To all stakeholders

Making a positive difference
for energy consumers

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Price cap – Programme of Work

The default tariff cap ('cap') was introduced on 1 January 2019 to protect existing and future default tariff customers, ensuring that less engaged customers pay a fair price for their energy. The cap is set out in legislation through the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the "Act") we describe the legislative framework and cap methodology in Annex 1. At the time the cap was introduced, we estimated that it would save roughly £1 billion per year for energy customers on default tariffs[1]. It has also incentivised suppliers to improve operational efficiency.

Since we introduced the cap, we have continued to monitor the methodology and make changes as appropriate. Most recently, in response to the volatile market conditions, we decided to change the wholesale methodology to promote market resilience and protect customers from supplier failure. In our decision document[2], we said we would consult on a proposed price cap Programme of Work (PoW) and seek stakeholders' views.

In this letter, we present our current PoW, which sets out the workstreams we intend to prioritise over the next two to three years, in light of the current cap methodology and market conditions. The PoW provides visibility of the areas of the cap methodology we intend to review and promotes transparent policy making. It also gives reassurance that we will continue to monitor the cap methodology while balancing cap changes from market uncertainty alongside other changes required to ensure customer protection. The cap is being used as a key driver for the reference price for calculating the level of

[1] Ofgem (2018), Price cap press release
https://www.ofgem.gov.uk/publications/energy-price-cap-will-give-11-million-fairer-deal-1-january
[2] Price Cap – Decision on the changes to the Wholesale Methodology.
https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology

support offered by the Government to customers under the Energy Price Guarantee (EPG). This PoW provides confidence to market participants that we continue to set the cap independently and protect customers now and in the future.

The PoW is subject to further change to ensure we remain flexible and responsive to future challenges in the market and changes in Ofgem's priorities. However, the intention is to provide stakeholders with an opportunity to understand the range of issues we plan to consider in more detail. This opportunity may help stakeholders to plan their resources based on when we may seek input on the various workstreams we intend to proceed with. We welcome stakeholder views on our work plan outlined in this letter and may adapt our proposed PoW in response to this feedback.

Latest cap developments

In response to high energy prices and cost of living pressures faced by customers, the Government has recently implemented additional support such as the Energy Bill Support Scheme (EBSS) and the EPG. We welcome the Government's actions, which brings much needed support to domestic customers who will struggle to pay their energy bills this winter.

The Energy Prices Act 2022 legislated for the EPG and amended the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the "Act") by removing the cap end date and adding the additional requirement for Ofgem to have regard to the impact of the cap on public spending.

Current role of the cap under the EPG

The introduction of the EPG means that a typical UK household on direct debit will pay up to an average of £2,500 a year on its energy bills from 1 October 2022 to 31 March 2023 and £3,000 from 1 April 2023 to 31 March 2024. However, the cost to suppliers of providing that energy may be higher. For instance, the default tariff cap level for period 9a (October 2022 – December 2022) and 9b (January 2023 – March 2023), is £3,549 and £4,279 respectively[3]. During these periods, the cap acts as a key driver of the reference price for the EPG scheme. The Government will use the difference between the cap level and the EPG level to calculate how much funding is provided to suppliers for supplying energy at the EPG level to customers on default tariffs.

The Government has also announced it will work with consumer groups and industry to consider the best approach to consumer protection from April 2024, including options

[3] The cap levels shown are for a dual fuel, direct debit customer, calculated using the latest Typical Domestic Consumption Values (TDCVs). All values rounded to the nearest £.

such as social tariffs, as part of wider retail market reforms. We support this approach and will work closely with the Government to ensure that future measures protect customers. In the meantime, we expect the cap will continue to drive the reference price for the EPG.

Duration of the cap

Initially, the cap was due to end in December 2023 (at the latest). A key change from the Energy Prices Act 2022 is the ability for the cap to continue beyond 2023, with the default position being the cap remains in place and is removed following notice given by the Secretary of State.

Our Programme of Work

Setting out our workplan

In setting out our intended PoW for the next two to three years, we have prioritised workstreams based on a number of factors, such as the urgency of changes and their potential impact on the cap level, the impact on default tariff customers, changes in market conditions, dependencies between workstreams and availability of information. We set out the list of workstreams in Annex 2. These are key areas where we will seek stakeholder views rather than an exhaustive list of work we carry out.

The PoW reflects the current view of our plan based on the information currently available to us and is subject to change based on changes to Ofgem's priorities and market conditions. Additional work may emerge at short notice, meaning we may re-prioritise existing work, either removing workstreams from the list or changing the timescales/delivery period. This programme should be seen as an indication of anticipated workstreams and timescales rather than a steadfast commitment to undertake said workstreams.

Considering default tariff customers in vulnerable situations

With regard to default tariff customers who are also vulnerable, we recognise that they are often also on low incomes and/or find engaging with their supplier or the retail market generally more difficult. We will continue to consider the impact of each of our policy workstreams on different customer groups. For example, we carried out a distributional impact analysis on our changes to the wholesale methodology. In our analysis, we considered the impact our decision would have on different groups of customers such as low income groups and those with protected characteristics.

While the aggregate of our work on the price cap mainly influences the overall amount which default customers have to pay, we also recognise there are non-financial impacts for customers. Although this programme of work relates only to the price cap, through our wider work, we are continually looking at ways to mitigate the impact of high prices and improve other aspects of supply for customers. Examples of our wider work include:

- Activity in our Delivery and Schemes team including administering the Energy Company Obligation (ECO) and the Warm Home Discount.
- Energy Redress Fund scheme.
- Our rules on the Priority Services Register.
- Our continued compliance work to hold suppliers to account for poor performance, including our recent market wide compliance review.
- The advice we offer to consumers, directly and through charities and consumer groups.

In addition, we will work closely with BEIS on the announced consideration of the best approach to consumer protection from April 2024, including options such as social tariffs, as part of wider retail market reforms.

Stakeholder feedback

We recognise the value of stakeholders' views on the work that we should prioritise for the cap. We are particularly interested in stakeholders' views of the order and timing of the workstreams and what we should deprioritise if suggesting additional workstreams.

We request that stakeholders send their views by 3 January 2023 by email to Retailpriceregulation@ofgem.gov.uk.

Yours faithfully,

Dan Norton
Deputy Director, Price Protection

Annex 1 – Cap background

Legislative framework

The Act requires us to put in place and maintain the licence conditions which give effect to the cap. The objective of the Act is to protect existing and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. We must have regard to five matters when setting the cap. The need to:

- Create incentives for holders of supply licences to improve their efficiency.
- Set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts.
- Maintain incentives for domestic customers to switch to different domestic supply contracts.
- Ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.
- Set the cap at a level that takes account of the impact of the cap on public spending.[4]

The requirement to have regard to the five 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 cap objective aligns with Ofgem's consumer interest framework. In our framework, we set out four high-level objectives: Fair prices, Quality & Standards, Low-Cost Transition and Resilience.[5] While the cap cuts across all of these objectives, its most closely linked with Fair prices. The cap objective and consumer interest framework drive our decision making when making changes to the methodology.

Cap methodology

The cap sets a maximum amount a supplier can charge default tariff customers for energy. It varies based on a number of different parameters, including, fuel type, benchmark consumption, meter types, regional differences, and payment methods. We

[4] The regard to public spending was most recently added to the list through 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)).
[5] Ofgem's proposed framework for defining consumer interests is set out in Net Zero Britain: developing an energy system fit for the future. https://www.ofgem.gov.uk/publications/net-zero-britain-developing-energy-system-fit-future

calculate the cap using a bottom-up assessment of a nominal supplier's costs (ie we calculate each cost component individually and then add them together) and set it to reflect the nominally efficient costs of supplying energy.

The methodology changes we have made since the cap was introduced have focused around the cap components. These components are outlined in Table 1.

Table 1: List and description of cap components

Component	**Description**
Wholesale costs	The cost of purchasing energy to supply customers. Most of a supplier's energy purchases are reflected in the direct fuel costs, so this is the largest element of the wholesale costs component. There are also further elements: additional direct fuel allowances (see below), an allowance to reflect the difference between the costs of energy for the upcoming cap period and for the upcoming year (backwardation costs or contango benefits), and allowances for the contracts for difference and capacity market schemes. The additional direct fuel allowances cover: shaping, forecast error, imbalance, transaction costs, additional risk and uncertainty.
Network costs	The regional costs of building, maintaining, and operating the energy network and system infrastructure to deliver energy to households. The network charges that suppliers pay vary depending on certain criteria, such as where a customer lives, what type of electricity meter they have and how much energy they use.
Policy costs	A supplier must adhere to the Government social and environmental schemes. In most cases, these schemes lead to additional costs to suppliers that are then reflected in customers' energy bills. The policy cost allowance currently covers: Renewable Obligation, Feed-in-Tariff, Energy Company Obligation, Warm Home Discount, Assistance for Areas with High Electricity Distribution Charges and Green Gas Levy.

Operating costs	Operating costs are a supplier's own costs of retailing energy, excluding the costs mentioned above. In many cases these costs are shared across the customer base rather than being attributable to a single account. The operating cost allowance reflects the costs of a direct debit customer.
Smart Meter Net Cost Change (SMNCC)	The SMNCC covers the additional net costs associated with delivering the smart meter rollout. It takes the difference between a given year and the 2017 costs included in the original operating cost benchmark.
Payment method uplift	The payment method uplift reflects the cost (additional to the operating cost benchmark) faced by a supplier when a customer pays by different methods.
Adjustment allowance	The adjustment allowance allows for additional ad-hoc adjustments in the cap (eg adjustments for debt-related costs due to COVID-19).
Nominal profit (EBIT)	A profit allowance to ensure a nominal efficient supplier could earn a return for the risks it bears to finance its supply activities.
Headroom	The headroom allowance recognises uncertain cost pressures that are not explicitly covered by other allowances.
VAT	This refers to the 5% tax added to the level of the tariff and is set by the Government.

Annex 2 – List of workstreams

In this annex, we set out two tables with workstreams. Table A2.1 is a list of workstreams we intend to deliver within the next 3 years, including the near-term work that is currently underway and the medium-term work we intend to undertake. Alongside each workstream, we provide its description, delivery period and rationale of workstream and timing. These workstreams are set out in anticipated delivery date order, with the earliest delivery date first and the latest delivery date last. The delivery period sets out when we expect the workstream to end and is based on factors such as complexity, level of process and information required.

Table A2.2 lists, in no particular order, the workstreams we may consider carrying out in the longer term, alongside their description. Given the long-term nature of these workstreams and our intention to remain flexible to potential changes in the market, we do not provide an intended delivery date.

Table A2.1: List of near-term and medium-term workstream priorities

Workstreams	Description	Delivery period	Rationale of workstream and timing
COVID-19 true-up	Reconciliation of final additional debt-related costs due to COVID-19	Spring 23	The workstream seeks to conclude our ongoing consultation process to allow a nominal supplier to recover efficient additional debt-related costs due to COVID-19. In February 2021 we set an initial estimate of these costs and we referred to it as a float. We said that we would adjust this initial estimate to reflect the final costs once there were fully known (a 'true-up').

Balancing Service use of System Charge (BSUoS)	Consideration of whether to amend the default tariff cap to reflect potential changes to the connection and use of system code (CUSC) proposed by CMP361 or a similar modification.	Spring 23	The workstream seeks to conclude our ongoing consultation process to reflect any change to the CUSC in the price cap's BSUoS allowance methodology. The intention is to ensure the cap accounts for the BSUoS costs incurred by a nominal supplier and to reduce negative impact on cashflow.
SMNCC - Review of the current process	Reconsideration of the process by which non-pass-through SMNCC values are reviewed and updated. The current proposal is to indefinitely pause the annual methodological reviews. We also consider changes to SMNCC modelling to reflect the removal of a fixed price cap end date.	Spring 23	We intend to publish new non-pass-through SMNCC allowances ahead of October 2023. We are therefore aiming to confirm the process by which we will do so by Spring 2023.

New energy efficiency schemes	Government has announced that it may bring forward legislation to implement new obligations on energy suppliers to help customers take action to reduce their energy bills. We expect proposals may be announced shortly. In this workstream, we would consider whether to update our annex model to reflect new obligations and consult on any changes.	Spring 23	It would be appropriate to reflect the introduction of a potential new scheme in the cap methodology to help ensure that an efficient supplier could recover its costs related to the scheme. This workstream is contingent on future announcements/proposals from the Government.
Earnings before Interest and Tax (EBIT) Allowance Review	Review of the current methodology to ensure the allowance continues to be appropriate in light of a range of market conditions.	Summer 23	We set the EBIT allowance was set in 2018 and since then, the market has gone through a number of changes. A review of EBIT is intended to ensure that the allowance still appropriately reflects a fair return for a notional efficient supplier. The consultation process for this review is underway.
SMNCC – Model update	Update of the non-pass through SMNCC allowances for credit and prepayment meters in the default tariff cap. The workstream is dependent on the outcome of reviewing the SMNCC process.	Summer 23	Updating the non-pass-through SMNCC model helps ensure the SMNCC allowances remain appropriate. The nature of the update undertaken is dependent on the outcome of the SMNCC process review.

Debt-related costs	Review of the debt-related costs allowance, in light of current energy market volatility, the government intervention and other factors.	Winter 23/24	Debt-related costs is one element of the price cap that is impacted by the government interventions and other macroeconomic factors such as interest rate rises. We intend to carry out a review to mitigate against a material discrepancy between costs and allowance, either temporarily or more systematically.
Price Cap Extension consultation	Update of supply licence conditions and dates in cap models to reflect removal of the 2023 end date for the price cap (as legislated for in the Energy Prices Act 2022).	Winter 23/24	We intended to reflect the Energy Prices Act changes to ensure the cap does not prematurely end in supply licences or cap models. This requires the changes to be in place before the end of 2023.
Price Cap Derogations	Review of the guidance on derogation requests for renewable tariffs from the default tariff cap and make changes as necessary.	Winter 23/24	As the cap no longer has a fixed end date, it is appropriate that we review the cap derogation process as market conditions have changed substantially and the current derogations are enduring. We have not reviewed the guidance since 2018.
Additional wholesale allowances review	Review of the current additional wholesale allowances that form part of the wholesale methodology. This includes shaping, imbalance, transaction costs and uncertainty.	Summer 24	We consider a review is appropriate to ensure the allowances appropriately reflect efficient costs incurred by a nominal supplier, particularly given our changes to the wholesale methodology and that the methodology has not been reviewed since 2018. This is an area we said we would consider in our August 2022 decision on changes to the wholesale methodology.

Review of the August 2022 changes to the wholesale methodology	A review of the policy to move to quarterly cap updates, reduce the notice period and the approach to backwardation (eg recovery period).	Winter 24/25	Our August 2022 decision to change the wholesale methodology was a significant change to how the cap functions. We consider it appropriate to review the change and consider whether it's the appropriate enduring approach. The intended timing for this workstream is based on when we consider sufficient information will be available to effectively assess the impacts.
Operating cost review	Re-benchmarking of operating costs across payment methods. Payment method uplift, SMNCC and bad debt all fall into operating costs. We intend to consider the approach to all these components as part of this workstream to ensure the allowance reflects the efficient costs of a nominal supplier. We may also consider differences in costs incurred by groups of default tariff customers (eg customers on different payment methods) in so far as we are able to within the cap framework.	Winter 24/25	The allowance was set in 2018 and subsequently indexed by inflation. Given the number of changes in the market and the changes we have made to the cap methodology, we consider a review of the operating cost allowance is appropriate to re-baseline a number of cap costs and ensure the allowance appropriately reflects efficient costs. The timing of this workstream reflects factors such as, the cross-cutting scope, potential complexity of methodology, the type of data we may require from stakeholders, and any other relevant considerations.

Table A2.2: List of long-term workstreams

Workstream	Description
Price Cap Green Tariffs Policy	A review of whether a minimum level of renewable energy supply should be required within the default tariff cap mechanism, and ensure suppliers provide this to consumers.
Network Costs	A review of the remaining elements of network costs. This follows changes to the BSUoS costs. We plan to consider whether any further changes are required.
Policy Costs	A review of the policy cost component contained in Annex 4 of the price cap to consider whether the calculation of policy costs is still appropriate and whether there are any further costs to add or remove.
Headroom allowance	A review of the headroom component. The Headroom allowance captures the residual net uncertainty across the cap methodology. Therefore we consider that if we review headroom, it should follow considering changes to the other cap components.