

To all stakeholders

Email: retailpriceregulation@ofgem.gov.uk

Date: 24 November 2022

Dear stakeholders,

Decision on changes to the wholesale additional risk allowance index within Annex 2 – Wholesale cost allowance methodology

On the 10 October 2022 we issued an open letter to consult stakeholders 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).

We proposed to maintain the approach applied when determining the price cap levels for the charge restriction period 9a (October – December 2022), announced on 26 August 2022

This letter sets out our decision to proceed with our proposals. These are:

- Maintain the approach set out in the 26 August 2022 published version of Annex 2 – wholesale risk allowance methodology (version 1.13)¹, with the Additional risk allowance inputs for direct fuel and backwardation being separated out within the '3a Allowances' tab

In reaching this decision, we have taken stakeholder feedback into consideration. Annex 1 to this decision letter provides a high-level summary of these views and sets out our response. The objective of the Domestic Gas and Electricity (Tariff Cap) Act 2018 ('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 have had regard to the following 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;
- 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.

¹ 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

- the need to set the cap at a level that takes account of the impact of the cap on public spending².

The requirement to have regard to the five matters identified in Section 1(6) of the Act³ 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.

Background

As set out in our February 2022 consultation decision document⁴, Ofgem decided on an adjustment of £61 (increase) to the cap level 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 8 and 9.

The Wholesale Additional Risk Allowance currently consists of two elements:

- 1% uncertainty allowance introduced in the original default tariff cap design⁵
- An additional percentage uplift which equates to £61 to account for unexpected wholesale related costs incurred during period seven.

Within our August 2022 decision document⁶, 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 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 affect modelled backwardation costs.

Decision

We have decided to maintain the approach adopted in charge restriction period 9a (October – December 2022) for the charge restriction period 9b (January – March 2023) as proposed in our October consultation. Following the consultation period, we received feedback from one stakeholder and no direct issues being raised with our proposals. We have summarised their comments and our considerations in Annex 1 of this letter.

This decision means that the Annex 2 model used in charge restriction period 9a will be used when updating the cap level for charge restriction period 9b.

² Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(e) as inserted by Schedule 3 to the Energy Prices Act 2022. In performing the duty under section 1(6)(e) we must have regard to any information provided by the Secretary of State, or any guidance given by the Secretary of State on this matter (section 1(6A)).

³ Domestic Gas and Electricity (Tariff Cap) Act 2018, Section 1(6). [Domestic Gas and Electricity \(Tariff Cap\) Act 2018 \(legislation.gov.uk\)](https://www.legislation.gov.uk/ukpga/2018/12/section/1)

⁴ 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 \(ofgem.gov.uk\)](https://www.ofgem.gov.uk/consult/condocs/defaulttariffcap/defaulttariffcap20220201.pdf)

⁵ 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](https://www.ofgem.gov.uk/consult/condocs/defaulttariffcap/defaulttariffcap20180801.pdf)

⁶ Price cap – Decision on changes to the wholesale methodology: [Price cap - Decision on changes to the wholesale methodology | Ofgem](https://www.ofgem.gov.uk/consult/condocs/pricecap/pricecap20220801.pdf)

Yours faithfully,

Dan Norton

Deputy Director, Retail Price Protection

Annex 1: Summary of relevant stakeholder views and consideration

We received one response to our October 2022 consultation on the wholesale additional risk allowance index within Annex 2 –Wholesale cost allowance methodology. No non-confidential responses were provided. We have provided a high-level summary of the points raised and our response below.

The response we received supported our proposal. It agreed with continuing the approach set out in charge restriction period 9a through to charge restriction 9b. With this ensuring that the backwardation uplift would not be inflated by wholesale shaping and balancing uplifts.

Stakeholder views

One stakeholder raised the suggestion of converting the risk percentage values to a monetary value. Stating that this would have minimal impact on Ofgem’s overall modelling and publication processes but would simplify any ongoing stakeholder modelling as wholesale markets continues to be volatile.

Considerations

Whilst we appreciate the proposed approach to amending the risk percentage value to a monetary value the wholesale additional risk allowance is only a temporary measure (due to cease after charge restriction period 9b). As such we believe it would not be reasonable or necessary to change the approach currently taken for a single charge restriction period.