

To all market participants and interested parties

Email: retailpriceregulation@ofgem.gov.uk

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Dear colleagues,

Final guidance on treatment of price indexation in future default tariff cap periods

This letter is to provide updated guidance to domestic energy suppliers on the treatment of wholesale prices observed during the transitional period to quarterly cap updates, which will start from 1 October 2022. It is intended to help inform suppliers' prudent risk management strategies alongside the publication of our decision on a new mechanism. We recognise that each supplier makes its own hedging decisions, and this is part of its commercial risk, but we consider a nominal supplier following the index in this letter. Specifically, this letter highlights updates to the weights applied in the index calculation during the transition period. This follows the guidance issued on 16 May 2022¹ following preceding letters we issued on 4 February 2022² and 15 March 2022.³

Today we have published our decision on changes to the wholesale methodology.⁴ Following our consideration of stakeholder responses to the May 2022 consultation,⁵ we have decided to proceed with implementing quarterly updates with a reduced notice period – the index will be set using a 3-1.5-12 [3] approach.⁶ The decisions will be implemented

¹ Ofgem (2022), May 2022 Updated guidance on treatment of price indexation in future default tariff cap proposals <https://www.ofgem.gov.uk/publications/price-cap-may-2022-updated-guidance-treatment-price-indexation-future-default-tariff-cap>

² Ofgem (2022), Price Cap - Guidance on treatment of reasonable risk management practices in future default tariff cap proposals <https://www.ofgem.gov.uk/publications/price-cap-guidance-treatment-reasonable-risk-management-practices-future-default-tariff-cap-proposals>

³ Ofgem (2022), Updated guidance on treatment of price indexation in future default tariff cap proposals <https://www.ofgem.gov.uk/publications/updated-guidance-treatment-price-indexation-future-default-tariff-cap-proposals>

⁴ Ofgem (2022), Price Cap – Decision on changes to the wholesale methodology <https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology>

⁵ Ofgem (2022), Price cap – Price cap - Statutory consultation on changes to the wholesale methodology <https://www.ofgem.gov.uk/publications/price-cap-statutory-consultation-changes-wholesale-methodology>

⁶ We express the price cap formula in an index with the format X-Y-Z [A], where X is the price observation period, Y is the notice period between the end of the observation period and the start of the price cap period starting, Z is the forward view period and A is the period for which the cap is in place, all in months. So, a 3-1.5-12 [3] index for delivery starting 1 October 2022 means a three-month observation period running from mid-May to mid-August where 12-month forward prices are observed. There is then a lag of 1.5 months from mid-August until the cap starts on the 1 October. And the cap runs for three months from 1 October to 31 December.

from 1 October 2022 and this letter is intended to be the final guidance we publish on this subject. From period 10a (April 2023 – June 2023), we expect a nominal supplier will have hedged in line with the enduring indexation methodology as set out in our decision. The index approach we set out here follows our latest decisions. We intend to review our decisions in the future once we have fully transitioned to quarterly updates and enough time has passed to evaluate the impact. We may, following consultation, make further changes to the index.

Updated cap indexation weights for cap periods 9a and 9b

Since the last letter¹ index weights have been updated to take account of updated reference demand shares for profile classes 1 and 2, and an adjustment to reflect the differences in volume weights between quarters and seasons. Details behind updated transition weights can be found in Appendix 1 of the decision document⁴ and full details can be found in the Annex 2 model published alongside it.

The net result of final adjustments is that reduced index weights will apply for cap period 9a between 8 August and 18 August 2022, and increased weights will apply for period 9b from 19 August 2022. Indicative weights for profile class 1 are summarised in this table.

Cap period	Index approach	Delivery product observed	Observation window start	Observation window end	Trading days	Final adjustment (Profile Class 1)
9a & 9b	6-2-12 [6] (identical to 7-1-12 [6] at this point)	Winter 2022	01/02/2022	15/03/2022	31	1.00
9a & 9b	7-1-12 [6]	Winter 2022	16/03/2022	19/05/2022	44 (22 weighted)	0.50
9a & 9b	7-1-12 [6]	Winter 2022	20/05/2022	01/06/2022	9	1.00
9a	3-1.5-12 [3]	Q4 2022	06/06/2022	05/08/2022	45 (52 adjusted)	1.13
9a	3-1.5-12 [3]	Q4 2022	08/08/2022	18/08/2022	9 (10 adjusted)	0.90
9b	3-1.5-12 [3]	Q1 2023	19/08/2022	16/11/2022	63 (62 adjusted)	1.04
10a	3-1.5-12 [3]	Q2 2023	17/11/2022	17/02/2023	64	N/A
10b	3-1.5-12 [3]	Q3 2023	20/02/2023	18/05/2023	61	N/A

Please note these revisions apply only to transitional weights for electricity.

Yours sincerely,
Neil Lawrence
Director - Retail