews** of allowances.

Format of adjustment

Context

5.3. We would need to include the adjustment in one of the cap models (ie the annexes to Standard Licence Condition 28AD of the electricity and gas supply licences (SLC 28AD)). We could include the adjustment in:

- the additional risk allowance, which sits within the wholesale cost allowance model (Annex 2 to SLC 28AD – the 'Annex 2 model'); or
- the adjustment allowance (Annex 8 to SLC 28D – the 'Annex 8 model').

5.4. In the February 2022 wholesale decision, we included the adjustment for cap period seven in the additional risk allowance. This was on the basis that we included this allowance within the cap methodology to account for uncertainty and volatility in wholesale costs.[79]

5.5. In this section, we consider which cap model to use to reflect an adjustment from this decision. We have not changed the location of the existing adjustment to reflect cap period seven costs – this will remain in the additional risk allowance. As set out in Chapter 1, we will apply the adjustment for cap period seven backwardation costs in the same model as used for the output of this decision.

Decision

5.6. We have decided to include the adjustment in the adjustment allowance (Annex 8) model, as this is the simplest approach.

5.7. We have decided to set separate adjustments by payment type (PPM/non-PPM), as this reflects the split of our cost data.

5.8. We have decided to set separate adjustments by fuel and electricity region. The adjustment by fuel reflects the associated cost differences, while the regional adjustment reflects locational electricity losses only.

5.9. We have decided not to set separate adjustments by electricity meter type, as we do not consider the additional complexity to be proportionate.[80]

5.10. We have decided to set an adjustment at benchmark consumption only, meaning that the adjustment would apply to the implied unit rate within the cap. This reflects that wholesale costs depend on how much energy a customer uses.

5.11. We have decided to edit the wholesale cost allowance model (the Annex 2 model), so that the increased additional risk allowance from the February 2022 decision does not

[79] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 2.12. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

[80] The final values of the adjustments will vary very slightly between electricity meter types because the values of electricity losses vary between them.

apply beyond cap period nine. This reflects the policy intent of our February 2022 decision. Given the complexities around the Annex 2 model in relation to the transition to a quarterly cap, we have decided to delay implementing our proposed changes until cap period ten. For the avoidance of doubt, we are making the decision now – we are only delaying the implementation of these changes.

5.12. All these positions are unchanged from our May 2022 consultation, except the change to when we will implement the changes to the Annex 2 model.

Overview of responses

5.13. We received limited feedback on the format of the adjustment. There was broad support over our proposal to implement the adjustment through the adjustment allowance (Annex 8 model). One supplier raised concerns over the proposed treatment of adjustments by meter type.

Considerations

High-level comparison of options

5.14. Conceptually, the costs under consideration would fit within the additional risk allowance. Unexpected SVT demand (ie the cost for which we have decided to implement an adjustment) is a wholesale-related cost. The additional risk allowance is intended to reflect wholesale costs which are not covered by the other allowances within the cap.

5.15. However, using the additional risk allowance poses practical challenges. We intend for the adjustment to reflect an absolute cost, but the additional risk allowance is set as a percentage of the core direct fuel cost. We would need to go through extra calculation steps to convert the additional costs to a percentage. We could only finalise these calculations once the core direct fuel cost is known – ie when the observation window is complete. This is just before announcing the cap level.

5.16. In contrast, the adjustment allowance is set in absolute terms, rather than as a percentage of other cap components. This reduces the need for additional calculation steps.

5.17. Two suppliers supported our proposal to use the adjustment allowance. Another supplier said that it had no preference over which model to use.

5.18. We have therefore decided to use the adjustment allowance, as this is the most practical option.

Adjustments by payment method

5.19. In the May 2022 consultation, we proposed to set separate adjustments for PPM and non-PPM payment types.[81] One supplier agreed with this proposal. However, one supplier disagreed with combining direct debt and standard credit (within the non-PPM category), but treating PPM separately. It said this was inconsistent and without justification.

5.20. We gathered separate cost data for PPM and non-PPM customers because of a hypothesis that non-PPM customers were more likely to incur unexpected SVT demand costs. The vast majority of PPM customers were already on SVTs, even before recent price rises. There was a clear rationale for looking at PPM costs separately.

5.21. We did not consider at the time whether to gather data broken down by direct debit and standard credit. We recognise that the costs incurred could differ between these payment methods. We expect that any such difference would result from differences in the proportion of customers moving from FTC to SVT, rather than differences in behaviour at an individual customer level. We therefore recognise that there could have been some accuracy benefits from requesting this additional breakdown. However, we would also have needed to consider the proportionality and feasibility of asking suppliers to provide this breakdown.

5.22. In any event, we do not consider that our data gathering approach has led to an inconsistent outcome for different payment methods. Data on the change in SVT customer numbers by payment method (between October 2021 and April 2022) shows that the largest percentage change was for direct debit. The percentage change was much smaller for standard credit, but there was still growth in standard credit SVT customer numbers. It is therefore reasonable to expect that there were associated costs of unexpected SVT demand for standard credit customers. In contrast, the percentage change in PPM SVT customer numbers was negligible – meaning that it is reasonable to expect that there were very limited costs of unexpected SVT demand.

5.23. We have therefore decided to maintain our proposal to set separate adjustments by payment type (PPM/non-PPM), as this reflects our cost data. We consider this is the most cost-reflective approach and would help protect PPM customers.

[81] Ofgem (2022), Price Cap – Consultation on possible wholesale cost adjustment, paragraph 5.8. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

5.24. There may be some distributional impacts between suppliers depending on their proportions of direct debit and standard credit customers. However, we would not expect these differences to be large, given the scale of differences between suppliers' proportions of these customers and the average proportions across suppliers.

Number of other adjustments

5.25. In addition to separate adjustments by payment type, we have decided to set separate adjustments by fuel and electricity region. We have cost data split by fuel, and have therefore decided to make adjustments which vary in the same way. Making separate adjustments by electricity region reflects that electricity losses vary regionally.[82] In response to the May 2022 consultation, one supplier agreed with our proposals in these areas.

5.26. We have decided not to set separate adjustments by electricity meter type (single-rate/multi-register). Costs per customer might vary between these meter types – either due to different consumption levels or due to different unit costs of purchasing energy. However, we do not have data on the cost differences between these meter types. Any variation in costs should also largely average out over an individual supplier's portfolio. We therefore do not consider the additional complexity of calculating separate adjustments would be proportionate. In response to the May 2022 consultation, one supplier agreed with our proposals in this area.

5.27. We have decided to define the adjustment at benchmark consumption only (and not at nil consumption), meaning that the adjustment would apply to the implied unit rate within the cap. This reflects that wholesale costs depend on how much energy a customer uses.

5.28. The decisions on electricity meter types and applying the adjustment at benchmark consumption mean that we will apply the same adjustment at benchmark consumption for both meter types. However, the impact on the implied unit rate will be different between meter types, because the benchmark consumption level is different. We consider that this is an implication of our decision not to set separate adjustments by meter type – and therefore covered by our considerations on proportionality above.

[82] We apply electricity losses to the adjustment, because these increase the amount of wholesale energy that suppliers need to purchase.

Model implications

5.29. We have published a revised version of the Annex 8 model alongside this decision. Appendix 7 describes the changes that we have made.

5.30. We have also decided to edit the Annex 2 model. We will apply a profile of percentage allowances, reverting to the original 1% additional risk allowance from cap period ten onwards. This change reflects the policy intent of our February 2022 wholesale decision.[83] The existing percentage values within the Annex 2 model are set as single percentage values for all cap periods and would therefore apply indefinitely without this change. We only want the increased wholesale additional risk allowance from the February 2022 wholesale decision to apply to the end of cap period nine, as the cap period seven wholesale costs would be recovered by this point. As noted above, we will apply this change from cap period ten.

5.31. In response to the May 2022 consultation, one supplier said that our proposal to use the adjustment allowance would imply removing the increased wholesale additional risk allowance beyond cap period nine.

Nature of adjustment

Context

5.32. The adjustment for additional wholesale costs will be subject to a degree of uncertainty because it will partly be based on expected costs. For cap period eight, most costs are actuals. However, cap period eight is in progress, so costs for the remainder of cap period eight are expectations. Some costs could also be expectations due to the lag between the provision of data and the decision.

5.33. We have considered whether the adjustment should be an initial value subject to further refinement in a later cap period (a 'float and true-up') or whether the adjustment should be a fixed value.

[83] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 1.0. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

5.34. We do not generally include true-ups within the cap. In our 2018 decision, we decided to "not include a mechanism in the cap for correcting previous forecast errors."[84] However, we did decide to adopt a float and true-up approach for debt-related costs linked to COVID-19. When explaining our decision, we said: "It is very uncertain what the total debt-related costs of COVID-19 will ultimately be."[85]

Decision

5.35. We have decided that the adjustment will be a fixed amount. We consider that this is more proportionate than a float and true-up. This remains unchanged from our May 2022 consultation position.

Overview of responses

5.36. We received limited feedback in this area, with mixed views from suppliers on which approach to use.

Considerations

Accuracy

5.37. A float and true-up could support accuracy, as further information will become available on suppliers' costs over time. As noted above, any adjustment would be partly based on forecast data. Forecasting costs is inevitably challenging when these depend on volatile wholesale prices. Actual data would therefore be more accurate.

5.38. This accuracy could benefit customers or suppliers. It would reduce the risk that customers pay more than the actual costs. It would also reduce the risk that suppliers under-recover their actual costs.

5.39. In response to the May 2022 consultation, one supplier said that a fixed adjustment seemed appropriate now, but said that we should not prohibit further changes if there were unexpected events. We consider further reviews in the section 'Future reviews of allowances' at the end of this chapter.

[84] Ofgem (2018), Default tariff cap: decision - overview, paragraph 3.17. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[85] Ofgem (2021), Decision on the potential impact of COVID-19 on the default tariff cap, p6. https://www.ofgem.gov.uk/publications/decision-potential-impact-covid-19-default-tariff-cap

5.40. Given our decision to adjust for cap period eight costs only, we consider that the impact on accuracy would be smaller than if we were adjusting for cap period nine costs. For cap period nine, we would have needed to use a greater proportion of forecast data and there would have been a longer period for wholesale prices to change after setting the allowance.

Covering costs in different scenarios

5.41. One supplier said that we should use a float and true-up approach, particularly in relation to cap period nine costs. To reduce the risk of supplier failure and consequent customer harm, it said we should cover supplier costs in the majority of scenarios, setting the adjustment above expected costs. It said that we could then claw back any material excess if needed.

5.42. We would generally consider that asking customers to pay for an allowance purposefully set above expected costs is not in line with the Act's customer protection objective – even with a later true-up.

Timeliness

5.43. For a float and true-up, we would need to gather further data to set the true-up. We would be able to gather such data (on actual costs) after the end of a cap period.

5.44. However, it would be challenging to apply the true-up in time for the next cap announcement – ie in a timeframe which is shorter than six months. We would need time to gather and analyse the data. We would then need to consult, consider responses and determine the revised cap level.

5.45. It is therefore more likely that any true-up would start to apply a year after the end of the cap period to which the costs related. For example, any true-up for cap period eight costs would likely only take effect from cap period eleven (currently October to December 2023).[86]

5.46. We consider that this lag would reduce the benefits of a true-up. In particular, it would increase the scope for changes in the numbers of default tariff customers, which

[86] On 6 July 2022, the government introduced the Energy Security Bill into Parliament, which makes provision for the potential extension of the cap beyond 2023.

could reduce the degree to which any amount recovered through the adjustment reflects the costs incurred by individual suppliers. This would mean that any true-up could itself be inaccurate.

Resource impacts

5.47. Carrying out a true-up would have resource impacts on suppliers (to provide data and respond to the consultation), and other stakeholders (to respond to the consultation).

5.48. We are conscious that stakeholders need to engage with a range of policy developments. For suppliers, this runs alongside responding to a range of information requests. We therefore need to bear in mind this wider context when determining how to prioritise any true-up. Our aim is to achieve the best possible outcome for customers across our work programme, so we want to manage the demands on stakeholders to achieve this. This is one reason why we do not normally carry out true-ups within the cap.

5.49. One supplier said that the additional resources required to deliver a true-up would be relatively small. It said that these were not sufficient to justify our proposal to set the adjustment as a fixed amount, given the scale of the costs involved.

5.50. We consider that a float and true-up would be disproportionate. This conclusion includes taking into account that the lag for a true-up would reduce its benefits. An assessment of proportionality takes into account both the benefits and the costs (eg the resources required) of delivering a particular action. However, our conclusion in this case does not depend strongly on the scale of the costs, because we consider that the benefits would be low.

Conclusion

5.51. While we recognise that a true-up could offer benefits in terms of accuracy, we do not consider that it would be proportionate given that it could only be implemented with a lag. This is particularly evident given our decision not to carry out an adjustment for cap period nine, where costs are more uncertain. We therefore do not consider that a true-up would be proportionate.

5.52. While we previously adopted a float and true-up approach for the debt-related costs linked to COVID-19, those costs were particularly uncertain, because it takes time to determine whether debts will be repaid or not. We consider that the situation for debt-related costs linked to COVID-19 was different to this case.

Duration over which to apply adjustment

Context

5.53. After identifying an amount of costs from a given cap period to recover through an adjustment, one question is how long this adjustment should last. This duration affects the speed at which customers would pay for these costs, and therefore how fast suppliers would recover them. It does not affect the total amount of costs to recover.[87]

5.54. We could apply any adjustment (for example):

- for six months;
- for one year; and
- for a period longer than one year.[88]

5.55. In the February 2022 wholesale decision, we decided to apply the adjustment over 12 months (ie two six-month cap periods). We said that a 12-month recovery period was more appropriate than a six-month period to limit the impact on customer bills.[89]

Decision

5.56. We have decided to apply the adjustment over a 12-month period. We consider that this protects customers better than a shorter recovery period, while ensuring that suppliers can recover costs in an appropriate timeframe. This remains unchanged from our May 2022 consultation position.

[87] The total amount of costs would change in nominal terms if we adjusted for inflation. However, we have decided not to do this, given that the adjustment for cap period eight costs would apply shortly after the costs were incurred.
[88] In principle, the move to quarterly cap updates could create more options. However, in practice these options would either be undesirable (eg recovering costs within three months would increase customers' bills significantly) or only marginally different from those above.
[89] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 2.14. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap

Overview of responses

5.57. We received limited feedback in this area. A couple of suppliers said that costs should be recovered immediately.

Considerations

5.58. One supplier said that it would prefer us to allow suppliers to recover the adjustment immediately. One supplier said that immediate recovery of costs would avoid an increased risk of supplier failure. However, it also said that it recognised the impact on consumer bills, so understood our proposal to recover the adjustment over a longer period.

5.59. We have decided to apply an adjustment over a 12-month period. This position is different from our decision on the backwardation adjustment in our August 2022 wholesale methodology decision, where we have decided to use a six-month recovery period. We explain our reasoning for the six-month recovery period in that decision. There are two main reasons to take different approaches in these cases.

- First, the unexpected SVT demand costs are significantly smaller than the backwardation costs. The size of the costs affects the impact of the recovery period chosen, particularly on suppliers' financial situations.

- Second, at the point we implement the adjustment, suppliers will already have incurred the unexpected SVT demand costs for cap period eight. The recovery will therefore improve their financial situations, regardless of the recovery period. In contrast, the August 2022 wholesale methodology decision relates to a cost that suppliers are still incurring, as suppliers will incur further backwardation costs in cap period nine. The impact of backwardation costs on suppliers' financial situations therefore depends on both future costs and future recovery – and the net impact depends on the speed of recovery in cases where the costs are large.

5.60. We consider that a 12-month adjustment is appropriate for unexpected SVT demand costs for the following reasons.

- A shorter recovery period (less than 12 months) would further increase customers' bills during cap period nine, at a time when they are already paying the remainder of the adjustment for additional wholesale costs incurred in cap period seven.

- We do not consider that such a further increase in customers' bills is justified in this case to support suppliers' finances (or reduce the risk of mutualised costs to customers in the event of supplier exit). Given the size of this adjustment, we consider that suppliers should generally be able to manage the cashflow impacts through existing tools.

- We recognise that a longer recovery period (more than 12 months) would have a negative impact on suppliers' cashflows – although this would again be limited by the size of the adjustment in this case.

5.61. Given our decision above to apply the adjustment through the Annex 8 model, there will be a small consequential increase in the size of the EBIT and headroom allowances.[90] This increase will provide an additional allowance to mitigate any further costs related to the slight delay in recovery. It will also help to mitigate the points discussed in the 'Other implementation issues' section below in relation to working capital for delayed recovery or the risk of non-recovery if customers move away from SVTs.

5.62. Based on the factors above, we consider that recovery over 12 months protects customers better than a recovery period shorter than this, while ensuring that suppliers can recover costs in an appropriate timeframe.

Other implementation issues

Context

5.63. Suppliers raised three main additional implementation issues in response to our May 2022 consultation. These were:

- the need for working capital as a result of delayed recovery;

- the potential under-recovery of the adjustment as customers move away from SVTs; and

[90] The cap methodology calculates the EBIT and headroom allowances as a percentage of other allowances, including the adjustment allowance.

- the concept of recovering costs outside the cap (eg through a levy across domestic customers), to allow suppliers to recover their own costs.

Decision

5.64. We have decided not to add a working capital element to the adjustment. We consider that suppliers should have short-term financing facilities in place as part of their day-to-day business. As noted above, suppliers will also receive a consequential increase to the EBIT and headroom allowances as a result of our adjustment decision, which will also help to mitigate any additional costs.

5.65. We have decided not to make any provision for recovering the proposed adjustment if customers move away from SVTs. We consider that there is insufficient evidence that there will be a significant overall impact, given supplier over-recovery of the adjustment for cap period seven costs (see the 'Considerations' section below). We have also taken a range of measures to mitigate the risk of particularly low FTC prices in a scenario where wholesale prices fall. Again, the consequential increase to the EBIT and headroom allowances will also help to mitigate any additional costs.

5.66. We have decided not to develop a levy-based approach for the proposed adjustment. We provide particular reasons for this in the 'Levy' section as part of our considerations below.

Overview of responses

5.67. Suppliers made the additional suggestions (as set out in the context above) in responses to the May 2022 consultation. In broad terms, the suppliers who raised these additional suggestions considered that they would better enable suppliers to recover their costs.

Considerations

Working capital

5.68. One supplier said that if an adjustment is recovered over a 12-month period then we should include increased working capital in the calculation. It said that funding to manage cashflow impacts was not free.

5.69. We consider that any working capital cost is based on a need for suppliers to cover the additional risk of a short-term delay in payments. Suppliers should have had short-term financing facilities in place as part of their day-to-day business.

5.70. As noted above, suppliers will also receive a consequential increase to the EBIT and headroom allowances as a result of our adjustment decision, which will also help to mitigate any additional costs.

Under-recovery due to movement away from SVTs

5.71. As set out above, we have decided to recover additional wholesale costs over 12 months. We would therefore apply the adjustment over cap periods nine and ten. However, the number of SVT customers from which suppliers can recover costs may change over time. For example, if FTCs become cheaper than SVTs, we may see more customers moving from SVTs to FTCs. This could lead to under-recovery, as any cap adjustment only applies to SVT customers.

5.72. In principle, suppliers could seek to take these costs into account – at least to some extent – when pricing FTCs. We discuss this issue in the 'Benchmarking' section of Chapter 3.

5.73. Four suppliers said that there was a risk of under-recovery as customers moved away from SVTs. They suggested some potential solutions.

- Two suppliers said that we could allow suppliers to recover any shortfall through the MSC.
- Two suppliers said that we could allow suppliers to recover their costs through a separate levy, rather than the cap. (If the separate levy applied to all domestic customers, then customer movement between tariff types would not affect recovery).
- One supplier said that we could adjust customer numbers when setting the allowance (either ex post or ex ante).

5.74. As a general point, we note that suppliers are currently over-recovering the additional risk allowance for cap period seven costs (implemented by our February 2022 wholesale decision), because there are more SVT customers now than during cap period seven – see Table 8 below. This over-recovery will offset (in whole or in part) any under-recovery of the adjustment for cap period eight costs due to movement away from SVTs. This means that there is insufficient evidence at present that there is a significant overall impact on the recovery of the adjustments. The net impact will depend in particular on

when customers start moving back to FTCs. We therefore do not consider that we need to implement a mechanism now to address any potential under-recovery.

Table 8: SVT customer numbers for electricity and gas across cap periods seven and eight

Average SVT customer numbers (millions)	Electricity	Gas
Cap period seven	18.94	15.35
Cap period eight	22.13	18.14

Source: Ofgem analysis of supplier RFI data.

5.75. However, for completeness, we consider the potential solutions that suppliers raised.

5.76. The MSC is temporary. We have consulted on extending the MSC to March 2023,[91] but it would still not cover the full length of the adjustment. It therefore does not appear to be the right tool to use to recover costs. However, the MSC does play a role in reducing the likelihood of particularly low FTC prices during the period it applies, so it does reduce the risk of suppliers under-recovering costs.[92]

5.77. We discuss the levy proposal in the next section.

5.78. At this stage, we do not consider that further adjustments for customer numbers would have significant accuracy benefits. Although we have supplier forecasts for their customer numbers, these are subject to uncertainty. A more accurate adjustment would need to have ex post data, but this would have the same lag issues as a true-up (see the 'Nature of adjustment' section above).

5.79. Several suppliers said that it would not be fair for more engaged customers to be able to avoid paying for unexpected SVT demand costs by switching away from SVTs. However, given that we have decided not to adjust for changes in SVT customer numbers, there would be no impact in practice on the remaining SVT customers.

[91] Ofgem (2022), Consultation on extending short-term interventions and adjusting MSC calculation. https://www.ofgem.gov.uk/publications/consultation-extending-short-term-interventions-and-adjusting-msc-calculation

[92] See Chapter 3 for further discussion of this.

Levy

5.80. Beyond the question of addressing any potential under-recovery as a result of customer movements, two suppliers said that a levy-based approach would allow suppliers to recover their own actual costs incurred. One of these suppliers said that over- or under-compensating suppliers created a market distortion. Another supplier said that we should recover costs market-wide.

5.81. We have decided not to develop a levy-based approach to make allowance for the additional costs to suppliers. We consider that it is preferable and more coherent to adjust the cap for that purpose, taking account of our statutory objectives and all relevant factors.

5.82. Although we have taken steps in relation to the SoLR Levy to support supplier financial stability, we do not consider that broader levy mechanisms are appropriate or necessary at this time. Any levy mechanism would have to fit with the wider regulatory framework and we have made various reforms to the current framework, including this decision on wholesale allowances, to recognise the additional costs which suppliers are now facing. Whilst levy mechanisms can, in the right circumstances, be a useful part of an overall framework, they are not inherently more beneficial for customers. Even where they provide flexibility to defer costs, that would likely increase costs to consumers overall as greater interest or other financing costs were to be recovered.

5.83. For this particular decision, we have considered carefully how to give effect to our primary objective of protecting the interests of current and future consumers whilst having regard to the other relevant considerations, including the need to ensure that suppliers who operate efficiently are able to finance their activities. We have concluded that making an adjustment to the wholesale allowance in the cap is the appropriate means at this time of taking account of additional SVT demand costs of suppliers. We consider that modifying the cap in the way we propose in this decision serves our primary objective while balancing the various other matters to which we should have regard. Furthermore, to date we have used the cap as an important, coherent and transparent means of providing price protection for consumers, while making due allowance for developments in the market and wider economy. It is inevitable that some suppliers may lose or gain from adjustments to the cap, but in setting the cap level we have had careful regard to the consideration of allowing efficient suppliers to finance their activities. Developing a levy alongside the cap at this time would risk creating inconsistency or incoherence in the means by which suppliers are compensated for wholesale costs. It would also present significant practical challenges. However, in our continuing work we are keeping under review the means by which we address all the effects of fluctuations in wholesale prices.

Future reviews of allowances

Context

5.84. In this section, we discuss:

- our approach to reviews for the areas where we have not made an adjustment;[93]
- supplier feedback on changes in costs for cap period seven; and
- reviews of the enduring allowances for shaping and imbalance costs, as well as transaction costs.

5.85. In our February 2022 wholesale decision, we set out our intention to consult on amending the additional direct fuel allowance for shaping and imbalance costs.[94] In our May 2022 consultation, we asked whether stakeholders considered that a review of the additional direct fuel allowance for shaping and imbalance costs is required, given the May 2022 wholesale methodology consultation (including proposals for quarterly cap updates).[95]

5.86. In our May 2022 consultation, we did not cover the transaction costs element of the additional direct fuel allowances.

Decision

5.87. For the cost areas where we have not made an adjustment (unexpected SVT demand costs for cap period nine, and shaping and imbalance costs for cap periods eight and nine), we consider that it would be up to stakeholders to make the case for any future reviews. This is a new issue for the decision, following supplier feedback.

[93] Unexpected SVT demand costs for cap period eight, and shaping and imbalance costs for cap periods eight and nine.
[94] Ofgem (2022), Price Cap - Decision on the potential impact of increased wholesale volatility on the default tariff cap, paragraph 7.2. https://www.ofgem.gov.uk/publications/price-cap-decision-potential-impact-increased-wholesale-volatility-default-tariff-cap
[95] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 4.52. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

5.88. We have decided not to amend the adjustment for cap period seven costs to take into account new data from suppliers.[96] We do not have sufficient evidence of a material cost difference at this stage. This is a new issue for the decision, following supplier feedback.

5.89. As set out in our August 2022 wholesale methodology decision, we intend to carry out a review of the enduring values of the shaping and imbalance allowance and transaction costs allowance. We are not making any changes to these values before this. In the May 2022 consultation, we did not set out a position on future reviews.

Overview of responses

5.90. Several suppliers said that we should keep areas under review if we did not make an adjustment now. Two suppliers said that their costs for cap period seven were higher than their figures used for the February 2022 wholesale decision. Two suppliers said we should review the shaping and imbalance component of the additional direct fuel allowance. Another supplier said that we should adjust for additional transaction costs.

Considerations

Reviews for areas where we have not made an adjustment

5.91. As discussed in Chapters 3 and 4, forecast costs are subject to change given wholesale price fluctuations. For example, in relation to shaping and imbalance costs, one supplier said that we should not draw firm conclusions on the need to adjust or not until the cap periods are complete. We also note the recent increases in wholesale prices and volatility in the immediate weeks before this decision.

5.92. We will therefore remain open to representations from stakeholders about whether we should carry out future reviews for the areas where we have not made an adjustment from 1 October 2022. We consider that it would be up to stakeholders to make the case for any future reviews.

5.93. As discussed in Chapter 4, we generally consider shaping and imbalance costs over multiple cap periods. Any case for future reviews of shaping and imbalance costs would

[96] This is separate from the cap period seven backwardation review that we discuss in Chapter 1. That review was a reconsideration of existing evidence only.

therefore need to demonstrate a sustained issue, rather than just fluctuations in outturn costs.

Cap period seven costs

5.94. One supplier said that its unexpected SVT demand costs for cap period seven were significantly higher than its figures used in the calculations for the February 2022 wholesale decision. Similarly, another supplier said that it incurred further costs for unexpected SVT demand as a result of wholesale price increases in spring 2022 (ie after the February 2022 wholesale decision). It said we should allow it to recover these costs in full.

5.95. We do not have comprehensive new data for cap period seven and do not consider there is a case to reopen this adjustment. In general, we do not intend to adjust previous adjustments as this risks introducing more uncertainty for suppliers and price volatility for consumers.

Future reviews of the shaping and imbalance allowance and the transaction costs allowance

5.96. One supplier said that we should review the additional direct fuel allowances for shaping and imbalance costs, to develop an ex ante approach. It said that the current allowances use 2018 data, which is no longer applicable.

5.97. As set out in our August 2022 wholesale methodology decision, we intend to carry out a review of the enduring value of the shaping and imbalance allowance. We are not making any changes to these values before this. Please see the 'Supplier wholesale impacts' section of Chapter 3 in our August 2022 wholesale methodology decision for more detail.

5.98. We did not gather data on transaction costs as part of the RFI, or include this area in the May 2022 consultation. However, in response to the consultation, one supplier said that we should increase the transaction cost allowance. It said that costs were higher than the allowance due to:

- the costs of using an intermediary to access wholesale markets;
- increased transaction costs as a result of wider bid-offer spreads; and
- increased transaction costs on shaping, with wider bid-offer spreads having a double impact when a supplier has to buy and sell volumes to shape.

5.99. We do not have sufficient information to set a revised allowance now for transaction costs. We intend to consider the existing allowance as part of the review of the additional direct fuel allowances.

5.100. We do not consider that the reasons put forward in response to the May 2022 consultation provide strong evidence that there is a current issue. This is for the following reasons.

- We would not include cost of trading through an intermediary, as this would not be coherent with the overall cap design. The EBIT margin within the cap is based on a supplier that carries out its own trading.

- Bid-offer spreads are likely to be wider in current market conditions, but we do not agree that a supplier carrying out its own trading would see the full increase as a cost. We will consider the impact of changes in market conditions as part of our review of the additional direct fuel allowances.

Appendices

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Appendix 1 – Cost values to use in adjustment calculation

1.1. This appendix gives the cost values which we have decided to include as inputs in the Annex 8 model.

1.2. These are not the final adjustment values, as we have applied uplifts for electricity losses and unidentified gas in the Annex 8 model. See Appendix 7 for more information on our calculation steps. We have published the revised Annex 8 model alongside this decision. This includes the final adjustment values by fuel, after applying uplifts for electricity losses and unidentified gas.

1.3. Given our decision to apply the adjustment over 12 months, the values below will affect the calculation of allowances for cap periods nine and ten.

Table A1.1 – Cost values to use in adjustment calculation

Consumption level	Payment type	Fuel	Cost value (£/customer)
Nil	All	Both	0
TDCV	PPM	Both	0
TDCV	Non-PPM	Gas	23.38
TDCV	Non-PPM	Electricity	15.57

Notes: Non-PPM values will apply to both Other Payment Method (ie direct debit) and Standard Credit). The same electricity values will apply to both single-rate and multi-register metering arrangements.

Appendix 2 – Consideration of additional supplier comments

1.1. This appendix contains our consideration of additional supplier comments. These are points which we do not address in the main body of the decision document, and which do not fall within the topics discussed in other appendices.

1.2. As set out in Chapter 3, we also specifically engaged during the May 2022 consultation with representatives from consumer groups and charities on this issue.

Consultation process

1.3. One supplier said that we should provide a disclosure process for unexpected SVT demand costs and shaping and imbalance costs – or otherwise explain why disclosure would not be appropriate. It said that such disclosure processes had allowed suppliers' representatives to provide useful feedback on other models.

1.4. We have used disclosure processes for some other workstreams related to the cap (such as the true-up for debt-related costs resulting from COVID-19). However, we did not carry out a disclosure process alongside the May 2022 consultation.

1.5. When reaching this position, we took into account two pieces of context.

- The calculation steps were sufficiently limited that we could explain them in the May 2022 consultation.[97]

- We carried out our work on a possible wholesale adjustment to respond to market developments, at a significant pace. In particular, we saw the May 2022 consultation as an opportunity for suppliers to provide additional data,[98] recognising that we set a two-week response period for the RFI.[99] The

[97] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, Appendices 2 and 3. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[98] See for example Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 2.2. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[99] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.17. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

evidence base available at the time of the May 2022 consultation could therefore have been only part of the evidence base used for the decision.

1.6. Given this context, we did not consider that a disclosure process would be proportionate. There would also have been practical challenges in setting up a disclosure process for a new work area.

1.7. In the event that we carry out future reviews, we will consider whether to carry out a disclosure process, taking into account the circumstances at the time of any such reviews.

Comments on other policies

1.8. Several suppliers provided comments on other Ofgem policies, including the MSC, which responds to the risk of falling wholesale prices, and the May 2022 wholesale methodology consultation. These areas were out of scope for the May 2022 consultation. In particular, we note that the risk of unexpected SVT demand costs, as discussed in the May 2022 consultation and this decision, relates to rising wholesale prices. We have already considered the risk of falling wholesale prices separately through our work on the MSC.

1.9. Several suppliers also provided comments on other cap methodology reforms that they consider are needed. Again, these areas were out of scope for the May 2022 consultation.

Risk of supplier failure

1.10. Two suppliers said that we should ensure that suppliers could recover costs to prevent further supplier failures, which would increase costs to customers.

1.11. We discuss the risks of supplier failure and the impact on customers in Chapter 5 in relation to the duration over which to apply an adjustment. Similar considerations apply and have been taken into account at appropriate points across this decision.

Appendix 3 – Additional consideration of supplier comments on non-efficiency and efficiency factors

Additional general comments

Forecasting wholesale price movements

1.1. One supplier said that it was unrealistic to expect that even an efficient supplier could have accurately predicted market developments, including the level of wholesale prices relative to the cap. Similarly, another supplier said that experience of incurring unexpected SVT demand costs did not make a supplier better able to forecast prices.

1.2. We do not expect that an efficient supplier would be able to forecast future wholesale price movements. In the May 2022 consultation, we said that "suppliers cannot reliably predict future changes in wholesale prices".[100]

1.3. However, suppliers would have forward prices as an indication of the wholesale market's expectations for wholesale prices. Suppliers would be able to take these forward prices into account in their demand forecasting and hedging decisions.

Impact of benchmarking approach

1.4. One supplier said that a low-cost benchmark could encourage risk-taking by suppliers.

1.5. In line with our February 2022 guidance letter, we expect suppliers to make prudent risk management decisions. We consider that our choice of benchmark supports this position. If we had instead continued to make adjustments using a weighted average benchmark, then in a rising market this would provide suppliers with an incentive to make less prudent risk management decisions.

Additional comments on non-efficiency factors

Natural variation

1.6. One supplier said that we could carry out benchmarking over a longer time period to reduce the impact of natural variation on suppliers' costs. However, it said that any such

[100] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.5. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

benchmark would still be dominated by the impact of costs from recent wholesale price volatility.

1.7. We do not have data to carry out benchmarking over a longer time period, as we do not have data on unexpected SVT demand costs in normal circumstances. In addition, we expect that such data would be difficult to collect, as we expect that the effects of unexpected SVT demand would be small in normal circumstances.

1.8. One supplier said that there was not enough data on suppliers' forecasting performance at times of high volatility to assess whether low costs were the result of efficiency or luck. It said this indicated that we should use a weighted average benchmark.

1.9. We do not agree with the implication that a weighted average benchmark is the default – as set out in Chapter 3, we generally use a benchmark at or near the lower quartile in the cap. We have to make a judgement on the best benchmarking approach to take in the circumstances, and we have done this having regard to our statutory objectives.

Additional comments on efficiency factors

Incentives for efficiency

1.10. One supplier said that suppliers have an incentive to forecast SVT demand accurately. It therefore said that, unless there is evidence to the contrary, there should be a presumption that suppliers have acted efficiently. Similarly, another supplier said that if suppliers have been able to manage risks more efficiently with additional time, then this would be reflected in the data for cap period eight.

1.11. We do not agree. Across their businesses, suppliers all have incentives to be efficient, but this does not mean that they will achieve equally efficient outcomes. Similarly, even though all suppliers had the opportunity presented by additional time to refine their risk management approaches, this does not mean that they would take advantage of this to the same extent.

Interpretation of efficiency

1.12. One supplier disagreed with our statement on the interpretation of efficiency in the May 2022 consultation.[101] It said that there was no reason why higher cost approaches were likely to be riskier. It also said that suppliers with lower costs would bring down a weighted average benchmark, meaning that customers would benefit.

1.13. In the paragraph mentioned from the May 2022 consultation,[102] we were not suggesting that approaches with high costs are necessarily the result of risky strategies. We were making an introductory point that the variability of outturn costs was part of our interpretation of efficiency when considering an adjustment to the cap. In this context, we noted that suppliers' strategies could affect the variability of outturn costs.

1.14. When we said that customer benefits would be unlikely, we referred to "circumstances where the strategies led to low costs". We did not intend this as a statement about the costs that materialised as a result of actual wholesale prices. We agree that, to the extent that a supplier's strategy led to low costs in practice, these would be reflected in a weighted average benchmark. Rather, in a different set of circumstances (ie under different wholesale prices), a risky strategy could have led to low costs. However, for customers to have benefitted from this low-cost outturn, this would have required a downward adjustment to the cap. Unless we made such downward adjustments, there would be an asymmetry where customers would pay for risky strategies where these led to high costs, but would not benefit when these led to low costs.

Alternative explanation for low costs

1.15. In response to the May 2022 consultation, one supplier said that achieving low costs in a volatile market could be a consequence of imprudent risk management.

1.16. We have not identified features of suppliers' approaches which would support this view.

[101] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.33. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment
[102] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.33. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

Evidence base

1.17. One supplier said that there was no evidence of any material variation in costs driven by efficiency factors.

1.18. We have reviewed the impact of specific efficiency factors and set out our comments in Chapter 3. However, we also note that we generally use a benchmark at or near the lower quartile in the cap.

Changes to forecasting, trading and hedging approaches

1.19. One supplier said that it disagreed with the implication in our May 2022 consultation that volatile wholesale prices could have led suppliers to carry out forecasting and hedging more efficiently. It said that volatility does not mean that the efficient approach has changed.

1.20. We consider that the current market circumstances should have prompted suppliers to reflect on whether their previous approaches remained appropriate. From the evidence provided by suppliers, we have examples of suppliers making changes to their approaches.

1.21. One supplier said that, when considering suppliers changing their approaches, we had not provided evidence that suppliers acted inefficiently in cap period seven. It said that we had approved an adjustment for cap period seven costs on the basis that these were efficiently incurred.

1.22. Our February 2022 wholesale decision implemented an adjustment for costs relating to cap period seven. However, at the same time we published our February 2022 guidance letter, which set out an expectation that suppliers would respond to now-known risks. We therefore signalled that we would not necessarily take the same approach for any future adjustments as we had for cap period seven.

1.23. One supplier said that even if suppliers had experience of volatility and had started to forecast more frequently, the context was no more certain than previously.

1.24. We accept that suppliers are continuing to face wholesale price volatility. However, as set out in our February 2022 guidance letter, we expect suppliers to respond to now-known risks.

Proportion of expected demand hedged

Supplier comments

1.25. One supplier said that suppliers would have faced downside risk regardless of whether prices increased or decreased. It therefore said it was not more risky to purchase energy for customers at the point they moved to SVTs, rather than hedging to expected SVT demand. Another supplier set out the impact of hedging above, at or below its central forecast for customer numbers, in different wholesale price scenarios.

1.26. Two suppliers said that the MSC was only confirmed in February 2022, after the end of the observation window for cap period eight costs. They also said that the calibration of the MSC (as proposed or as confirmed in February 2022) would only have protected suppliers from extreme downward market movements, leaving large risks for suppliers to manage. One of these suppliers also said that risks were only partially mitigated through the changes to the MSC, so suppliers had to consider the risks of falling prices.

Considerations

1.27. Suppliers had to hedge in a context where they could incur costs in a rising or falling market. Any such costs would result from changes in customer numbers as customers responded to changes in wholesale prices.

1.28. In principle, a supplier could use the proportion of expected demand hedged as a tool for mitigating this risk. As set out by one supplier, a supplier could hedge above, at or below its expected customer numbers.

1.29. If the risks were symmetrical, then hedging at expected customer numbers could be preferable. The expected costs (across different wholesale price scenarios) might or might not be lower than the alternative hedged positions, but the variability of costs could be lower. The table below shows a stylised view of impacts.

Table A3.1 – Stylised view of impacts under different wholesale price scenarios and hedged positions

	Price increases	Price flat	Price falls
Hedge above expected customer numbers	No impact – hedged position covers increased movement of customers to SVTs	No impact from timing of purchases	Very negative impact – sell back large excess volume at a loss
Hedge at expected customer numbers	Negative impact – buy volume at a higher price for additional unexpected SVT customers	No impact from timing of purchases	Negative impact – sell volume at a loss relating to expected SVT customers who moved away from SVTs
Hedge below expected customer numbers	Very negative impact – cover short position on expected customers and buy volume for additional unexpected SVT customers	No impact from timing of purchases	No impact – hedged position already reflects movement of customers away from SVTs

1.30. However, if the impacts were not symmetrical, then this could provide a case for not hedging to expected customer numbers. There are several factors which could affect the impacts.

1.31. The **numbers of customers expected to be on FTC and SVT** would affect the number of customers who could move unexpectedly between tariff types if wholesale prices changed.

1.32. The **impact of price changes on customer movements** does not need to be symmetrical (for a price change of a given size). For example, customer movements may be particularly affected by whether a wholesale price change means that the SVT is the cheapest tariff.

1.33. **Policy interventions** (in particular the MSC) affect the impacts of wholesale price changes. The introduction of the MSC, and changes to its parameters, would affect the impacts of a wholesale price fall. As set out in the 'Benchmarking' section of Chapter 3, we

have also made further interventions to support market stability, beyond the MSC. These interventions reduce the risk of customers moving away from the SVT in a falling market.

1.34. A supplier could have a view that the impacts were not symmetrical, without taking a view on whether prices were more likely to rise or fall. If a supplier chooses to take a view on the direction of wholesale prices, then we do not consider that it should be compensated by customers in the event that wholesale prices move in the opposite direction.

Conclusion

1.35. Given the considerations above, we do not consider that hedging at a different level from expected SVT demand is necessarily a clear source of inefficiency. However, we would expect a supplier to make careful judgements when considering whether to hedge at a different level.

Appendix 4 – Detail on unexpected SVT demand analysis

Supplier evidence submitted

1.1. Following our March 2022 RFI, ten suppliers submitted evidence on unexpected SVT demand costs they had experienced and/or were expecting to incur for cap periods eight and nine. One supplier provided a nil return due to its wholesale purchasing arrangements. We have included this case as a zero value in our calculations – although see our discussion of the lower quartile calculation below.

1.2. In response to our May 2022 consultation, an additional supplier also provided data on unexpected SVT demand costs for these two cap periods, increasing our total sample of suppliers who submitted data to eleven.

1.3. We excluded one supplier from our cap period eight analysis and two from our cap period nine analysis. We excluded suppliers due to:

- **incomplete data**: a supplier considered that it was unable to provide cost forecasts at this stage for cap period nine given uncertainties; and
- **unrepresentative data**: a supplier forecasted costs which were unrepresentative given its unique circumstances.

1.4. The included data represents a significant majority of the SVT customer base for both cap periods – albeit with more data for cap period eight than cap period nine.

1.5. Suppliers provided evidence regarding the split of unexpected SVT demand costs between fuels (gas and electricity) and payment types (PPM and non-PPM). A small number of suppliers did not provide cost estimates by payment type but did provide justifications. Where necessary, we have made assumptions based on suppliers' responses to allocate total costs between payment types.[103]

[103] Similarly, one supplier did not provide average annual consumption values by payment type. In this case, we have assumed that the average consumption is the same across payment types.

1.6. Following the May 2022 consultation, we have reviewed suppliers' approach to allocating costs between payment types. We have made three types of changes as a consequence.

- We received a revised split from one supplier after a follow-up question, which we have used in our analysis.

- We have reallocated two suppliers' reported PPM unexpected demand costs to non-PPM. One of these suppliers had allocated unexpected SVT demand customers between payment types based on the proportion of PPM customers within its customer base. Given that it did not have PPM customers on FTCs in October 2021, it would not have incurred PPM unexpected SVT demand costs. Similarly, the other of these suppliers also did not have PPM customers on FTCs in October 2021.

- One supplier had given an upper bound for the proportion of total unexpected SVT demand costs which related to PPM. For the May 2022 consultation analysis, we had used this figure directly. We have now refined our approach, by using the mid-point between zero and the upper bound provided. We consider that this is a better way to reflect the information provided by the supplier in our analysis, given that this was an upper bound.

1.7. The overall impact of reallocating costs between PPM and non-PPM is to reduce reported PPM costs and increase reported non-PPM costs. We consider that this is likely to be a more accurate allocation of the costs suppliers incurred than the approach in our May 2022 consultation analysis.

1.8. We have sought to avoid suppliers including any costs which they will reasonably recover through the SoLR levy claims process. We consider that this is met.

1.9. One supplier said that it was expecting a higher number of SVT customers than previously for cap period nine, as a result of regulatory changes (such as the ban on acquisition tariffs) and an expectation that FTC prices would include higher margins than previously.

1.10. Changes in expected SVT customer numbers would only create unexpected SVT demand costs if these occurred since the start of the observation window. This was the

start of February 2022 for cap period nine. We do not expect the factors mentioned to have changed significantly since February 2022.

- We published the ban on acquisition tariffs decision in mid-February 2022 (ie near the start of the observation window),[104] and had already consulted on this policy.[105]

- We are unclear why suppliers' target FTC margins (on a per customer basis) would have changed since February. For example, we had already signalled our programme of regulatory reform in October and December 2021.[106]

Variation in suppliers' methodologies

1.11. In the March 2022 RFI, we asked suppliers to provide the methodologies used to calculate their reported estimates. Suppliers provided varying levels of detail to allow us to understand their estimates. Based on the information received, we understand that suppliers have taken different calculation approaches. However, we have not identified fundamental differences between approaches (for the suppliers who provided detailed explanations).

1.12. In our calculations, we have not made any adjustment to the reported figures considering these methodological differences.

[104] Ofgem (2022), Decision on short-term interventions to address risks to consumers from market volatility.
https://www.ofgem.gov.uk/publications/decision-short-term-interventions-address-risks-consumers-market-volatility
[105] Ofgem (2021), Statutory consultation on potential short-term interventions to address risks to consumers from market volatility.
https://www.ofgem.gov.uk/publications/statutory-consultation-potential-short-term-interventions-address-risks-consumers-market-volatility
[106] Ofgem (2021), Rising wholesale energy prices and implications for the regulatory framework.
https://www.ofgem.gov.uk/publications/rising-wholesale-energy-prices-and-implications-regulatory-framework
Ofgem (2021), Action plan on retail financial resilience.
https://www.ofgem.gov.uk/publications/action-plan-retail-financial-resilience

Weighted average methodology

Calculation of cost per customer at benchmark level of consumption

1.13. As part of the RFI template, we included automated calculations to convert suppliers' estimates from their own annual average consumption level to benchmark consumption.[107] This is one of the refinements that we were able to make through issuing a standardised RFI.

1.14. We have calculated the number of expected SVT customers by fuel (gas and electricity) and payment type (PPM and non-PPM), as described in the section below.

1.15. For each of the suppliers that provided cost estimates (split by fuel and payment type), we have divided each cost estimate by the respective numbers of expected SVT customers. We did this to estimate the cost per SVT customer.

Calculation of customer numbers

1.16. Our main data source was the expected numbers of default electricity and gas accounts in the relevant timeframe from the Financial Responsibility Principle RFI (version dated 11 April 2022).

1.17. However, the data in this RFI does not include a payment type split. We therefore used the data provided by each supplier in the Customer Account and Tariff April 2022 RFI to calculate the weights of PPM and non-PPM SVT customers. We then applied these weights to the expected SVT customer numbers from the Financial Responsibility Principle RFI.

1.18. In the May 2022 consultation analysis, we used data from the Customer Account and Tariff October 2021 RFI for the weights of PPM and non-PPM SVT customers. We said that we would not expect these proportions to change significantly over this period.[108] We now consider that this is incorrect, because PPM and non-PPM customers move onto SVTs at different rates. Non-PPM customers will therefore represent an increased proportion of SVT customers over time. We have therefore used the latest available data from the Customer

[107] Benchmark consumption is based on the consumption values of 3,100 kWh for electricity and 12,000 kWh for gas.
[108] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, Appendix 1, paragraph 1.13.
https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

Account and Tariff RFI, and have aligned this to the date of the Financial Responsibility Principle RFI.

1.19. We also assumed that the proportion of customers using credit or PPM remain static over time. We do not have alternative data for the future weights of PPM and non-PPM customers. We consider that using the April 2022 data is a reasonable approximation. In particular, many customers have already moved between FTC and SVT, meaning that the issue of different rates of change for the proportion of customers on SVTs between PPM and non-PPM should be less important. However, the customer numbers themselves are not static over time, as suppliers provided a profile of expected customer numbers.

Calculation of weighted average costs

1.20. Using the cost per SVT customer figures, we applied weights based on suppliers' numbers of SVT customers (for the relevant fuel and payment type) to calculate the weighted average costs.

1.21. The weighted average values were £45.15 per dual fuel SVT customer for non-PPM and £4.04 per dual fuel SVT customer for PPM in cap period eight. The equivalent values were £4.59 for non-PPM and £0.65 for PPM in cap period nine.

Lower quartile methodology

1.22. The lower quartile methodology was the same as for the weighted average, except as described below.

Calculation of lower quartile costs

1.23. Before calculating the lower quartile of each supplier's cost per SVT customer figures, we excluded suppliers who are PPM-focussed from the non-PPM lower quartile calculation. This was to reduce the risk of suppliers with few or no non-PPM customers affecting the calculation.

1.24. We also excluded one additional supplier from the lower quartile calculation. This is a change to our May 2022 consultation analysis. As set out in the 'Supplier evidence submitted' section above, one supplier provided a nil return due to its wholesale purchasing arrangements. In response to the May 2022 consultation, one supplier said that we should satisfy ourselves that this reflected genuine economic costs.

1.25. We consider that it is correct to include the supplier's data as a zero value in the calculation of the weighted average, given that this represents the costs it incurred. However, we consider that including this zero value could unduly influence the lower quartile, as we do not consider that this zero value results from a replicable source of efficiency. While using a lower quartile benchmark would already reduce the influence of this zero value (for example compared to a frontier benchmark), on balance we do not consider that this mitigates the impact sufficiently. This is a judgement in the context of this data, especially given the number of suppliers included.

1.26. After these exclusions, we then calculated the lower quartile.

1.27. We have reported the lower quartile dual fuel costs in Chapter 3.

1.28. These lower quartile values are higher than those reported in the May 2022 consultation. This is largely the result of a calculation error, which we have now corrected.

Appendix 5 – Cost offsets

1.1. This appendix provides further information on cost offsets.

- We consider general supplier feedback on cost offsets.
- For the 1% additional risk allowance and the switching benefit, we consider detailed supplier feedback and explain how we estimated the potential cost offsets.
- For the other indexed allowances, we consider detailed supplier feedback and explain our assessment of how costs would change relative to these allowances.
- We also consider supplier comments on other allowances.

General feedback on offsets

1.2. One supplier agreed in principle that we should consider whether costs could be offset.

1.3. One supplier said that we were selectively reviewing costs. It said that we should only look at cost offsets which were material. It also said that we should consider other costs which have materially and systematically diverged from allowances.

1.4. We do not agree with this characterisation of materiality. We have considered whether increased wholesale prices have changed suppliers' efficient costs in a material and systematic way. In principle, the materiality of the net impact on suppliers' efficient costs could depend on both reported costs and any cost offsets. We have considered the additional supplier evidence on other costs incurred from increased wholesale prices, so we do not agree that our review was selective.

1.5. One supplier said that it was not appropriate to offset against some existing allowances unless all costs are addressed in full.

1.6. As set out in the May 2022 consultation, we are considering costs linked to higher wholesale prices – we do not consider that we need to reconsider all elements of the cap

methodology when considering changes to one element.[109] Suppliers have had the opportunity through the May 2022 consultation to provide us with information about any other costs linked to higher wholesale prices which we had not included in our considerations.

1% additional risk allowance

Consideration of detailed supplier feedback

1.7. One supplier said that we would need to review all costs linked to current market volatility if we were to offset against the 1% additional risk allowance.

1.8. We have considered how costs have changed following increases in wholesale prices. However, in order to make any adjustment in time for implementation in October 2022, we need to proceed based on the information available to us - this applies to our consideration of both suppliers' reported costs and potential cost offsets.

1.9. One supplier said that wholesale market liquidity has reduced, preventing suppliers from hedging in line with the cap and requiring the use of proxy hedges. It said that this and other risks meant that the 1% additional risk allowance was already exceeded.

1.10. We have not carried out a detailed assessment of changes in wholesale market liquidity. However, to the extent that there had been any changes, we accept that this could be a relevant factor affecting the 1% additional risk allowance.

1.11. One supplier said that any offset against the 1% additional risk allowance would be small, and so might not be feasible to measure accurately. We do not consider that the size of a potential offset automatically affects whether it can be measured accurately.

1.12. One supplier said that suppliers were still incurring costs resulting from other Ofgem policies, referring to the deadband for backwardation costs and the MSC parameters. We do not consider other policy decisions here, as they are covered in other policy decisions running in parallel to this workstream.

[109] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.59. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

Calculation steps

1.13. We calculated the annual core direct fuel cost by multiplying the wholesale index value (in £/MWh) by the benchmark consumption used in the cap (in MWh). In annual terms, the 1% additional risk allowance is then equal to 1% of the annual core direct fuel cost.

1.14. We calculated the value of the 1% additional risk allowance over cap period eight (a summer season), by multiplying by the proportion of consumption in summer. We used the seasonal consumption value from the Annex 2 cap model.

1.15. In line with the position described in Chapter 3, we calculated the offset as 10% of the value of the additional risk allowance over cap period eight. 10% is the length of cap period eight as a proportion of the current length of the cap.

Switching benefit – consideration of supplier feedback

1.16. Suppliers raised three main issues in relation to the switching benefit. These related to:

- the sales and marketing costs included in the operating cost benchmark;
- the prospect of a rebound in future switching rates; and
- the costs of sales teams.

1.17. We discuss these issues in turn below. We also consider other points from suppliers.

Operating cost benchmark

1.18. One supplier said that the cap did not include sales and marketing costs for SVT customers, as we had already taken lower costs for these customers into account in our 2018 decision.[110] It therefore said that there was no allowance which could be offset.

[110] Ofgem (2018), Default tariff cap: decision – overview, Appendix 6, paragraph 3.46. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

1.19. Our operating cost benchmark was based on suppliers' operating costs across domestic customers (ie including both SVT and FTC customers). The benchmark therefore included sales and marketing costs as a starting point.

1.20. As noted by the supplier, in our 2018 decision we then considered lower sales and marketing costs for SVT customers as an offsetting factor for features which could cause them to have higher costs (eg greater offline account management). We therefore could only include a switching benefit to the extent that there is a sales and marketing cost included in the operating cost benchmark which we have not already offset through our 2018 decision.

1.21. However, we do not agree that there are no sales and marketing costs in the operating cost benchmark for SVT customers. Suppliers incur sales and marketing costs with the aim of receiving benefits from the customer relationship over a period of time. (In our 2018 decision, we amortised customer acquisition costs over a five-year customer term).[111] This includes the case where a supplier acquires a customer on a FTC, but the customer moves to an SVT during the period while its customer acquisition costs are still being amortised.[112]

1.22. We therefore consider that there are still some sales and marketing costs within the operating cost benchmark which could be offset. However, we recognised in our 2018 decision that it was hard to allocate some sales and marketing costs between customers.[113] This means that any amount to offset would be an approximation.

Future switching rates

1.23. Four suppliers said that switching rates were likely to increase in future to above-average levels. This would mean that suppliers would incur higher costs in future, offsetting any current benefit. Several of these suppliers referred to this as a postponement of switching.

[111] Ofgem (2018), Default tariff cap: decision – overview, Appendix 6, paragraph 3.55. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[112] We refer to amortisation in line with the approach taken to assessing sales and marketing costs on a comparable basis across suppliers in our 2018 decision. We recognise that suppliers' accounting treatments of sales and marketing costs differ. Ofgem (2018), Default tariff cap: overview document, Appendix 6, paragraph 2.81. https://www.ofgem.gov.uk/publications/default-tariff-cap-overview-document
[113] Ofgem (2018), Default tariff cap: decision – overview, Appendix 6, paragraph 3.46. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview

1.24. We accept that switching could increase above the average level for a period. However, there is uncertainty about when switching levels might increase and the extent to which these would be above the historical average. We expect that the timing of any switching increase would largely depend on wholesale price trends. The size of any switching rebound might depend on a number of factors, such as: the savings available (including as a result of the MSC), the extent to which customers switch externally rather than switching tariffs with their current supplier, whether financial pressures encourage customers to engage, and whether customers' attitudes to switching have changed.

1.25. Even if there is a switching rebound, this would not necessarily be sufficient to eliminate the switching benefit from the period of below-average switching. There could still be a reduction in the cumulative costs of switching, as customers would not have switched for a period. We therefore consider the scale of any potential switching rebound in the 'Switching benefit methodology' section below, but do not consider that this means that the switching benefit is zero.

Sales teams

1.26. Two suppliers said that they had incurred costs of closing down sales teams, and would incur future costs of re-establishing them once switching restarted.

1.27. We accept that suppliers would incur some costs from changing the scale of their sales activities. However, we noted in the May 2022 consultation that suppliers could incur internal administrative cost savings (depending on the extent to which staff and resources could be reallocated).[114] We did not quantify these as part of our initial estimates.

1.28. We recognise that there could be knock-on impacts on suppliers' operations, which could reduce the administrative cost savings. For example, with a greater number of customers on the SVT, suppliers will need to issue more price increase notifications than previously. This would lead to costs of sending letters and of receiving contacts from customers as a result.

1.29. In the round, we do not consider that administrative costs are likely to be a significant issue, although we recognise that this is subject to uncertainty.

[114] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 3.72. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

Other supplier comments

1.30. One supplier said that we had calculated estimates based on broad assumptions without gathering data from suppliers. It also said that the market had changed significantly since the 2017 data used to set the operating cost allowance.

1.31. We consider that our approach to consulting on this potential cost offset was appropriate. We put forward an estimate with a clear methodology explanation and invited stakeholders to provide further evidence.

1.32. We also do not consider that any general changes in operating costs since 2017 are relevant to this decision, as we are focussed on changes relating to increased wholesale prices.

Switching benefit methodology

1.33. We used two different approaches to estimate the switching benefit – a bottom-up approach and a top-down approach. This is unchanged from May 2022 consultation. Following supplier feedback, we refined our methodology to consider savings relative to an estimate of the sales and marketing costs related to SVT customers, and to take into account a possible rebound in the switching costs in the future.

1.34. This section provides details of our estimation approach.

Bottom-up approach

1.35. This approach has three main elements: the change in switching since 2017; the proportion of switches completed through price comparison websites (PCWs); and the commission per switch.

1.36. We estimated the change in switching using industry data on electricity switching.[115] We used a 2017 baseline, because this was the year of the data used to calculate the operating cost allowance in the cap. The data source used included both domestic and non-domestic switches in 2017, so we used the same scope when looking at the most recent switching data (the first five months of 2022). We consider that this is acceptable because of the small relative size of the non-domestic segment. We estimated 2022 switching by

[115] We do not consider that it is a significant limitation that the data only covers electricity, because the majority of domestic switches are dual fuel, so switching rates should be similar across fuels.

assuming that switching continued at the same rate over the remainder of the year as in the first five months.[116] In the May 2022 consultation we used switching data from the first three months of 2022 to develop our estimate, but we have now been able to incorporate additional data.

1.37. We estimated the proportion of switches completed through PCWs using Ofgem survey data from 2019. This is the most recent point when the relevant questions were included.[117] In any case, this sits between 2017 and 2022, and may therefore be a broadly appropriate assumption for both years.

1.38. We used public statements by PCWs from 2015 as an estimate of the PCW commission per fuel switched. There is limited data available publicly on PCW commission, due to commercial confidentiality. In the May 2022 consultation, we said that we welcomed any more recent data from suppliers that would help us to refine this estimate,[118] but we did not receive any such information.

1.39. We multiplied the three main elements together to calculate an annual benefit from reduced switching (in £). We converted this to a benefit per meter point, using the number of domestic and non-domestic meter points (for consistency with the switching data).

1.40. We converted this to a benefit (per meter point) over a six-month cap period, by dividing the annual benefit by two. We converted to a dual fuel benefit (over a six-month cap period) by multiplying by two. Finally, we adjusted for inflation between the year of the cost figures and 2022.

Top-down approach

1.41. This approach used data on operating costs that suppliers provided in response to a 2018 RFI, at the point we were designing the cap. As part of this RFI, suppliers provided

[116] Given that our estimate of the switching benefit relates to cap period eight, in effect we are only assuming that switching would continue at the same rate over cap period eight. We consider it reasonable to assume that switching is likely to remain low during cap period eight, given current wholesale prices mean that the cap is the cheapest tariff available.
[117] We used the percentage of customers who found out about deals through a PCW when they last switched, and, of customers who switched through a PCW, the percentage who completed the switch through a PCW. We multiplied these figures together. This is because a commission would not be payable when a customer found out about deals through a PCW, but completed the switch in another way.
[118] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, Appendix 2, paragraph 1.9.
https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

data on third party commissions in 2017. The scope of this data may be slightly broader than under the bottom-up approach, as the RFI defined third party commission costs as "brokers' costs and intermediaries' sales commissions".

1.42. We took the lower quartile of this data for the suppliers included in the 2018 operating cost analysis. We used a lower quartile to broadly align with the efficiency benchmark we used to calculate the operating cost allowance.[119] This gives us a cost per dual fuel customer.

1.43. We used the same switching data as described in the bottom-up approach. We converted this to a percentage change in switching. We applied this to the cost per dual fuel customer, to give an estimate of the annual saving per dual fuel customer.

1.44. We converted this annual saving to a benefit during a six-month cap period, by dividing by two. Finally, we adjusted for inflation between 2017 (the year of the cost data) and 2022.

Combining methodologies

1.45. We do not consider that there is a strong reason to prefer one of the methodologies we set out. Averaging the results of the two methodologies to take a mid-point may therefore be appropriate.

1.46. This gives a benefit of £2.24 per dual fuel customer during cap period eight, before the further adjustments below.

Adjustment for 2017 benchmark

1.47. We do not have data on the sales and marketing costs relating to SVT customers in 2017 (the year of the operating cost benchmark). However, we can estimate this.

1.48. We considered a proxy for the proportion of SVT customers for whom a supplier might be amortising sales and marketing costs. We have data on whether customers have been on an SVT for three or more years, or less than three years. To make use of this data, we assumed that customers who had been on an SVT for three or more years would have

[119] We set the operating cost benchmark at the lower quartile minus £5. We do not consider it necessary to take the £5 deduction into account, as it represents a small proportion of the overall operating cost allowance.

no sales and marketing costs being amortised, as it would be at least four years since they were acquired. We assumed that the remainder of SVT customers would have sales and marketing costs being amortised.

1.49. We therefore calculated the proportion of SVT customers in 2017 who had been on an SVT for less than three years.[120] This was 43%. We included this proportion of the average switching benefit to reflect the sales and marketing costs associated with SVT customers.

Adjustment for switching rebound

1.50. We considered a number of scenarios for a potential switching rebound. These scenarios are based on the time when switching restarts and the expected number of customers switching. All scenarios considered were subject to uncertainty.

1.51. For the purpose of estimating the switching benefit, we considered that a balanced scenario involved a switching rebound in January 2023, driven by customers who did not switch in cap period eight but would normally have done so.[121] This is an illustrative scenario for the purpose of this analysis only. We considered that this was appropriate for the following reasons.

- It is unlikely that we would see significant switching in October 2022, given current forward prices are above those observed during the indexation window for cap period 9A (October to December 2022). Therefore, the earliest switching is likely to be from January 2023 (cap period 9B, which runs from January to March 2023), or later.

- In principle, previously engaged customers who did not switch during cap periods seven or eight might be likely to do so once cheaper tariffs are available. However, it would be a strong assumption that they would all do so immediately.

1.52. Under this scenario, we calculated the extent to which the reduction in switching in cap period eight would be offset by the switching rebound. We only considered the impact of the switching rebound within a year from the middle of cap period eight – ie the year

[120] We calculated this using data from: Ofgem (2017), State of the Market 2017, figure 2.7. https://www.ofgem.gov.uk/publications/state-energy-market-2017
[121] We calculated this by taking the difference between the baseline number of switches for six months in 2017 and the assumed number of switches in cap period eight.

starting in July 2022.[122] This reflected that if a rebound was delayed beyond this, it would be equivalent to skipping a switch (for a customer who switched each year).[123] In that case, suppliers would save the full cost of a switch. Even where a customer switched partway through the year starting in July 2022, there would still be a saving from the months where the customer did not switch.

1.53. We calculated the remaining switching benefit as a percentage. This was 50%. We applied this to the average switching benefit (after the previous adjustment).

Offsetting against other indexed allowances

EBIT

1.54. In response to the May 2022 consultation, one supplier said that the risks suppliers face were higher than when setting the EBIT allowance originally. Another supplier said that a supplier's required working capital would increase when its costs increased. It said that any offset would reduce the EBIT margin below a normal rate of return.[124]

1.55. The cap's EBIT margin is calculated using an estimate of capital employed and a 10% nominal pre-tax cost of that capital.

1.56. Increased wholesale prices will affect elements of a supplier's capital base in different ways.

- Some of the capital employed relates to fixed assets (eg vans) or intangible assets (eg IT software or customer relationships). These would not be affected by wholesale prices.

- Some of the capital employed relates to working capital – eg to manage the timing of payments, to provide capital for trading, or to provide cash balances to manage risks. The former category is likely to scale with customers' bills. The latter two are likely to scale with wholesale prices.

[122] The start of July 2022 is the mid-point of cap period eight.
[123] We consider that this is a reasonable assumption because the most common length for a FTC is one year.
[124] The normal rate of return is a standard economic concept, reflecting the minimum profit that providers of capital require, given the risks involved and the amount of capital employed.

1.57. The EBIT margin in the cap increases at a single rate. This will overstate the growth of parts of the capital base and understate the growth of other parts. It would not be straightforward to demonstrate that the allowance had increased faster than costs – this would require detailed information on a supplier's capital base.

1.58. One supplier said that the cost of capital had increased. The position above does not require us to take a view on whether the cost of capital has changed as a result of market developments.

1.59. Some suppliers said the EBIT allowance was understated. Given the position above, we have not sought to reach a conclusion on this point.

Headroom

1.60. In response to the May 2022 consultation, one supplier said that the risks suppliers face were higher than when setting the headroom allowance originally. Another supplier said that an increase in the absolute level of costs would increase the absolute size of the uncertainties that headroom was designed to cover, so we should not use headroom as an offset. One supplier said that examples of increased risks included increased bad debt and increased Renewables Obligation (RO) mutualisation. Another supplier referred to RO mutualisation and mutualised gas charges.

1.61. The headroom allowance takes into account a wide range of cost and risk items.

1.62. We have considered each individual item we mentioned when setting headroom in the 2018 decision, and how these might change as a result of increased wholesale prices. There are a mixture of impacts across these items, summarised at a high level below.

- A couple of items (volume risk and backwardation) would already be addressed by proposed policy changes.

- Some items would not be affected by changes in wholesale prices (eg items relating to policy costs which do not depend on wholesale prices, such as the CM or Data Communications Company charges).

- Some items would broadly scale with wholesale prices (eg the impact of including Balancing Services Use of System charges in the cap with a lag).

- Some items would scale with wholesale prices and could increase at a faster rate than this (eg wholesale market liquidity impacts or risks linked to extreme weather).

1.63. Overall, there is no clear evidence that there is a material difference between the growth in allowances and the growth in costs.

1.64. As in relation to EBIT, some suppliers said that the headroom allowance was understated. Again, given the conclusion above, we have not sought to reach a conclusion on this point.

Payment method uplift

1.65. In response to the May 2022 consultation, one supplier said that the payment method uplift reflected the increased bad debt, administration and working capital costs from payment by standard credit. It said that these would have increased at the same speed or faster than increases in wholesale costs. Another supplier made a similar point, and said higher bills could increase the proportion of customers unable to pay.

1.66. We would only consider offsetting the indexed part of the payment method uplift. This element reflects bad debt and working capital costs. These costs relate to the bills that customers receive. We would therefore expect them to scale in line with the size of customers' bills. We have therefore decided not to apply the increase in the payment method uplift as an offset.

Considering feedback on other allowances

1.67. One supplier said that administrative costs relating to industry codes had increased since the baseline operating costs.

1.68. We have not considered this as a potential offset, as these costs do not relate to increases in wholesale prices.

Appendix 6 – Detail on shaping and imbalance analysis

Supplier evidence submitted

Responses and exclusions

1.1. In response to our March 2022 RFI, nine out of eleven suppliers submitted evidence on shaping and imbalance costs they had experienced and/or were expecting to incur for cap periods eight and nine. One supplier provided a nil return due to its wholesale purchasing arrangements. We have included this case as a zero value in our calculations – although see our discussion of the lower quartile calculation below. We have also treated another supplier's response as a nil return, as the supplier provided a duplicate figure to its response to the unexpected SVT demand question. We have excluded that case from our calculations, as we do not have information about what the supplier's costs were.

1.2. One supplier submitted evidence on unexpected SVT demand costs in response to the May 2022 consultation. However, this supplier provided a nil return to the shaping and imbalance cost questions. It considered the costs it would be facing would be similar to other suppliers' costs. We have excluded this supplier from our sample.

1.3. Out of the nine suppliers, we excluded four suppliers from our analysis. We excluded suppliers due to:

- **incomplete data**: some suppliers were unable to provide cost forecasts, were unable to provide a central estimate for their cost forecasts and/or have only provided costs they have incurred until the point the RFI was issued;
- **unrepresentative data**: a supplier forecasted costs which were unrepresentative given its unique circumstances; and
- **lack of confidence in the calculation methodology**: one supplier forecasted costs using the existing shaping and imbalance percentages from the cap model. We consider that this creates a circularity when trying to assess whether the existing allowances are sufficient.

1.4. The data used in the analysis therefore only represents 47% of the SVT customer base. This percentage is higher than the figure reported in our May 2022 consultation

(42%). This is in part due to changes in the customer number data we use, rather than changes in the suppliers included in our analysis.[125]

Explanation for the variation in reported costs

1.5. For the suppliers included in our analysis, there were significant variations in reported costs. While there were potential outliers on both the low side and the high side, the overall impact would be to increase the weighted average, especially for cap period nine.

1.6. In our RFI, we asked suppliers to provide the methodologies used to calculate the reported estimates. Based on the responses, we observed the following inconsistencies (not exhaustive) in the methodologies used to estimate the costs.

- Suppliers may have included different **aspects of shaping and imbalance costs** in their estimates. For example, one supplier did not include the impact of rehedging day-ahead (from seasonal normal to actual demand).

- Suppliers may have included different **assumptions about future wholesale prices**. For example, one supplier's methodology included the impact of possible changes to wholesale prices by the time of shaping. Another supplier's methodology (in its RFI response) used the same percentage uplifts that it provided in response to the November 2021 consultation, which were calculated during a period of rising wholesale prices.

1.7. We note that in our calculations we have not made any adjustment to the reported figures in light of these methodological differences. We also note that suppliers provided varying levels of detail to allow us to understand their estimates.

Approach to weighting

1.8. We use weighting to calculate a weighted average. In our May 2022 consultation, we asked stakeholders for feedback on our approach to weighting.[126] We proposed to calculate weights which varied by fuel type and payment type (ie separate weights for PPM and non-

[125] For our May 2022 consultation, we used the October 2021 Customer Account and Tariff RFI to calculate the market share. Here we use the April 2022 Customer Account and Tariff RFI to calculate the market share.
[126] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, paragraph 4.34. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

PPM). We said that, even though the cost per customer (for a given supplier) only varies with fuel type, the weighted average costs vary by both payment type and fuel type, due to the weighting approach. We said an alternative approach would be to calculate a single weight for PPM and non-PPM for each fuel based on the number of SVT customers. This would result in a common weighted average cost for PPM and non-PPM for each fuel.[127]

1.9. We did not receive any feedback on our approach to weighting. Therefore, we have decided to set the weighting based on our proposed approach, to better reflect the costs faced by suppliers serving customers in a particular segment. However, there is still uncertainty around the reliability of any consequent differences in the weighted average benchmark between payment types.

Calculation steps

Calculation of cost per customer at benchmark level of consumption

1.10. As for unexpected SVT demand costs, we used the RFI template to convert suppliers' submissions to benchmark consumption. This is to improve comparability.

1.11. To calculate the cost per customer at the benchmark consumption level we divided each cost estimate by total (SVT and FTC) expected customer numbers for a given supplier and fuel. See Appendix 4 for how we calculated customer numbers.

Calculation of weights

1.12. We calculated the cost per customer based on a supplier's total (FTC and SVT) customers. However, when weighting to calculate a weighted average, we used data on SVT customers only. This is because the cap applies to default (roughly equivalent to SVT) customers only.

1.13. As discussed above, our calculated weights vary by fuel type and payment type (ie with separate weights for PPM and non-PPM).

[127] Ofgem (2022), Price Cap - Consultation on possible wholesale cost adjustment, Appendix 3, paragraphs 1.10 and 1.11. https://www.ofgem.gov.uk/publications/price-cap-consultation-possible-wholesale-cost-adjustment

1.14. We note that weights have slightly changed since our May 2022 consultation. This is because we used the latest Customer Account and Tariff RFI account data (April 2022) to calculate the weights for PPM and non-PPM SVT customers.

Calculation of weighted average costs

1.15. To calculate the weighted average costs, we multiped the cost per customer by each included supplier's relevant weight. Please refer to Chapter 4 for our derived value of these costs.

Calculation of lower quartile costs

1.16. As for unexpected SVT demand, we excluded one supplier from the calculation of the lower quartile. Please see Appendix 4 for the rationale.

1.17. There were no additional steps before taking the lower quartile.

1.18. We have calculated the lower quartile dual fuel costs for both PPM and non-PPM. We derived estimates of £11 per dual fuel SVT customer for both PPM and non-PPM in cap period eight. The equivalent figure was £20 for both payment types in cap period nine.

Appendix 7 – Implementing changes in cap models

Annex 8 – Adjustment allowance methodology

1.1. This section sets out the changes that we have made to Annex 8, given our decision to make an adjustment. We have published an updated version of the Annex 8 model alongside this decision.

Inputs: sheet '3d Electricity losses'

1.2. In our May 2022 consultation, we said we would update this sheet with the latest values from the Annex 2 model. We have decided to use the historical values (ie losses for cap period eight) instead. This is a minor refinement to improve accuracy – the costs suppliers incurred during cap period eight depended on the electricity losses during that cap period, as they affected the additional electricity suppliers needed to buy.

Inputs: new sheet 3g

1.3. In our May 2022 consultation, we said we would include the latest copy of sheet '3a allowances' from the Annex 2 model and that we would use this sheet as the source for the relevant unidentified gas values. We have decided to include a new sheet (to avoid affecting previous calculations) with only unidentified gas values. This is because we are not using other allowances within sheet '3a allowances' from the Annex 2 model. We also decided to use values relating to cap period eight, for the same reason as for electricity losses (as noted above).

1.4. We will use this sheet as the source for the relevant unidentified gas values.

Inputs: new sheet 3h

1.5. Include calculated cost to recover for unexpected SVT demand costs related to cap period eight. This is the output calculated based on the lower quartile of supplier estimates received. We have not included the underlying calculations using supplier-specific data in the public Annex 8 model. The values included in this sheet vary between different customer groups – eg by fuel and payment type.

Inputs: new sheet 3i

1.6. Include calculated cost to recover for backwardation costs related to cap period seven. This is the output of a review of cap period seven backwardation estimate. We have not included the underlying calculations in the public Annex 8 model. The values included in

this sheet vary by fuel type. The values included in this sheet do not vary by payment type – this is for consistency with our February 2022 wholesale decision.

Calculations: new sheet 2c

1.7. Add sheet to calculate the adjustment for specific wholesale costs. Under our decision to recover costs over 12 months, the cap level adjustment (in annualised terms) is the same as the calculated cost to recover. We only need to apply regional electricity losses and unidentified gas.

Calculations: new sheet 2d

1.8. Add sheet to calculate the adjustment for backwardation costs related to cap period seven. Under our decision to recover costs over 12 months, the cap level adjustment (in annualised terms) is the same as the calculated cost to recover. We only need to apply regional electricity losses and unidentified gas. When doing so, we use the values of electricity losses and unidentified gas for cap period eight. This is for consistency with our treatment of the other costs relating to cap period seven in our February 2022 wholesale decision.

Outputs: sheet '1a Adjustment Allowance'

1.9. Pull through the outputs from sheet 2c and 2d into the values at typical consumption for cap period nine. Enter zero for the cap period nine values at nil consumption.

Annex 2 – Wholesale cost allowance methodology

1.10. This section sets out the changes that we will make to the Annex 2 model. In our May 2022 consultation, we said we would make these changes in time for the cap period starting on 1 October 2022. However, given the complexities around the Annex 2 model in relation to the transition to a quarterly cap, we have decided to delay implementing our proposed changes until cap period ten (April to September 2023). We will reflect the following changes in time for cap period ten. For the avoidance of doubt, we are making the decision now – we are only delaying the implementation of these changes.

Inputs: sheet '3a Allowances'

1.11. Create a table for each set of allowances (electricity single rate, electricity multi-register, gas non-PPM, gas PPM) which has a separate column for each cap period. This will allow us to enter different allowance values for each cap period, where necessary.

Outputs: sheet '1a Direct Fuel Cost Component'

1.12. At step 2, we apply the allowances. Change the cell references to reference the relevant allowance values for a given cap period.