To all stakeholders

Email: retailpriceregulation@ofgem.gov.uk

Date: 10 October 2022

Consultation on the wholesale additional risk allowance index within Annex 2 – Wholesale cost allowance methodology

Dear stakeholders,

In this letter, we are consulting on the approach to calculating the wholesale additional risk allowance within the default tariff cap (‘**the cap’**) methodology for the charge restriction period 9b (January – March 2023). This letter sets out the background to the issues and the detail of the approach we applied when determining the price cap levels for the charge restriction period 9a (October – December 2022), announced on 26 August 2022, and provides the opportunity for comment on the use of this approach going forwards.

We want to ensure transparency with stakeholders and provide this opportunity to comment on this approach ahead of the January 2023 cap announcement. Please provide any relevant responses by **24 October 2022**.

Summary

The default tariff cap (‘**the cap’**) protects default tariff customers by limiting the amount they can be charged for their gas and electricity. We set the level of the cap to reflect the typical costs to suppliers of supplying this energy plus a fair margin. The overarching objective of the price cap is to ensure default consumers pay no more than a fair price for their energy.

To account for increased efficient and material costs incurred by suppliers during cap period 7 (Oct 2021 – Mar 2022) we decided to make an adjustment of £61 (increase) to the cap level, at benchmark consumption[1], as part of our February 2022 decision[2]. We decided to account for this £61 via an adjustment to the additional wholesale risk allowance within Annex 2 – wholesale allowance methodology model (previously set at 1% of direct fuel costs). We set out that this adjustment would be in place for a 12 month period (from April 2022 – March 2023). Separately, an ex-ante backwardation allowance was introduced into the price cap as part of our August 2022 decision[3], which

[1] Dual fuel, at the ‘benchmark consumption level’ value ie the typical consumption values used to set the cap (3,100kWh for single-rate electricity and 12,000kWh for gas). Note that the benchmark consumption value used to set the cap is not the same as TDCV.
[2] Decision on the potential impact of increased wholesale volatility on the default tariff cap, Feb 2022: [Decision on the potential impact of increased wholesale volatility on the default tariff cap (ofgem.gov.uk)]
[3] Price cap – Decision on changes to the wholesale methodology: [Price cap - Decision on changes to the wholesale methodology | Ofgem]

would be inflated by the raw or unadjusted additional wholesale risk allowance, set at 1% of direct fuel costs.

Prior to the publication of the period 9a cap level announcement it was identified that the ex-ante backwardation allowance calculation was being additionally and incorrectly uplifted by the inflated additional wholesale risk allowance, which would have caused a potential over-recovery of the backwardation allowance.

In order to avoid this over recovery scenario, we propose to separate out the additional risk allowance into two separate sub-components, including:

- Direct Fuel Only: taking into the base 1% risk allowance along with the £61 for recovery of associated period 7 costs, in line with the February 2022 decision
- Backwardation Only: taking into account only the base 1% risk allowance, in line with the August 2022 decision.

We welcome proposals from all stakeholders on our proposals for addressing this issue.

Background

As set out in our February 2022 consultation decision document, Ofgem decided to increase cap level increase of £61 to account for additional costs incurred by industry due to unprecedented wholesale market volatility. The adjustment would be recovered over a 12 month period from April 2022 – March 2023, covering cap periods eight and nine.

The Wholesale Additional Risk Allowance currently consists of two elements:

- 1% uncertainty allowance introduced in in the original default tariff cap design[4]

- An additional percentage uplift which equates to £61 to account for unexpected wholesale related costs incurred during period seven.

Within our August 2022 decision document, we introduced an ex-ante backwardation allowance into the price cap. These costs were to be calculated by comparing the direct fuel element of the wholesale allowance under the index approach for a given season or quarter to the cost of a nominal supplier buying the energy for only that season or quarter.

A nominal supplier buying the energy for a given season or quarter may still incur costs covered by the wholesale allowances. Therefore, we calculate backwardation costs after applying the allowances. This means any changes to the wholesale allowances also affects modelled backwardation costs.

Impact on price cap

As set out in our August 2022 decision document, we decided to update the wholesale methodology to include ex-ante modelled backwardation costs, which we would calculate quarterly at each cap update.

This methodology applies the additional direct fuel allowances in the calculation of backwardation to reflect costs a nominal supplier may incur, including the 1% additional

[4] The 1% additional risk allowance is included as part of a number of 'additional direct fuel allowances' that uplift the core direct fuel allowance for wholesale related costs including shaping and imbalance, transaction costs and additional risk and uncertainty. Further detail can be found in our 2018 decision [Default tariff cap: decision - overview | Ofgem]

wholesale risk allowance to account for uncertain wholesale costs and risks (in line with the 2018 decision).

The original layout of the Annex 2 table which sets out the additional direct fuel allowances (*figure 1*) previously only allowed for the additional wholesale risk allowance to be set as a single percentage value. However, the consequences of the August 2022 decision combined with the February 2022 decision meant that, in order for the policy intent to be delivered, the additional wholesale risk allowance should consist of two values (*figure 2*). With the value used to inflate the direct fuel allowance being set at 1% of direct fuel costs plus the £61 additional wholesale risks allowance costs, in line with the February 2022 decision. The value used to inflate the ex-ante backwardation allowance should be set at 1% of direct fuel costs only, in line with the August 2022 decision.

In order to reconcile the policy intent of both the February 2022 decision and the August 2022 decision – the additional wholesale risk allowance should therefore have two values for the period that a different percentage value must be used to inflate the direct fuel costs compared with the ex-ante backwardation allowance. Using the 1% plus £61 value alone would therefore lead to an over-recovery for suppliers. Conversely, using the 1% value alone would lead to an under-recovery. Due to the complexities of interactions within the model, it was also not possible to use a weighted average single figure to mitigate the risk of over and under recovery.

Timing considerations

This requirement to differentiate the additional wholesale risk allowance into two sub-components only exists for the remainder of period nine. Therefore we are consulting on changes until the end of period 9b only. Absent any further consultation, the additional wholesale risk allowance will revert to its single value of 1% from 1 April 2023 for both the backwardation and direct fuel uplifts.

Approach taken for cap period 9a

As set out in our most recently published version of Annex 2 – wholesale risk allowance methodology (version 1.13)[5], the Additional risk allowance input was separated out within 3a Allowances tab:

- Additional risk allowance – Direct Fuel <u>only</u> (inclusive of Wholesale Additional Risk Allowance uplift)

- Additional risk allowance – Backwardation <u>only</u> (benchmarked at 1%)

With one percentage value inflating direct fuel costs (to a level that includes the £61 additional wholesale risks allowance costs) and a separate row introduced (at 1%) to inflate the backwardation cost allowance.

Please see below figures 1 and 2 illustrating changes made to published version of Annex 2 – wholesale risk allowance methodology (version 1.13):

[5] Annex2 – wholesale risk allowance methodology, v1.13: https://www.ofgem.gov.uk/sites/default/files/2022-08/Annex_2_-_wholesale_cost_allowance_methodology_v1.13.xlsx

Electricity		
	Single rate	Multi-register
Seasonal to monthly shaping	0.23%	0.23%
Monthly peak/baseload to hourly shaping	4.16%	4.16%
Rehedging day ahead	0.29%	0.29%
Imbalance	1.31%	1.31%
Transaction costs	0.39%	0.39%
Additional risk allowance	8.68%	6.66%
Total	15.1%	13.0%

Figure 1:Additional risk allowance as set out in: [Price cap - Decision on changes to the wholesale methodology]

Electricity		
	Single rate	Multi-register
Seasonal to monthly shaping	0.23%	0.23%
Monthly peak/baseload to hourly shaping	4.16%	4.16%
Rehedging day ahead	0.29%	0.29%
Imbalance	1.31%	1.31%
Transaction costs	0.39%	0.39%
Additional risk allowance - Direct Fuel only	4.57%	3.67%
Additional risk allowance - Backwardation only	1.00%	1.00%
Total - Direct Fuel	10.96%	10.05%
Total - Backwardation	7.38%	7.38%

Figure 2:Additional risk allowance as set out in: [Default tariff cap level: 1 October 2022 to 31 December 2022]

As mentioned above, the intention of the wholesale additional risk allowance uplift is to include a £61 allowance in the cap for costs previously incurred rather than reflecting reoccurring cost. As such any additional uplift (via Wholesale Additional Risk Allowance) would cause potential over-recovery of backwardation costs. The separating out of the Additional risk allowance for Direct Fuel and Backwardation ensure that the cap reflects the efficient backwardation costs faced by suppliers and the cap does not materially depart from an efficient level of costs.

Please note that in order to make sure that the price cap worked as intended, the above approach was taken in relation to the August 26th price cap announcement[6]. This ensured that consumers did not pay more than the efficient cost benchmark and that it reflected both the February 2022 decision on the impact of increased wholesale volatility and the August 2022 decision to introduce an ex-ante backwardation allowance to the wholesale methodology. We are now specifically consulting on the use of this approach going forwards and would welcome comments from stakeholders

We will give due regard to any and all representations provided in response to this consultation and if the outcome of this decision is that an alternative approach is more appropriate, then we will make the necessary adjustments to the relevant models for their use going forwards from cap period 9b.

[6] Default tariff cap level: 1 October 2022 to 31 December 2022: [Default tariff cap level: 1 October 2022 to 31 December 2022 | Ofgem]

Next steps and consultation responses

We welcome views on the approach set out in this letter. We ask stakeholders to send any comments to RetailPriceRegulation@ofgem.gov.uk by **close of business on 24 October 2022**.

Yours faithfully,

Dan Norton

Deputy Director, Retail Price Protection