Call for Input

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Price cap: Call for input of our approach to reflecting potential changes to BSUoS charges in the price cap

Introduction

The Gas and Electricity Market Authority (the Authority) is considering modifying the way that Balancing Services Use of System ('BSUoS') charges are collected from electricity network users. The proposed modification follows the recommendation of the Second Task Force that BSUoS charges should take the form of *a flat volumetric charge, set in advance*.[1] Currently, BSUoS charges are recovered using a volumetric charge (£/MWh) which varies in each half-hour period based on the amount of energy imported from, or, exported onto the network within that time. The proposed change is covered by Connection and Use of System Code (CUSC) modification CMP361, on which the Authority has today published a minded-to decision and consultation to approve.[2] Should this modification be approved, we are considering amendments to the default tariff cap (the cap) to reflect this modification. This Call for Input provides stakeholders with the opportunity to provide comments on our initial view regarding how to amend the cap in response to this modification, specifically in relation to the transitional arrangement for a move from a lagged ex-post cost recovery mechanism.

We are seeking written comments by 03 October 2022.

Context

Balancing Services Use of System ('BSUoS') charges are the means by which the Electricity System Operator ('ESO') recovers costs associated with balancing the electricity transmission system. The charges are currently set on a half-hourly basis, changing in each settlement

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[1] National Grid ESO (2020) Final Report: Second Balancing Services Charges Task Force, http://chargingfutures.com/media/1477/second-balancing-services-charges-task-force-final-report.pdf

[2] CMP361 is accompanied by a further modification, CMP362, which would facilitate the implementation of the CMP361 solution by introducing and updating required definitions into CUSC section 11. Given that it is a consequential mod, dependent on the decision reached in CMP361, it is not the main subject of this Call for Input.
Ofgem (2022) CMP361/362 - Minded-to decision and draft impact assessment https://www.ofgem.gov.uk/publications/cmp361362-minded-decision-and-draft-impact-assessment

period and charged to both generation and demand. From April 2023, liability for BSUoS charges will move fully onto Final Demand.[3]

Under the cap, BSUoS charges are included in the 'Annex 3 Network cost allowance methodology elec' (referred to in this document as Annex 3). These charges are passed through on a lagged basis. The model calculates a weighted average of BSUoS charges in £/MWh in each settlement period across the preceding calendar year (in February) and preceding year running from 1 July to 30 June (in August).[4]

What are the proposed modifications?

CMP361 proposes to introduce an ex-ante *fixed* volumetric BSUoS tariff to replace the existing variable charge. The Authority's minded-to position is to approve a proposal which provides a fixed tariff period of 1 year, with 3 months' notice provided to users ahead of the fixed tariff period. This means the ex-ante fixed charge would be published in December every year and would come into effect from April for a 12-month period. If approved, the modification would be implemented in April 2023. In our minded-to decision and consultation, we have reached the view that the proposed modification would help suppliers and end users by improving the predictability of BSUoS costs and reducing volatility, which could aid effective competition. Together, we consider these effects are likely to deliver lower costs for consumers in the years ahead.

How will this affect the cap?

If the modification is approved, we will need to reflect this change in the cap methodology by replacing the lagged variable volumetric charge with an ex-ante fixed volumetric charge in time for cap period 10a (April 2023-June 2023). This change would ensure that the price cap aligns with suppliers' costs in future cap periods. As a result, it would eliminate the potential cashflow issue suppliers otherwise would have encountered with the lagged recovery of the costs. If the modification is approved, we are therefore minded to adopt the new ex-ante fixed charge in the cap.

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[3] Ofgem (2022) CMP308: Removal of BSUoS charge from Generation, https://www.ofgem.gov.uk/publications/cmp308-removal-bsuos-charges-generation

[4] This means that the BSUoS charges for a given period is used to calculate the weighted average BSUoS allowance in the cap for two cap periods. For example, the BSUoS charges in January 2020 would be reflected in the BSUoS allowance for cap periods five and six. This means that charges for a given period are recovered over one year.

Customers would also benefit from having greater certainty for this cost element in their bills, and potentially any future additional cost included in the price cap allowance relating to funding the working and risk capital cost required from the current ex-post BSUoS calculations.

We also acknowledge the modification CMP308, which will be implemented in April 2023, establishes that only Final Demand - rather than demand and generation - will be liable for BSUoS charges.[5] It aims to better align the GB 'generation cost stack' with those in other EU markets, facilitating competition between generators. All things being equal, removing BSUoS charges from generation should result in lower wholesale prices, ultimately offsetting an increase in demand charges. Hence, we consider this modification to be neutral for default tariff customers. It is effectively out of scope for this cap change as it will be implemented at the same time as the change to ex-ante charging, so automatically included in the change and expected by the market.

Under the current price cap methodology, BSUoS charges are calculated *ex-post* and recovered through a lagged recovery. The BSUoS component of the network charges, then, reflects, and allows suppliers to recover, costs they have already borne. For instance, the BSUoS charges recovered in cap period seven (October 2021 – March 2022) reflected the BSUoS charges suppliers already bore between the 01 July 2020 and the 30 June 2021. A lagged cost recovery exposes suppliers to potential cashflow issues, exacerbated by the intrinsic volatility of BSUoS charges.

Introducing a 12-month *fixed* tariff would allow calculation of the BSUoS component of the Network charges using *forecasted charges* rather than those already incurred. This would mean removing the lagged recovery and aligning the price cap with suppliers' costs. Suppliers' exposure to cashflow and volatility issues would be reduced.

Replacing the lagged nature of the existing methodology with an ex-ante tariff would mean that there would be a period of BSUoS charges incurred by suppliers (January 2022 – March 2023) that would not be fully reflected and recovered through future price caps. Customers will have paid an allowance for BSUoS in every cap period, and if BSUoS charges did not change over time, charges recovered through the lifetime of the cap are likely to be equal to the charges incurred by suppliers during the lifetime of the cap.

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[5] Ofgem (2022) CMP308: Removal of BSUoS charge from Generation, https://www.ofgem.gov.uk/publications/cmp308-removal-bsuos-charges-generation

Changes in in BSUoS charge trends from January 2022 to March 2023, not fully reflected in the cap, versus lagged costs or future ex-ante costs, may lead to a surplus or shortfall in the costs recovered. This means that an adjustment may be needed. We will need to consider how we will reflect this potential surplus or shortfall in the cap. We refer to this element as the 'transitional' element.

Areas for comment

The issue to be addressed is how we would adjust for the transitional element of the change in the BSUoS charge in the default tariff cap, that is fairly balanced between protecting customers and having regard to suppliers' finances.

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.[6] 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, of which one is the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence. 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.

The transitional element of the change is the subject of this call for input. There are several design elements which feed into this adjustment. We discuss the elements below.

In the transitional arrangements, we might need to consider **how to calculate** any shortfall or surplus in the BSUoS charge, and what could be the **most appropriate method for allocating the adjustment**.

We consider that BSUoS charges until the end of December 2021 are fully recovered by the end of cap period 9b (January 2023-March 2023). We consider BSUoS charges from January 2022 up to and including June 2022 to be partially recovered by the end of the cap period 9b

[6] 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

(January 2022-March 2023). The charges from July 2022 up to and including March 2023 are not and would not be recovered through the cap if we amend the cap to include the ex-ante fixed volumetric charge. Therefore, our initial view is that we would consider the BSUoS charges from January 2022 up to and including March 2023, when calculating the adjustment.

Under existing arrangements, we take the potential uncertainty around BSUoS charges into account when setting the headroom allowance in the cap.[7] The modification to move to an ex-ante fixed charge would mitigate against some of these future uncertainties. Therefore, our initial view is that **we could consider offsetting** the transitional adjustment against the appropriate future headroom allowance relevant to uncertainty around the BSUoS charge.

Suppliers have recovered some BSUoS charges they incurred outside of the cap periods through the cap. This is particularly the case in early cap periods. Our initial view is that when calculating the adjustment, **we could consider these historical BSUoS charges** that suppliers have recovered through the cap and potentially offset this against the BSUoS recovered in the transitionary arrangements.

As we will be taking a decision on changes to the cap in February 2023, at the time of the decision, not all the data on the actual BSUoS charges for the periods January 2023-March 2023 will be available. As part of our work, we will need to consider how to calculate any surplus or shortfall given the lack of actual data for the entire period. At this stage, potential options we could consider are:[8]

- **Option A, Actual data method:** We would split the transitional element into two stages. In stage one, we would use the most recent available actual data to calculate the surplus or shortfall. This would include actual data from January 2022-December 2022. Any surplus or shortfall would be reflected from cap period 10a (April 2023-June 2023). In stage two, we would consider the actual data for the rest of the period (ie actual data from January 2023 to March 2023) to calculate the surplus or shortfall. Any adjustment in the second stage would be reflected from cap period 11a (October 2023-December 2023).
- **Option B, Float and true-up method:** We would use actual data from January 2022-December 2022 and a 'float' for the period January 2023-March 2023, based on forecasts at the time from the National Grid Electricity System Operator (ESO), to estimate the required adjustment. We would apply this adjustment from cap period 10a

[7] Ofgem (2018) Appendix 2 – Cap level analysis and headroom, page 29, para 3.77-3.79. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[8] In all options we assume that we would apply the adjustment over a duration of one year.

(April 2023-June 2023) . When actual data becomes available, we would then 'true-up' the periods where we used a float. If a true-up adjustment is needed, we would apply the adjustment from cap period 11a (October 2023-December 2023). Yet, the level of uncertainty and materiality determine whether a float and true-up is required. At this stage, we are not clear if the transitional adjustment would meet the required level of uncertainty and materiality to justify this approach.

- **Option C, Deferred Method:** We would defer implementing the transitional adjustment until the actual data becomes available for the full period (ie January 2022-March 2023). We would adjust the cap with the potential surplus or shortfall from cap period 11a (October 2023-December 2023).

At this initial stage, we consider option A to be the most appropriate method as it relies on actual data whilst spreading the adjustment over a longer period of time relative to the other options. We consider Option B could give rise to further complications, such as additional processes carrying out a true-up at a later time. We consider Option C at this initial stage to require an extended deferral.

We will also need to consider **the duration over which to apply the adjustment** under any chosen options. At this stage, we have the option of applying any adjustment for two quarterly cap periods, for one year or for a period longer than one year.[9] We will consider the duration over which the current methodology recovers BSUoS costs and will also consider how this would impact consumers and suppliers. At this stage, we consider that a shorter recovery period would potentially make the cap deviate from underlying ex-ante costs by a greater amount but for a shorter period of time.

We will need to consider **which allowance to use** to perform the transitional adjustment. For the moment, we consider that the most appropriate options could be to use the 'Annex 8 Adjustment Allowance' or the Annex 3 allowance.

Next Steps

We welcome any further comments on the approach to reflecting changes to BSUoS charge in the price cap, particularly in the areas mentioned above.

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[9] We also note that at this stage, the cap is due to expire end of 2023. However, the Department for Business, Energy & Industrial Strategy (BEIS) has previously set out guidance that it is legislating to enable the cap to be extended beyond 2023 if specific conditions for an extension are met. We will take this into account when considering the duration over which to apply the adjustment.

We welcome any written comments by 03 October 2022. Please send any comments to retailpriceregulation@ofgem.gov.uk. Please include detail and supporting evidence in your comments wherever possible. As part of your comments, please explain how any suggested approaches would be deliverable in practice.

We are also keen to speak to stakeholders to hear views on how we should develop the approach to reflecting changes to BSUoS charge in the price cap. If you would like to arrange a call, please contact us through retailpriceregulation@ofgem.gov.uk. We are happy to speak either before or after you submit written comments.

Following this call for input and potential bi-lateral stakeholder engagement calls, we will publish our statutory consultation towards the end of the year. We cannot give exact dates for our statutory consultation at this stage. We will publish our decision in February 2023.

If you have any questions, please contact us using: retailpriceregulation@ofgem.gov.uk.

Yours faithfully,

Daniel Norton
Deputy Director Price Protection