

Consultation



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Price cap: Consultation on reflecting potential changes to BSUoS charges in the price cap

Subject	Details
Publication date:	25 November 2022
Response deadline:	23 December 2022
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The Gas and Electricity Market Authority (the Authority) is considering changing the way Balancing Services Use of System ('BSUoS') charges are recovered from electricity network users. The proposed modification intends to replace the ex-post variable charge, which varies in each half-hour period, with a flat volumetric charge, set in advance. The proposed change is driven by Connection and Use of System Code (CUSC) modification CMP361, on which the Authority has published a minded-to decision and consultation to approve.¹

This document is considering whether and how to modify the price cap, if Ofgem makes the separate decision to approve CMP361, or equivalent modification². This includes considering whether any transitional adjustment is required and, if so how to implement it. We would like views from all stakeholders with an interest in the domestic retail energy supply market. We particularly welcome responses from energy suppliers, consumer groups and charities. We would also welcome responses from other stakeholders and the public.

¹Ofgem (2022) Consultation on CMP361/362 - Minded-to decision and draft impact assessment.
<https://www.ofgem.gov.uk/publications/cmp361362-minded-decision-and-draft-impact-assessment>

²In September 2022, Ofgem published a minded-to decision to approve CMP361, however, we have recently published a supplementary consultation to reconsider the viability of our minded-to position. It follows that the introduction of the ex-ante fixed tariff might be delivered via a different mode (not CMP361), which would be a variation of CMP361. More details can be found here: Ofgem (2022) Consultation on CMP361 - Update to our minded-to and draft impact assessment
<https://www.ofgem.gov.uk/publications/cmp361-update-our-minded-and-draft-impact-assessment>

This document outlines the scope, purpose and questions of the consultation and how you can get involved. Once the consultation is closed, we will consider all responses. We want to be transparent in our consultations. We will publish the non-confidential responses we receive alongside a decision on next steps on our website at [Ofgem.gov.uk/consultations](https://www.ofgem.gov.uk/consultations). If you want your response – in whole or in part – to be considered confidential, please tell us in your response and explain why. Please clearly mark the parts of your response that you consider to be confidential, and if possible, put the confidential material in separate appendices to your response.

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Executive summary

The price cap, as set out in law in 2018, reflects what it costs to supply energy to our homes by setting a maximum suppliers can charge per unit of energy. Ofgem introduced the default tariff cap (the 'cap') on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs').

In September 2022, Ofgem published a minded-to decision and consultation to approve CMP361, a modification which would change the way Balancing Services Use of System ('BSUoS') charges are recovered from suppliers³. The proposed modification intends to replace the ex-post variable charge, which varies in each half-hour period, with a flat volumetric charge, set in advance. This document is considering whether and how to modify the price cap, if Ofgem makes the separate decision to approve CMP361 or equivalent modification.⁴ This includes considering whether any transitional adjustment is required and, if so how to implement it. If CMP361, or equivalent modification, is approved, it would come into effect from April 2023. It follows that we are currently consulting on its approval and, in parallel, this consultation seeks to address how we might reflect the changes in the price cap.

Background

The issue

Under the current methodology, the BSUoS allowance in the cap is updated twice yearly and is calculated using lagged charges. The allowance for the summer cap periods (implemented in April of each calendar year) is estimated by calculating a weighted average of BSUoS charges in £/MWh in each settlement period during the preceding calendar year.⁵ The allowance for the winter cap periods (implemented in August of each calendar year) is estimated similarly and uses BSUoS charges across the preceding year running from 1 July to 30 June.

³ Ofgem (2022) Consultation on CMP361/362 - Minded-to decision and draft impact assessment <https://www.ofgem.gov.uk/publications/cmp361362-minded-decision-and-draft-impact-assessment>

⁴ In September 2022, Ofgem has published a minded-to decision to approve CMP361, however, we have recently published a supplementary consultation to reconsider the viability of our minded-to position. It follows that the introduction of the ex-ante fixed tariff might be delivered via different mode (not CMP361), which would be a variation of CMP361. More details can be found here: Ofgem (2022) Consultation on CMP361 - Update to our minded-to and draft impact assessment

<https://www.ofgem.gov.uk/publications/cmp361-update-our-minded-and-draft-impact-assessment>

⁵ A settlement period is a half-hour period used for trading and balancing electricity. The ESO publishes a charge for each period per day. A day consists of 48 settlement periods.

The proposed CMP361, or equivalent modification, aims to introduce an ex-ante fixed volumetric BSUoS tariff to replace the existing variable charge in time for cap period 10a (April 2023-June 2023).

If the CMP361, or equivalent modification, is approved, three major elements should be considered while assessing whether and how to reflect it in the price cap:

- Moving from a lagged methodology to an ex-ante variable tariff, means a period of BSUoS charges incurred by suppliers (January 2022–March 2023) that would not be fully recovered through future price caps. Hence, when implementing the new methodology, a notional supplier might fail to recover some efficient costs.⁶
- Because of the lagged recovery mechanism, suppliers recovered some BSUoS costs incurred outside of the price cap (July 2017 to December 2018) during the first three cap periods (January 2019 to March 2020). Those costs have then been recovered twice: before and after the price cap.
- We have observed an increasing trend in BSUoS costs, making it *more likely* that suppliers will not fully recover costs at the time of change.

Although the price cap works on a nominal basis and so there is no guarantee that suppliers will recover their actual costs (even when they are arguably efficient), leaving such gaps (as is considered to be the case for the January 2022-March 2023 BSUoS costs) may, depending on the scale and all the other circumstances, not be in consumers' best interests.

Why reflect CMP361, or equivalent modification, in the price cap

We consider suppliers, and indirectly customers, would benefit from introducing of an ex-ante fixed tariff in the price cap methodology. This would reduce uncertainties around BSUoS charges and, therefore, suppliers' costs associated with managing those uncertainties.

In this consultation, we also discuss the need for a transitional adjustment. As mentioned above, when replacing the existing lag methodology with an ex-ante tariff, suppliers would not fully recover the costs incurred between January 2022 and March 2023. We therefore consider that a transitional adjustment would allow a notional supplier to recover its efficient costs.

⁶ The notional supplier is a theoretical and efficient supplier that has no direct comparison with existing suppliers but draws from the properties across efficient suppliers in the market.

From a customer’s perspective, we estimate that the transitional adjustment would likely mean an increase in costs of c. £27 per typical electricity customer at the cap benchmark consumption over the transitional period, subject to uncertainty of BSUoS prices for the remainder of winter. Yet, we also acknowledge that suppliers’ costs have recently increased since the Electricity System Operator (‘ESO’) has had to implement some policies⁷, such as the Winter Contingency Contracts and the Demand Flexibility, to ensure security of supply this winter. It follows that, failing to allow suppliers to recover the transitional adjustment costs might lead them to experience a substantial under-recovery, in the current fragile market conditions, this could contribute to further failures.

In these circumstances we therefore think that it is in customers’ interests to reflect the potential CMP361, or equivalent modification, in the price cap, including the introduction of a transitional adjustment. Doing so would reduce customers’ exposure to the costs and risks of suppliers’ failure. It would also make it more likely that the ESO would recover from the suppliers the appropriate charges for the actions it has undertaken in securing supply this winter.

We note that the transitional adjustment costs do not ultimately increase the amount customers are expected to pay as the current lagged methodology would ultimately recover these higher costs. At the time of moving to ex-ante methodology, a notional supplier would not have recovered all of its ex-post costs, leading to a consequential overlap in collection.

Purpose of this consultation

We are seeking views on whether to change the cap, **if CMP361, or equivalent modification, is approved**. Specifically, we are looking for stakeholders’ views on:

- whether and how to update the BSUoS allowance on an enduring basis; and
- whether a transitional adjustment is needed moving from an ex-post to an ex-ante BSUoS recovery mechanism, and if so, how to implement it.

If CMP361, or equivalent modification, are not approved by the Authority, our proposal would be to make no change to the cap methodology.

⁷ For more details on the ESO winter 2022/2023 policies: <https://www.nationalgrideso.com/winter-operations>.

Our proposal

If CMP361, or equivalent modification, is approved, we are proposing:

- To modify the price cap methodology by replacing the lagged variable charge with an ex-ante fixed volumetric charge in time for cap period 10a (April 2023-June 2023). This would allow suppliers to recover BSUoS costs as they incur them, thereby reducing suppliers' risks.
- To introduce a transitional adjustment of c. £27 per typical electricity customer at the cap benchmark consumption. This would prevent the transition to alternative charging structures potentially leading to further market instability and, ultimately, does not increase the amount that customers have to pay.
- For the implementation of the adjustment, we are proposing:
 - To calculate the adjustment by offsetting the costs incurred by suppliers between January 2022 and March 2023 against the costs recovered under the first three cap periods (January 2019 to March 2020).
 - Not to offset the adjustment against the headroom allowance.
 - To implement the adjustment over two stages (cap period 10a, April 2023–July 2023, and cap period 10b, July 2023–September 2023).
 - To apply each adjustment over a twelve month period and include it in the 'Annex 3 Network cost allowance methodology elec'. The former means suppliers would recover the full transitional costs by the end of cap period 12a (April 2024- June 2024).

Next steps

We are requesting responses by 23 December 2022. We intend to issue a decision in February 2023. If we decide to update the cap methodology, this will take effect from 1 April 2023 (cap period 10a, April 2023-June 2023).

1. Consultation process

What are we consulting on?

1.0. We are consulting in order to seek views on whether and, if so, how to reflect the potential change in the way Balancing Services Use of System ('BSUoS') charges are recovered in the default tariff cap ('cap'). This also includes whether and how to introduce a transitional adjustment.

1.1. We invite stakeholders to submit comments on any aspect of this consultation on, or before, **23 December 2022**.

1.2. Responses to this consultation, and any supporting evidence, can be submitted to Ofgem by emailing RetailPriceRegulation@ofgem.gov.uk. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

1.3. We are also happy to speak to stakeholders during the consultation period, to understand their initial views. If you would like to arrange a call, please contact us through retailpriceregulation@ofgem.gov.uk.

1.4. We intend to publish a decision in February 2023, so that, if needed, any changes may come into effect from 1 April 2023 (cap period 10a April 2023-June 2023).

1.5. This document is split into five chapters:

- Chapter 1: Consultation process;
- Chapter 2: Introduction;
- Chapter 3: Enduring changes to the cap;
- Chapter 4: Transitional arrangement; and
- Chapter 5: Implementation of the transitional arrangement.

Related publications

1.6. The main documents related to the potential change in the way BSUoS charges are recovered in the cap are:

- 2018 decision on the cap methodology ('2018 decision'): <https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>
- April 2022 decision on CMP308 removal of BSUoS charges from generation: <https://www.ofgem.gov.uk/publications/cmp308-removal-bsuos-charges-generation>
- September 2022 call for input on our approach to reflecting potential changes to BSUoS charges in the price cap ('September 2022 Call for input'): <https://www.ofgem.gov.uk/publications/price-cap-call-input-our-approach-reflecting-potential-changes-bsuos-charges-price-cap>
- September 2022 consultation on CMP361/362 - Minded-to decision and draft impact assessment: <https://www.ofgem.gov.uk/publications/cmp361362-minded-decision-and-draft-impact-assessment>
- November 2022 consultation on update on CMP361 - Update to our minded-to and draft impact assessment ('Supplementary consultation'): <https://www.ofgem.gov.uk/publications/cmp361-update-our-minded-and-draft-impact-assessment>

How to respond

1.7. We want to hear from anyone interested in this consultation. Please send your response to the person or team named on this document's front page.

1.8. We've asked for your feedback throughout. Please respond to each one as fully as you can.

1.9. We will publish non-confidential responses on our website at www.ofgem.gov.uk/consultations.

Your response, data and confidentiality

1.10. You can ask us to keep your response, or parts of your response, confidential. We will respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000, the Environmental Information Regulations 2004, statutory directions, court orders, government regulations or where you give us explicit permission to disclose. If you do want us to keep your response confidential, please clearly mark this on your response and explain why.

1.11. If you wish us to keep part of your response confidential, please clearly mark those parts of your response that you *do* wish to be kept confidential and those that you *do not* wish to be kept confidential. Please put the confidential material in a separate appendix to your response. If necessary, we will get in touch with you to discuss which parts of the information in your response should be kept confidential, and which can be published. We might ask for reasons why.

1.12. If the information you give in your response contains personal data under the General Data Protection Regulation (Regulation (EU) 2016/679) as retained in domestic law following the UK's withdrawal from the European Union ("UK GDPR"), the Gas and Electricity Markets Authority will be the data controller for the purposes of GDPR. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. Please refer to our Privacy Notice on consultations, see Appendix 4.

1.13. If you wish to respond confidentially, we'll keep your response itself confidential, but we will publish the number (but not the names) of confidential responses we receive. We won't link responses to respondents if we publish a summary of responses, and we will evaluate each response on its own merits without undermining your right to confidentiality.

General feedback

1.14. We believe that consultation is at the heart of good policy development. We welcome any comments about how we have run this consultation. We would also like to get your answers to these questions:

1. Do you have any comments about the overall process of this consultation?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Were its conclusions balanced?
5. Did it make reasoned recommendations for improvement?
6. Any further comments?

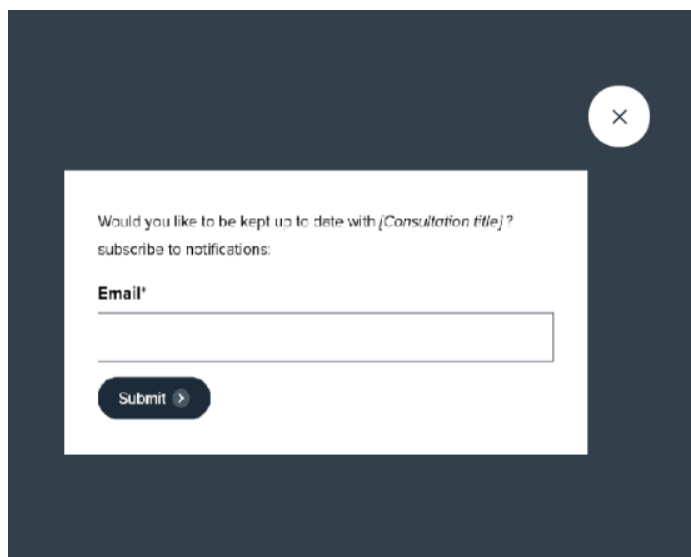
Please send any general feedback comments to stakeholders@ofgem.gov.uk

How to track the progress of the consultation

You can track the progress of a consultation from upcoming to decision status using the 'notify me' function on a consultation page when published on our website.

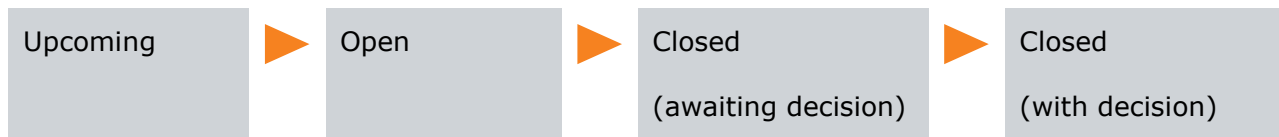
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The image shows a dark-themed modal window with a white background for the form. At the top right of the modal is a white circle with a black 'x' icon. The form text reads: "Would you like to be kept up to date with [Consultation title]?" followed by "subscribe to notifications:". Below this is a label "Email" and a text input field. At the bottom left of the form is a dark button with the text "Submit" and a right-pointing arrow.

Once subscribed to the notifications for a particular consultation, you will receive an email to notify you when it has changed status. Our consultation stages are:



2. Introduction

Section summary

This chapter provides context on the cap and the statutory framework. It also discusses context on BSUoS charges, BSUoS allowance in the cap, the proposed CMP modification and trends in BSUoS charges. It then explains the consequent scope of the consultation and our approach to considering adjustments to the cap.

What are we consulting on?

The cap

2.0. We introduced the cap on 1 January 2019, which protects households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures default tariff customers pay a fair price for the energy they consume, reflecting its underlying efficient costs.

Statutory framework

2.1. 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. 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 of a notional supplier. 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;
- 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;
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence; and

- the need to set the cap at a level that takes account of the impact of the cap on public spending.⁸

2.2. 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.

2.3. In setting the cap, we may not make different provisions for different holders of supply licences. This means that we must set one cap level for all suppliers.

The issue

2.4. Ofgem is considering modifying how BSUoS charges are recovered from electricity network users. The modification (proposed by CMP361, or equivalent modification) intends to replace the ex-post variable charge which varies in each half-hour period with a flat volumetric charge, set in advance. **If CMP361, or equivalent modification, is approved,** we are considering whether and, if so how to update the cap methodology to reflect this change. Given the present lagged BSUoS recovery mechanism in the cap and the recent increase in the BSUoS trend, we are examining whether the change would also require a transitional adjustment and if so, how best to implement it.

2.5. Our proposals build on our initial thinking in the September 2022 Call for Input⁹, considering stakeholders' responses.

⁸ 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)).

⁹ Ofgem (2022) Price cap: Call for input on our approach to reflecting potential changes to BSUoS charges in the price cap: <https://www.ofgem.gov.uk/publications/price-cap-call-input-our-approach-reflecting-potential-changes-bsuos-charges-price-cap>

Context

BSUoS charges

2.6. The National Grid Electricity Systems Operator ('ESO') is responsible for ensuring electricity supply meets demand second by second. This process is called balancing the grid.¹⁰ This also includes having winter contingency contracts in place that will provide electricity if needed to ensure security of electricity supply. This is particularly relevant at this time where there are wider concerns around security of supply, given the global energy crisis.

2.7. The ESO recovers costs associated with balancing the electricity transmission system through the BSUoS charges.

2.8. Under the status quo, Final Demand and liable generators¹¹ are charged an ex-post BSUoS volumetric charge (£/MWh) based on the amount of energy imported from or exported onto the network within each half-hour period. As the charges are ex-post, the exact level of charge is not known until after the period for which the balancing services have been provided.

2.9. Following the approval of CMP308, from April 2023, liability for BSUoS charges will move fully on to Final Demand. This change is likely to improve competition in the generation market.¹² As such, we note that, there is the possibility that the removal of BSUoS charges leads to wholesale price decreases, as generators no longer pass through these costs in their wholesale market prices. The impact on end users might then be neutral.

Allowance for BSUoS in the cap

2.10. Under the cap, BSUoS charges are included in the 'Annex 3 Network cost allowance methodology elec' (referred to in this document as 'Annex 3 model'). The allowance for a particular cap period is set by calculating the weighted average of BSUoS charges in £/MWh in each settlement period across the preceding calendar year (for summer cap periods) and

¹⁰ National Grid ESO (2022), How do we balance the grid?

<https://www.nationalgrideso.com/electricity-explained/how-do-we-balance-grid>

¹¹ Final Demand is currently defined in CUSC as electricity consumed other than for the purposes of generation or export onto the electricity network.

Liable generators are generators that uses the transmission network to supplier their energy.

¹² Ofgem (2022) CMP308: Removal of BSUoS charges from Generation,

<https://www.ofgem.gov.uk/publications/cmp308-removal-bsuos-charges-generation>

preceding year running from 1 July to 30 June (for winter cap periods). These charges are passed to customers on a lagged basis. For the avoidance of doubt, we note that, following the decision¹³ on the frequency of the cap update (which was to move from six monthly updates to quarterly updates), the frequency of the network costs allowance update remained unchanged at twice yearly, in April and October.

Proposed Modification CMP361

2.11. In February 2021, the ESO proposed to modify the way that BSUoS charges are collected from electricity network users, through Connection and Use of System Code (CUSC) modification CMP361.¹⁴ The proposed CMP361 modification follows the recommendation of the Second Balancing Services Charges Task Force¹⁵ that BSUoS charges should be levied in the form of a flat volumetric £/MWh charge¹⁶, known to users in advance and fixed for a set period.

2.12. The proposal also included the following elements to help the ESO mitigate financial risks resulting from setting a fixed ex-ante tariff in addition to the relevant working capital facility.¹⁷

- **Fixed period:** This is the period for which the fixed BSUoS tariffs are set eg twelve months. Even though the tariff is intended to be fixed for a set period, it is possible that it might be changed within this period. In chapter 2, we discuss when and how such an event might occur.

¹³ Ofgem (2022) Price cap – Decision on changes to the wholesale methodology, p27.

<https://www.ofgem.gov.uk/sites/default/files/2022-08/Price%20cap%20-%20Decision%20on%20changes%20to%20the%20wholesale%20methodology.pdf>

¹⁴ The Connection and Use of System Code is the contractual framework for connecting to and using the National Electricity Transmission System

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 modification, dependent on the decision reached in CMP361, it is not the main subject of this consultation.

¹⁵ Charging Future (2020), Final Report: Second Balancing Services Charges Task Force

<http://chargingfutures.com/media/1477/second-balancing-services-charges-task-force-final-report.pdf>

¹⁶ Currently BSUoS charges are recovered using a £/MWh volumetric charge that varies in cost in each 30 minute settlement period to reflect the specific costs that arose in that period

¹⁷ Working capital facility is set up to fund National Grid ESO's cashflow requirement. A proportion of facility is allocated to fund cashflow requirements due to BSUoS charges.

- **Notice periods:** This is the period for which tariffs will be known to users in advance of being in place.
- **BSUoS fund:** This is the buffer of industry money built up via an additional component on BSUoS charge over time and used by the ESO if they under-recover costs via the fixed BSUoS tariff.
- **P-level:** This is a representation of a given proposal’s likelihood to provide tariffs that, under normal circumstances once set, will not change, based on the number of years out of 100 that tariffs would be expected remain certain. Therefore, a higher P level of certainty requires the Fund to be sized accordingly to prevent Tariffs being reset, as more eventualities will need to be covered. For example, a P99 level reflects a 1 in 100 year probability of tariffs needing to be reset within the fixed period, with a Fund size to cover this level of probability.
- **BSUoS fund recovery:** This is the period over which the BSUoS fund is built-up.

2.13. In September 2022, Ofgem published a minded-to position to approve one of the proposals under CMP361 (WACM5) which would introduce a fixed tariff for a one year period, with three months’ notice, provided to users ahead of the fixed tariff period¹⁸. The approved proposal also includes a BSUoS fund, set at P99 level, and a five year BSUoS fund build-up starting from April 2023.

2.14. Following industry concerns in relation to certain elements of Ofgem’s minded-to position, in November 2022, Ofgem published a supplementary consultation to address these concerns, providing additional information and associated considerations.¹⁹ Particularly, the consultation seeks further inputs on the appropriate level of risk (P-Level) to set the value of the BSUoS fund.

¹⁸ Ofgem (2022), CMP361/362 - Minded-to decision and draft impact assessment. <https://www.ofgem.gov.uk/publications/cmp361362-minded-decision-and-draft-impact-assessment>

¹⁹ Ofgem (2022) CMP361 - Update to our minded-to and draft impact assessment. <https://www.ofgem.gov.uk/publications/cmp361-update-our-minded-and-draft-impact-assessment>

2.15. For avoidance of doubt, we continue to support the principle of fixing BSUoS charges. We expect the additional code modification to still introduce a fixed ex-ante tariff, but with more options related to the P-Level and the corresponding BSUoS fund level.

2.16. We consider that the principles of an ex-ante BSUoS tariff would likely provide significant competition benefits to suppliers by reducing uncertainty, volatility and risk premiums. Together, we consider these effects are likely to deliver lower costs for default tariff customers in the years ahead.

2.17. If CMP361, or equivalent modification, is approved, it would be implemented in April 2023.

Other modification: CMP308

2.18. We also acknowledge that the modification CMP308, which will be implemented in April 2023, establishes that only Final Demand - rather than Final Demand and generation - will be liable for BSUoS charges. It aims to better align the GB 'generation cost stack' with those in other EU markets, facilitating competition between generators, internationally. All things being equal, removing BSUoS charges from generation should result in lower wholesale prices, ultimately offsetting an increase in demand charges. Hence, while benefiting suppliers, we consider that this modification might also be neutral for default tariff customers over time.

2.19. The fixed ex-ante tariff, proposed through CMP361 or equivalent modification, would reflect the increased suppliers' liability, following from CMP308, from April 2023, such that the proposed changes to the price cap would also reflect this.

2.20. As noted above, we are currently reconsulting on our CMP361 decision. As part of that consultation, we note that whilst we continue to support the principle of fixing BSUoS charges from April 2023, we consider that our previous minded-to position (to approve WACM5) is highly unlikely to be an appropriate solution. Therefore, in addition to reviewing other options available under CMP361, we have requested that National Grid ESO bring forward an alternative modification proposal, which continues to work towards implementation from April 2023 where possible. We will continue to work with industry to reach a decision on these modifications as soon as reasonably practicable.

2.21. In the event that CMP361, or an equivalent modification, was not approved for implementation from April 2023 prior to our February decision ahead of cap period 10a (April 2023-June 2023), it would not be appropriate to proceed with the proposed corresponding

changes to the price cap in this period. In such circumstances, we might issue a consultation to seek views on the most appropriate approach to reflect the impact of CMP308 in the cap.

2.22. We understand that the implementation of CMP308 from April 2023 without a concurrent change to the price cap might affect suppliers' cash flow temporarily, as without a change to the price cap BSUoS allowance (following the increased suppliers' liability) would ultimately be recovered through the existing mechanism. **We are seeking stakeholder views on the expected significance of this and would be particularly interested on views as to how we may minimise any significant impacts through the cap moving forward.**

Trends in BSUoS charges

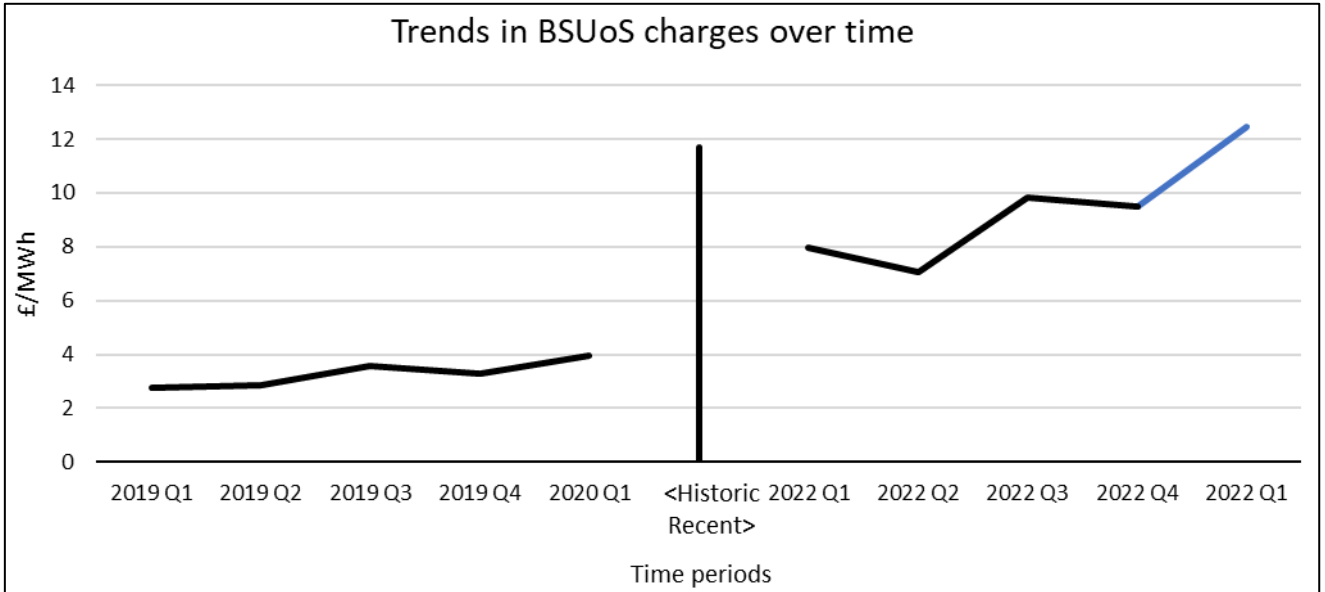
2.23. Figure 1 compares historical and recent trends in average BSUoS charges. The latter have almost tripled since the introduction of the price cap in 2019 and are now at record highs. Charges in early cap periods (January 2019 - March 2020) were, on average, £3/MWh, while charges in current cap periods (January 2022 - March 2023), are estimated to be, on average, £9/MWh (not fully accounting for the cap on BSUoS charges at maximum £40/MWh between 6th October and 31st March).²⁰

2.24. The ESO has identified several factors behind the recent cost increase, including high prices and tighter margins across Europe due to gas security issues, increased GB interconnection exports and network constraints in the south of England. We would expect the increasing trend to continue (as presented by the forecasted figures) over the winter period, particularly because of the costs associated with policies undertaken by the ESO to maintain safe and secure operation of the electricity system throughout Winter.

²⁰Ofgem (2022), Connection and Use of System Code (CUSC) CMP395: Cap BSUoS costs and Defer payment to 2023/24 to protect GB customers(CMP395).

<https://www.ofgem.gov.uk/sites/default/files/2022-10/CMP395%20Decision.pdf>

Figure 1: Trends in BSUoS charges in £/MWh (historical and recent)



Line graph showing quarterly average BSUoS charges over time. The graph is divided into two, left-hand side presents the historical trend, and the right-hand side presents the recent trend. The historical period includes data from 2019 Q1 up until 2020 Q1 (inclusive). The recent period includes data from 2022 Q1 up until 2023 Q1 (inclusive).

Source: Ofgem Analysis using ESO data. **Notes:** the £/MWh figures are calculated using the total BSUoS charges divided by the total implied consumption. A combination of actual (in black) and forecast data (in blue) is used for the most recent periods.

Implications to the price cap methodology

Enduring changes

2.25. If the CMP361 or equivalent modification is approved, we are considering whether to update 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).

Why a transitional adjustment might be needed

2.26. 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 between January 2022 and March 2023 that would not be fully reflected and recovered through future price caps. Because of the lagged recovery mechanism, suppliers are likely to have recovered some

BSUoS costs incurred prior to the cap's introduction (July 2017 to December 2018) during the first three cap periods (January 2019 to March 2020). Consequently, these costs were likely recovered twice: before the cap was introduced and under the first three cap periods.

Assuming that the BSUoS trend did not increase over time, the just mentioned historical recovery would net out with the costs suppliers incurred between January 2022 and March 2023, that they might fail to recover. It follows that, under this scenario, the BSUoS costs incurred and recovered by suppliers under the price cap may be broadly equal.

2.27. However, as illustrated in figure 1, the BSUoS trend has increased over time, making it less likely that the costs incurred and recovered by suppliers under the price cap will be equal. It follows that, when implementing the ex-ante mechanism, a transitional arrangement might be needed to allow suppliers to recover their costs and such that customers are not negatively affected by their failure to do so. If the expected trends in BSUoS were to change, and we expected suppliers to over-recover costs, we might also adjust the cap.

Consultation scope

2.28. This document sets out our consideration on whether (and if so, how) to reflect the proposed modification from cap period 10a (April 2023-June 2023).

2.29. Specifically, this consultation focuses on our approach to:

- updating the BSUoS allowance on an enduring basis; and
- assessing whether a transitional adjustment is needed, and if so, how to implement it.

2.30. We provide further information on these areas in Chapters 3, 4 and 5 respectively.

3. Enduring changes to the cap

Section summary

We explain our proposed approach to updating the BSUoS allowance on an enduring basis, if CMP361 or equivalent is approved. We also set out our proposed approach in the event of the BSUoS tariff changing within the twelve month fixed period.

Changing the cap methodology

Context

3.1. As discussed in Chapter 2, Ofgem published a minded-to decision to change how BSUoS costs are charged. We are now considering reflecting the changes in the price cap.

3.2. As we stated in our September 2022 Call for Input, if the modification is approved, we are minded to reflect the new ex-ante fixed charge in the cap. To reflect the change, we would need to update the Annex 3 model to input the new fixed charge.

3.3. In total, we received responses from 10 stakeholders – 8 suppliers and 2 consumer groups - to our September 2022 Call for Input.

Proposal

3.4. Our minded-to position remains unchanged: we propose to update the Annex 3 model to input the new fixed tariff, including any BSUoS fund contributions.

Overview of stakeholder responses

3.5. In response to the call for input, 8 stakeholders agreed with our minded-to position, if the modification is approved. The two remaining stakeholders have not expressed a position on this.

Our considerations

3.6. Allowances in the price cap are generally set ex-ante to avoid the risk of distorting competition in the wider market. However, the BSUoS component is set ex-post. This is

because BSUoS charges are particularly volatile and the forecasts available at the time of the 2018 decision²¹ were not sufficiently accurate for our purposes.

3.7. By introducing an ex-ante fixed tariff, the ESO would set the BSUoS allowance using forecast charges rather than actual costs to balance the system. As a result, suppliers would be able to recover their costs as they incur them. Future forecasts would then be adjusted to account for any over-allocation or under-allocation by the ESO. Allowing suppliers to recover their costs as they are incurred would reduce suppliers' cashflow risks. One respondent supported these points.

3.8. The implementation of CMP308 in April 2023 would temporarily exacerbate the cashflow issues suppliers would face under the current lag recovery mechanism. For example, in cap periods 10a&b (April 2023-September 2023) suppliers would be liable to pay the entire BSUoS charge, while they recover the BSUoS charges they incurred between January 2022 and December 2022, which is a portion of the BSUoS charge that suppliers were liable for before CMP308. Therefore, we consider the proposed changes to implement the fixed- ex-ante tariff in the cap, if CMP361 or equivalent is approved, would minimise the temporary cashflow risks that might be caused by implementing CMP308 alone.

3.9. Customers would also benefit from implementing an ex-ante fixed tariff in the price cap. Indeed, given the uncertainty around the BSUoS trend, retaining a lagged ex-post recovery mechanism, leaves open the possibility of changes in costs associated with lagged recovery. An upward change might expose suppliers, and ultimately customers to higher costs.

3.10. One respondent agreed with our minded-to position, yet they also said that a holistic review of the price cap would be preferred, rather than amending discrete elements of it, such as the BSUoS methodology. Ofgem currently does not intend to restructure the price cap. However, as with all cost components, where there is evidence of material and systematic changes in costs, we will make considerations accordingly.

3.11. We include details on how we will update the Annex 3 model in the Appendix 1.

²¹ Ofgem (2018) Default Tariff Cap: Decision appendix 5- Policy and network costs
https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_5_-_policy_and_network_costs.pdf

The possibility of BSUoS tariff changing within the fixed period

Context

3.12. As noted in Chapter 2, to reduce the financial risks of moving to a fixed ex-ante tariff, the proposed CMP361 modification includes a BSUoS fund, set at P99 level, and a 5 year BSUoS fund build-up starting from April 2023 in addition to the working capital facility.²² These elements are interlinked. The presence of a fund, the speed at which the fund is built up and the level of the working capital facility impacts the likelihood of a tariff reset.

3.13. Where the ESO has strong evidence that the combination of the BSUoS fund and the capacity available in their working capital facility would be insufficient to meet expected future cashflow requirements within the fixed period, the tariff would be reset within the period. Since BSUoS charges are highly volatile²³, it is possible that outturn costs and future expected costs (within the fixed period) of the ESO deviate from the tariff set in advance, thereby exposing the ESO to financial risk and potentially increasing the possibility of a tariff reset within the fixed period.

3.14. We therefore need to consider our approach to adjusting the BSUoS allowance in the price cap, due to the possibility of a tariff reset within the fixed period. We did not include this in our September 2022 Call for Input.

Proposal

3.15. Due to the possibility of a tariff reset during the fixed period, we propose:

- To review the BSUoS allowance on a quarterly basis. Compared to reviewing it every six months in line with the wholesale methodology decision, updating it quarterly would reduce the amount of time the allowance may differ from the reset fixed price. This would reduce any additional costs suppliers would face due to

²² We note that there is a possibility that these elements may change as a result of the Supplementary consultation and the equivalent modification that follows.

²³ At times between May 2021 and May 2022, the cost of BSUoS charges fell below c.£-6/MWh for some periods and reached c.£100/MWh at other times.

delayed cost recovery and would also mitigate future customers paying for costs incurred by customers at the point of reset.

- To include any additional adjustment resulting from the difference between the initial tariff and the revised tariff, until the point we update the allowance, in a future cap period, following consultation. This is because we consider it appropriate to allow a notional supplier to recover its efficient costs in these particular circumstances.
- The National Grid ESO to proactively engage with us if such an event is likely to occur. This is because the ESO is best placed to inform us of a possible tariff reset.

Overview of stakeholder responses

3.16. In response to the September 2022 Call for Input, one supplier requested clarity on our approach to the cap if and when a tariff reset occurs during the fixed period. Further, in our bi-lateral calls and in response to our CMP361 minded-to decision consultation, two other suppliers also requested clarity on our approach.

Our considerations

3.17. In the event of a tariff reset within the fixed period, we consider it appropriate to allow a notional supplier to recover its efficient costs, thereby protecting current and future default tariff customers. We consider it appropriate to review the BSUoS allowance at a time (ie on a quarterly basis) that would reduce the time period over which it may differ from the reset fixed price.

Moving to quarterly review of the BSUoS allowance

3.18. In our August 2022 decision on the frequency of cap updates, we said we would update the Annex 3 model every six months.²⁴ This is because we considered network costs are set using information published either twice yearly or annually only. Since there is a possibility that the fixed tariff could change within the fixed period, it would be prudent to reconsider whether more frequent updates (ie on a quarterly basis) would be beneficial. In

²⁴ Ofgem (2022) Price cap – Decision on changes to the wholesale methodology, p27
<https://www.ofgem.gov.uk/sites/default/files/2022-08/Price%20cap%20-%20Decision%20on%20changes%20to%20the%20wholesale%20methodology.pdf>

the paragraphs below, we discuss how increasing the frequency of the Annex 3 model update would impact suppliers and customers.

Customer impacts

3.19. We consider future customers would benefit from reviewing the allowance on a quarterly basis. Any delay in updating the cap to reflect the new tariff, and any subsequent additional adjustment, could cause future customers to pay for the costs incurred by customers at the time of change. Therefore, moving to quarterly makes the whole system more robust and less likely to compound any market instability, which is in both existing and future customers' interests.

Supplier impacts

3.20. We consider suppliers would also benefit from reviewing the allowance on a quarterly basis. One supplier said a quarterly review would minimise delay in suppliers recovering their incurred costs. We acknowledge this point and indeed consider that this would also reduce any additional costs incurred by supplier due to the delayed recovery.

Additional adjustment

3.21. We consider that there might be instances where the tariff would be reset within the cap period, and we might not be able to update the allowance till the next cap update. In such circumstances, for a short period of time, suppliers might face a difference between the costs they incurred and the costs they recover through the cap. We would therefore consider this difference and adjust the cap in a future cap period.

3.22. Since the additional adjustment falls outside of the regular cap update, as well as the fact that it depends on the time the reset occurs, we would need to conduct a consultation regarding this matter. The adjustment would then be reflected in the appropriate cap period following consultation.

Other Consideration

3.23. Monitoring the likelihood of such an event taking place would require resources and access to the ESO data. We believe the ESO to be best placed to monitor and inform us of a potential reset since, unlike us, it would have a framework in place and access to the data.

3.24. One supplier asked for clarity around how the allowance would be adjusted to cover a situation where the ESO has drawn down on the BSUoS fund and needs to top up the fund in subsequent periods. The BSUoS allowance in the cap would include two components: the main fixed tariff and the fund tariff. Therefore, any top-up to the fund in subsequent periods would be captured by the fund tariff component and would be reflected in the cap.

4. Transitional adjustment

Section summary

We explain our proposed methodology on how to calculate a transitional adjustment and assess whether a transitional adjustment is needed.

How we calculate the adjustment

Context

4.0. As part of this consultation, we are assessing whether a transitional adjustment is required when moving from an ex-post to an ex-ante BSUoS recovery mechanism. To assess whether an adjustment is needed, in this chapter we discuss its scale as well as how it might be estimated.

4.1. When moving from an ex-post to an ex-ante recovery mechanism, suppliers might fail to recover the BSUoS charges incurred between January 2022 and March 2023, because these would not be fully recovered through future price caps²⁵. Calculating the adjustment can be done through two approaches:

- The first approach takes the difference between BSUoS costs incurred and recovered by suppliers in each quarter (January 2019 to March 2023). In this consultation, we refer to this approach as “the true-up approach”.
- The second approach would instead look at the charges that suppliers might fail to recover, ie charges incurred between January 2022 and March 2023. When looking at those charges, we might then consider offsetting them against historical BSUoS charges, incurred prior to the cap’s introduction (July 2017 to December 2018) and

²⁵ It is important to note that customers would not, as a whole, be disadvantaged as those costs would ultimately be recovered.

recovered under the early cap periods (January 2019 to March 2020). We refer to this approach as the "offsetting approach"

4.2. In the September 2022 Call for Input, we sought views on the most suitable approach to calculate the adjustment and proposed the offsetting approach in principle.

Proposal

4.3. We propose to use an offsetting approach because it would reduce the risk of suppliers over-recovering costs and reduce the risk of customers incurring unnecessary charges. Following this approach, we estimated (using actual and forecast charges) that the adjustment would be c.£24 per typical electricity customer at the cap benchmark consumption. The final adjustment value, after accounting for regional electricity losses, would be c.£27 per typical electricity customer at the cap benchmark consumption.²⁶ We note that this would be a temporary adjustment paid as a one-off payment in two tranches.²⁷ Its value remains uncertain until all charges have been published.

4.4. We propose calculating the adjustment using a cost-based offsetting approach, rather than a revenue-based offsetting one. We consider the former to be more accurate and compatible with an early recovery.

Overview of stakeholder responses

4.5. In principle, three stakeholders were supportive of using an offsetting approach. One stakeholder, instead, rejected it. Three stakeholders suggested alternative calculation approaches.

Our considerations

Avoiding historical over-recovery

4.6. Allowances are generally set ex-ante in the cap. The BSUoS component, however, is set ex-post. As we move from an ex-post methodology to an ex-ante methodology, we must consider how to account for the different timings. In the event that we implemented a

²⁶ The values are at the benchmark annual consumption values used to set the cap (3,100kWh electricity. These are higher than the current typical domestic consumption values (2,900kWh electricity).

²⁷ The next chapter discusses our consideration for paying the adjustment in two tranches.

transitional approach that allowed suppliers to catch up and recover the lag period without creating an offset, we would expect suppliers to over-recover costs. Under an ex-ante mechanism, the costs should relate to the period they were incurred. Therefore, it is logical to roll back BSUoS costs to the beginning of the cap and offset them with the costs recovered in the first three cap periods - as these were incurred before the cap started.

4.7. Since BSUoS charges have been recovered on a lagged basis, during the first three cap periods (January 2019 to March 2020), suppliers recovered costs incurred prior to the beginning of the price cap (July 2017 to December 2018). The costs incurred between July 2017 and December 2018 are therefore likely to have been recovered twice: before (through supplier-calculated provisions) and under the first three cap periods.

4.8. While arguing against the offsetting approach, one stakeholder said that the costs recovered under the early cap periods were efficient costs fully recognised by Ofgem.

4.9. We acknowledge that a notional supplier would have incurred some efficient costs between July 2017 and December 2018. However, if suppliers are allowed to recover their costs until the new recovery methodology is implemented, with no offsetting, they may over-recover some pre-cap costs. Therefore, offsetting against historical recovery mitigates against default tariff customers from incurring unnecessary charges.

Standard Variable Tariff ('SVT') customer changes

4.10. One respondent disagreed with offsetting against historical recovery, arguing that offsetting would have disproportionate cost implications on those suppliers who have either acquired SVT customers through the Supplier of Last Resort ("SoLR") process, seen significant growth over the past few years, or have only recently entered the market.

4.11. Since BSUoS costs are currently recovered using a lag mechanism, it is implicitly assumed that suppliers will face some changes in their customer numbers over time which could potentially impact the amount recovered by suppliers. As a result, the cap assumes that this impact will net out in the round and any variances will be covered by existing uncertainty allowances, such as headroom.

4.12. Nevertheless, we acknowledge that unprecedented market conditions have exacerbated changes in SVT customer numbers. Since this has led some suppliers to face higher BSUoS costs, we propose to account for SVT customer number changes when

calculating the adjustment by weighting the costs incurred and recovered by suppliers against total SVT customer numbers in different periods. Further details can be found in Appendix 2.

Alternative Approaches

True-up approach

4.13. Two suppliers suggested computing the transitional adjustment by calculating the difference between the BSUoS costs incurred and recovered in each quarter since the price cap began, ie from January 2019 to March 2023. One stakeholder said this approach would be preferred for its simplicity. Since this approach entails considering the costs incurred and the allowances recovered by suppliers, we consider it resembles a true-up of the costs over the lifetime of the cap.

4.14. We consider that using a true-up approach is not necessary, since suppliers have been in a position to recover their BSUoS costs sufficiently accurately. Indeed, a lagged recovery mechanism aimed at guaranteeing an accurate recovery and the remaining uncertainties have been captured by a portion of the headroom allowance.

Costs vs revenue-based approach

4.15. One supplier has proposed a slightly different offsetting approach, which calculates costs incurred and recovered by suppliers from a revenue, rather than a cost, perspective. For instance, from a revenue-based perspective, the costs incurred by suppliers between January 2022 and March 2023 are estimated as a portion of the allowances to be recovered in cap periods 10a&b (April 2023-September 2023), cap periods 11a&b (October 2023-March 2024) and cap periods 12a&b (April 2024-September 2024). From a cost-based perspective, instead the costs are computed as the costs incurred by suppliers between January 2022 and March 2023, disregarding future allowances.

4.16. We identified two main complications associated with a revenue-based approach:

- Firstly, it entails the use of future volume forecasts to calculate the allowances for cap periods 10a&b, 11a&b and 12a&b.²⁸ This exposes us to accuracy risks²⁹.
- Secondly, if an adjustment is required, this approach would be incompatible with implementing the final adjustment as early as under cap periods 10a. This is because the *actual* volumes for cap periods 10a&b, 11a&b and 12a&b would not be available at the time of the decision.

4.17. For the reasons above, we propose to use a cost-based offsetting approach, which in our opinion is more accurate and more compatible with an early recovery.

Offsetting against the headroom

Context

4.18. In our 2018 decision, we set the headroom allowance to account for uncertain cost pressures that are not already accounted for in our efficient cost benchmark. As mentioned above, within the allowance, we explicitly considered residual uncertainties around the recovery of BSUoS charges.³⁰

4.19. The move to the fixed charge would mitigate some of these uncertainties. When estimating the size of the adjustment, we therefore consider it appropriate to discuss the possibility of offsetting the adjustment against the headroom allowance. Offsetting the adjustment against the headroom allowance would affect the amount to be recovered through the transitional adjustment.

4.20. In the September 2022 Call for Input, we said we could potentially offset the transitional adjustment against the relevant portion of the headroom allowance.

²⁸ We use volumes to calculate the weighted average costs which is used to set the allowance.

²⁹ The risks might be exacerbated by the implementation of CMP308, which removes BSUoS charges from generation, leading to an overall change of the volumes.

³⁰ 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>

Proposal

4.21. We propose not to offset the transitional adjustment against a portion of the headroom allowance. This is due to the complexity around estimating the appropriate BSUoS share of the headroom allowance.

Overview of stakeholder responses

4.22. Three stakeholders disagreed with our initial view to potentially offset against a proportion of the headroom allowance. Despite not explicitly rejecting the proposal, one supplier said that further analysis would be required before deciding whether to offset against the headroom allowance.

Our considerations

4.23. The headroom allowance was estimated using a top-down approach. In other words, the headroom figure was estimated holistically rather than as the sum of many different cost components. In that regard, one stakeholder said if we consider reviewing the headroom allowance, it should only be considered holistically. Two stakeholders shared a similar view that there is no objective and easy way to calculate the BSUoS share of the headroom allowance. Two stakeholders also said that even if it was possible to estimate it, the figure would likely be small.

4.24. We recognise that moving to a fixed ex-ante tariff would substantially reduce all the uncertainties around recovering BSUoS charges in the cap. However, as mentioned above, given the complexity of estimating the BSUoS share of the headroom allowance, we are considering not to account for the substantial reduction in uncertainties.

4.25. Two suppliers also made the following arguments against our approach to offsetting against the headroom allowance:

- The BSUoS portion of the headroom allowance has not been conceived to accommodate unrecovered costs over the life of the cap.
- The headroom allowance has already been exceeded by other unaccounted costs.

4.26. Regarding the first point above, in the 2018 decision³¹, under the heading ‘Treatment of residual uncertainties in the headroom allowance’, we mentioned two residual BSUoS uncertainties. One being the possibility of BSUoS under-recovery, due to the uncertainty around BSUoS trends. Moreover, we consider that further evidence and analysis would be required to support the second point raised by stakeholders.

Whether to introduce a transitional adjustment

Context

4.27. Having estimated the size of the adjustment, in this section, we consider the case for introducing a transitional adjustment when replacing the lagged variable charge with an ex-ante fixed charge.

Proposal

4.28. We propose to introduce a transitional adjustment of c.£24 per typical electricity customer at the cap benchmark consumption, since the costs to be recovered through the adjustment are material, systematic and unforeseen. The final adjustment value, after accounting for regional electricity losses, would be c.£27 per typical electricity customer at the cap benchmark consumption. As mentioned earlier, we note that this value remains uncertain until all charges have been published.

Our considerations

4.29. In our 2018 decision, we said that: *"Nonetheless, if in the future we consider there are material systematic issues that require correction, we might modify the licence. The Act includes specific provision for us to make supplemental modifications to the licence conditions. This would allow us to make any changes required to correct how the cap was updated, if it systematically and materially departed from an efficient level of costs."* We also

³¹Ofgem (2018), Default Tariff Cap: Decision Appendix 2 – Cap level analysis and headroom https://www.ofgem.gov.uk/sites/default/files/docs/2018/11/appendix_2_-_cap_level_analysis_and_headroom.pdf

said that: "*The type of specific systematic errors for which we would adjust the cap would need to be unforeseen, clear, material, and necessitate changes.*".³²

4.30. We consider that the transitional adjustment costs should not be regarded as additional BSUoS costs. At the time of moving to an ex-ante methodology, a supplier would not have recovered all of its ex-post costs, leading to a consequential overlap in collection. We consider that the BSUoS costs, which would be recovered through the adjustment, meet the requirements mentioned in our 2018 decision. To mitigate the risk that arguments are made that various other things should be considered because of this, we illustrate below why we consider that to be the case:

- **Material:** We have estimated the adjustment to be c.£24 per typical electricity customer at the cap benchmark consumption (excluding regional electricity losses). The total efficient costs that a notional supplier would recover through the adjustment is therefore substantial.
- **Systematic:** BSUoS costs are a common cost faced by all suppliers and, as observed in Chapter 2, they have increased over time. Since the trend is not expected to change before April 2023, we consider that a notional supplier would not be able to recover their efficient costs without an adjustment.
- **Unforeseen:** As mentioned in the 2018 decision, "*there is considerable uncertainty over future trends in BSUoS charges, with factors which could cause these to rise or fall in the future*".³³ The recent unprecedented market condition has exacerbated the unpredictability in the BSUoS charges trend. Additionally, we consider the proposed modification to be unforeseeable when the price cap was enacted.

³² Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16.

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

³³ Ofgem (2018), Default Tariff Cap: Decision, Appendix 2 – Cap level analysis and headroom, paragraphs 3.77

<https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview>

5. Implementation of the transitional adjustment

Section summary

We explain when we would reflect the adjustment if we were making one. We also explain the length of time over which we would recover any amount, and how we would amend the cap model.

When do we reflect the adjustment

Context

5.0. As mentioned in the sections before, a transitional adjustment would allow suppliers to fully recover the BSUoS charges incurred between January 2022 and March 2023. In February 2023, we will take a final decision on how to reflect changes in the price cap. It follows that not all the data of actual BSUoS charges, for the period January 2023-March 2023, will be available by the time of the February 2023 decision. Given the lack of comprehensive actual data, in this chapter, we take into consideration how to best implement the adjustment.

5.1. In our September 2022 Call for Input, we set out three approaches to implement the adjustment and proposed to implement Option A-Actual data method.

5.2. These three proposed approaches are:

- **Option A-Actual data method:**
 - The transitional element is implemented in two stages. In stage one, actual data from January 2022-December 2022 is considered, and any adjustment is reflected from cap period 10a (April 2023-June 2023).

- In stage two, actual data for January 2023-March 2023 is considered and any adjustment is reflected from cap period 10b (July 2023- September 2023).³⁴
- **Option B-Float and true-up method:**
 - Actual data from January 2022-December 2022 is considered as well as a 'float' for the period January 2023-March 2023. The 'float' would be estimated using the most recent forecasts published by the ESO. We would then apply this adjustment from cap period 10a (April 2023-June 2023).
 - We would then 'true-up' the adjustment in time for cap period 11a (October 2023-December 2023).
- **Option C-Deferred Method:**
 - A transitional adjustment is not implemented until actual data is available for the January 2022–March 2023 period.
 - We would then adjust the cap with any adjustment from cap period 10b (July 2023-September 2023).³⁵

Proposal

5.3. Our proposal remains unchanged. We propose to implement Option A because it allows for most accurate calculations, is less complex, provides a timely recovery for a notional supplier. It also has the benefit of being less resource intensive and so allows us to focus more on other areas of important change for consumers.³⁶

³⁴We note that, we have slightly changed the 'Option A- Actual data method' since our September 2022 Call for Input, to reflect the proposal to review the BSUoS allowance on a quarterly basis discussed in Chapter 3. We have changed the implementation of the second stage adjustment from cap period 11a (October 2023-December 2023) to cap period 10b (July 2023-September 2023).

³⁵ Similar to option A, we note that, we have slightly changed this option since our September 2022 Call for Input, to reflect the proposal to review the BSUoS allowance on a quarterly basis discussed in Chapter 3. We have changed the implementation of the adjustment from cap period 11a (October 2023-December 2023) to cap period 10b (July 2023-September 2023).

³⁶ This means that suppliers would start recovering a portion of the c.£24 per typical electricity customer at the cap benchmark consumption (or c.£27 per typical electricity customer at the cap benchmark consumption after electricity losses) for cap period 10a (April 2023-June 2023) whilst the rest in cap period 10b (July 2023- September 2023).

Overview of stakeholder responses

5.4. 8 stakeholders supported Option A while one partially supported it.

5.5. One supplier was in support of both Options A and C.

Considerations

5.6. We assessed options A to C against a set of criteria. These are: accuracy, complexity, timing, and resource impact. We discuss our considerations on each of the options against the criteria below:

Accuracy

5.7. The transitional adjustment could be implemented using actual or forecast data. We evaluate the approaches as more or less accurate depending on whether actual or forecast data is used.

5.8. We consider that options A and C would be more accurate than option B. This is because they rely on actual data, while option B uses forecasts. We note that, following the true-up, option B would eventually lead to an accurate cost recovery. However, this level of accuracy is not achieved immediately. Two suppliers supported this argument.

Complexity

5.9. Under this criterion, we assess the processes that would likely be involved in implementing each option. Depending on the complexity of the processes involved, we evaluate the options as more or less complex.

5.10. We consider that options A and C are relatively less complex than option B. This is because option B entails a float and true-up exercise, which would require additional processes to be implemented. One respondent supported this argument.

Timing

5.11. We assess the different options, depending on when we would be able to implement the adjustment. We consider that the timing around when we would apply the adjustment may affect suppliers' financeability.

5.12. We consider options A and B would allow suppliers to start recovering costs earlier than option C, which entails a deferral. One supplier supported the argument above.

Resource Impacts

5.13. Under this criterion, we assess the resource requirements within each option.

5.14. We consider that, option A is the least resource intensive option. For example, by comparison, option B would require stakeholders to engage with Ofgem to complete the true-up at a later point.

The duration over which we apply the adjustment

Context

5.15. After identifying the amount to recover and how we would implement the adjustment, a further question is how long this adjustment should last. This duration affects the speed at which customers would pay for these costs, and therefore how fast suppliers would recover them. It does not affect the total amount of costs to recover.

5.16. We could apply any adjustment (for example):

- for six months;
- for one year; and
- for a period longer than one year.³⁷

5.17. In our September 2022 Call for Input, we identified the above options and sought views on the favoured approach, without expressing a preferred one.

³⁷ We recognise, since moving to quarterly update, one other option we could consider is to recover the costs over three months. However, in practice, we consider this option to be undesirable given the detrimental impact it would have on customer bills.

Proposal

5.18. We are proposing to apply the adjustment over a period of one year. This would be in line with the way BSUoS charges are recovered under the status quo. We consider that this protects customers better than a shorter recovery period, while ensuring that suppliers can recover costs in an appropriate timeframe.

Overview of stakeholder responses

5.19. Two stakeholders proposed to recover the adjustment over a six month period. One, instead, over a three month period.

Our considerations

Precedent

5.20. Currently, BSUoS charges are recovered in the price cap over twelve months. Indeed, BSUoS charges are considered as fully recovered only once they are recovered over a twelve-month period. Based on precedent, we consider that applying the adjustment over twelve months would be appropriate.

General discussion: Customer and supplier impact

5.21. As a general point, a shorter recovery period (ie shorter than twelve months) would have a negative immediate impact on existing customers' bills, particularly those in vulnerable situations, but a positive immediate impact on suppliers' finances.

5.22. Recovery over a shorter period would benefit suppliers, by allowing them to receive money more quickly. All else being equal, this would help to improve their financial situations, with particular impacts on any suppliers experiencing financial constraints. However, many suppliers have significant access to working capital (through parent companies), and such suppliers supply a significant proportion of default tariff customers. Additionally, Ofgem closely monitors suppliers' finances. The process in place includes carrying out quarterly stress tests through which we test whether suppliers are robust to a range of scenarios. It also includes collecting monthly financial information to support financial monitoring. We therefore consider that the scale of this adjustment should be manageable over twelve months and would better protect default tariff customers. Under the Act, we must exercise our functions with a view to protect existing and future default tariff customers, and in doing so, we must "have regard to" supplier financeability alongside the other factors in the Act, while having to set a single cap level. We set a single cap based on a notional supplier. The

notional supplier is a theoretical and efficient supplier that has no direct comparison with existing suppliers but draws from the properties across efficient suppliers in the market. Therefore, an adverse impact on a minority of suppliers may be sufficient to outweigh the impact on customers, noting in particular our overarching role of protecting existing and future default tariff customers.

5.23. We recognise suppliers exiting the market can have indirect effects across the market. Where costs are passed onto customers, the certain impact of higher immediate bills (due to a shorter recovery period) must be weighed against the possibility of higher bills at some future point for future customers (due to the risk of supplier exits). We would need clear evidence that a shorter recovery period was likely to deliver significant benefits to customers.

5.24. Those suppliers who proposed a shorter recovery period said that it would allow them to recoup the incurred BSUoS charges effectively, reducing cashflow and volume risks and working capital impacts. It has also been said that, from a customer perspective, the impact of a shorter recovery would be neutral due to the Energy Price Guarantee³⁸ (the “EPG”), which provides some security for consumers.

5.25. We recognise that a shorter recovery would benefit suppliers by minimising cashflow, volume risks, and working capital. We also recognise that, a shorter recovery would be covered by the EPG, since its extension to April 2024³⁹. However, we consider that the EPG resembles a maximum price that default tariff customers would pay whilst the price cap being above the EPG level. We also consider that if the price cap level falls below the EPG level, the price cap would become the maximum price that default tariff customers would pay. Given the expected EPG level (currently set at £3,000 per customer from April 2023), there are uncertainties around the cap levels falling below the EPG level during its lifetime. If the cap falls below the EPG level, we consider a shorter recovery would expose default tariff customers, particularly those in vulnerable situations, to the negative impact of an immediate increase in customers’ bills.

³⁸ More details can be found here: <https://www.gov.uk/government/publications/energy-bills-support/energy-bills-support-factsheet-8-september-2022>

³⁹Autumn Statement (2022)
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1118417/CCS1022065440-001_SECURE_HMT_Autumn_Statement_November_2022_Web_accessible_1_.pdf

5.26. We recognise that, a relatively longer recovery period may result in suppliers need for working capital. However, given that the network allowance (where we propose to include the transitional adjustment) is uplifted by EBIT, suppliers would gain a small consequential allowance which would mitigate any further costs related to the slight delay in recovery.

5.27. Based on the above, we consider that a twelve month recovery period strikes an appropriate balance and protects customers better than a shorter one, while ensuring that suppliers can recover costs in an appropriate timeframe. **We welcome views from stakeholders.**

Customer impacts and the EPG

5.28. Recovering the transitional adjustment over a twelve month period would mean that the adjustment would be fully recovered by suppliers by June 2024. Since the EPG has been extended until the end of March 2024, the majority of the recovery period would fall within the period in which the EPG is in place. Whilst recognising the potential impact on public spending, if the price cap remains above the current expected EPG levels (currently set at £3,000 per customer from April 2023), on balance we still consider the impact of the adjustment on customers energy bills would likely be neutral until April 2024, since the recovery of BSUoS costs would not affect customers' energy bills.

5.29. However, the recovery of the last three months of the second stage of the adjustment (April 2024 - June 2024) is after the EPG. We therefore consider that there may be a negative impact on customers' energy bills during this three month period, whereby customers are likely to pay the remainder of the transitional adjustment.

5.30. On the assumption that the EPG is not extended beyond April 2024, we have estimated that the impact of recovering the last three months of the adjustment would cost around c.£2 per typical electricity customer at the cap benchmark consumption after accounting for regional electricity losses.⁴⁰ We note the value remains uncertain until all charges have been published.

⁴⁰ We estimated this value by multiplying the final stage two adjustment figure by the relevant demand share for the periods April 2024-June 2024.

5.31. Under the Equality Act 2010 we are required to observe our equality duty and consider how our policies or decisions affect people who are protected under that Act. Given the modest expected cost per customer, we do not expect this recovery to have a substantial impact on customers, including those with protected characteristics.

Cap extension and having regard to public spending

5.32. We also recognise that the recent Energy Prices Act 2022⁴¹ made changes to how and when the price cap might cease to have effect. The Act removes the 2023 end date for the cap and, provides a mechanism for the Secretary of State to give notice that the cap ceases to have effect. Given that, we continue consider it appropriate to work on the assumption that the cap will continue to exist until notice is given and therefore consider that a twelve month recovery would still be appropriate.

5.33. We are required to exercise our functions under the Domestic Gas and Electricity (Tariff Cap) Act 2018 with a primary focus on protecting consumers on default rates, while having regard to specified considerations (see s. 1(6) of that Act). Following the coming into force of the Energy Prices Act 2022, those specified considerations to be taken into account include ‘the need to set the cap at a level that takes account of the impact of the cap on public spending’. That new consideration reflects the fact that, while the Government’s Energy Price Guarantee is in force, the cap level affects the levels of payments by Government to energy suppliers. Before we make a final decision on this matter, we shall review the issues to be decided with a view to the full set of statutory considerations, to ensure that our approach and conclusions are appropriate. **In the meantime, we would invite any views from stakeholders on whether there are any further particular factors or information which we should consider in making our decision.**

How we would update the cap model

Context

5.34. We would need to include any transitional adjustments in one of the cap models (ie the annexes to Standard Licence Condition 28AD of the electricity and gas supply licences (SLC 28AD)).

⁴¹ Energy Price Act (2022) <https://www.legislation.gov.uk/ukpga/2022/44/enacted>

5.35. In the September 2022 Call for Input, we identified two main models to perform the adjustment:

- Annex 3 model (Annex 3 to SLC 28AD); or
- The Adjustment Allowance (Annex 8 to SLC 28D – the 'Annex 8 model').

Proposal

5.36. We propose that any adjustment would be included in the Annex 3 model, since this would be the most consistent approach.

Overview of stakeholder responses

5.37. One stakeholder supported using the Annex 3 model. One, instead, proposed to use the Annex 8.

Our considerations

5.38. Network costs are estimated in the Annex 3 model. BSUoS costs are currently part of the Network Costs, therefore, we consider that the most appropriate model to include the adjustment to be the Annex 3 model. Having it there would also facilitate accurate comparisons of Network Costs across time, which was acknowledged by one supplier.

5.39. On the other hand, one supplier mentioned that the adjustment is temporary, so it should be included in the Annex 8 model. We recognise that the adjustment is temporary, however, as noted above, implementing it in the adjustment in Annex 3 would be the most consistent and transparent approach.

5.40. We have published a revised version of the Annex 3 model alongside this decision. Appendix 1 describes the changes that we have made.

Appendices

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Appendix 1 – Annex 3: detailed model modifications

1.1. In this Appendix we summarise the proposed modifications to 'Annex 3 - Network cost allowance methodology elec' of standard licence condition 28AD of the electricity and gas supply licences (SLC28AD). We note that these changes do not require a change in the default tariff cap overview model.

1.2. In the revised Annex 3 model, published alongside this consultation, the updated cells are highlighted in yellow.

1.3. The revised Annex 3 model provides stakeholders the opportunity to comment on the changes that would be made to Annex 3, in the event we decide to introduce an ex-ante fixed volumetric BSUoS tariff to replace the existing variable charge, as well as a transitional adjustment. **We invite stakeholder's views on these possible amendments.** A summary of the modifications we have made can be found below.

1.4. If further changes are needed to accommodate other proposals, then we may make consequential amendments before our decision.

1.5. We note that the current structure of the Annex 3 model only allows us to amend the model up until December 2023 (the initial end date for the cap). Because we propose to apply the adjustment beyond December 2023, we cannot fully incorporate the proposed modification into the model (ie extend the cells beyond December 2023). Given that the Energy Prices Act 2022 extends the cap beyond 2023, we intend to reflect this change by extending the cap models to include cap periods beyond December 2023. We plan to carry this out in the next year. Therefore, we would ensure the proposed model modification is fully reflected in the updated models.

Enduring changes to the cap

3e BSUoS charges

1.6. Added rows 8:9: to include 28AD charge restriction periods and the date at which the figures are updated.

1.7. Updated columns W and X and added column Y: to reflect the move to update the BSUoS allowance on a quarterly basis. Columns W and X are renamed to reflect the quarterly dates. As noted earlier this would allow any tariff reset within the fixed period to be reflected in the cap allowance.

1.8. Added rows 13:22: in the event we decide to introduce an ex-ante fixed volumetric BSUoS tariff, we have created a table to add, as inputs, the ex-ante fixed volumetric BSUoS tariff, published by the ESO. The ex-ante fixed BSUoS tariff would have two main components: a main tariff (£/MWh) – row 19 onwards - and a fund tariff (£/MWh) – row 20 onwards. As noted in the Chapter 2, we split these charges into quarterly periods to facilitate tariff update in the event of a tariff reset within the fixed period.

1.9. Cells W11:Y11: We have updated the formulas in the cells to sum the main tariff and the fund tariff from cells 19C and 20C onwards, rather than calculating the weighted average of the final settlement data (historical approach) in the cell 23B and below.

1.10. In addition, we have added a caveat in the tab description, stating that the data in step 3 (from cells 23B and below) cell in the tab 23B:23H are historical data, and is no longer used.

Introducing a transitional adjustment

3g BSUoS trans arrangement

1.11. New input tab '3g BSUoS trans arrangement' created to introduce the BSUoS transitional adjustment figures estimated in the 'Transitional adjustment calculations model v.1'.

1.12. Cells B8:F10: table created that draws the two final adjustment figures (for stage 1 – January 2022 to December 2022 and stage 2 – January 2023 to March 2023) from the 'BSUoS Transitional arrangement calculation' model tab 'output' cells E13:E16.

2c BSUoS

1.13. Updated columns AA and AB and added column AC: to reflect the move to update the BSUoS allowance on a quarterly basis. Columns AA and AB are renamed to reflect the quarterly dates.

1.14. Cells AA11:AC38: We have updated the formulas in those cells such that the appropriate transitional adjustment figures from tab '3g BSUoS trans arrangement', cells E9 and F9, are summed to the BSUoS allowance before uplifting them to account for losses and demand.

1a Network Cost Allowance-Elec

1.15. Updated columns Z and AA and added column AB: to reflect the move to update the network allowance on a quarterly basis since BSUoS would be updated quarterly. Columns Z and AA are renamed to reflect the quarterly dates.

1.16. Cells Z14 and AB69: We have updated the formulas in those cells such that the relevant '2a TNUoS', '2b DUoS' and '2c BSUoS' for the indicated quarterly period are summed to calculate the regional electricity network Cost allowance.

Appendix 2: Details on how we calculated the transitional adjustment

Overview of the transitional adjustment calculation

1.17. In this appendix, we provide a detailed view of how we estimated the transitional adjustment, using the offsetting approach (costs base). The steps in the calculation address 4 main questions:

- *Question 1:* How much will the suppliers' BSUoS costs be between January 2022 and March 2023?
- *Question 2:* How much of the BSUoS costs that suppliers incurred between January 2022 and June 2022 are being recovered in cap period 9 (October 2022 to March 2023)?
- *Question 3:* How much of the costs incurred prior to the cap's introduction have suppliers recovered in cap period 1 (January 2019 to March 2019), cap period 2 (April 2019 to September 2019) and cap period 3 (October 2019 to March 2020)?
- *Question 4:* How much is the net transitional adjustment in stage 1 and 2 of implementation, when accounting for SVT customer changes?

1.18. Note that all the figures have been calculated for single and multiple benchmarking metering arrangements. Also, the BSUoS input data published by the ESO and used in the calculations below are settlement final data, the same data used to estimate the BSUoS price cap allowances.

Calculation details

1.19. The table below illustrates the steps completed to address Q.1 to Q.4. Further details on each step can be found in the 'Transitional adjustment calculations model v.1' published together with this consultation.

Table A2: Summary of calculations

Questions:	Q.1	Q.2	Q.3	Q.4
Type of output:	BSUoS costs incurred by suppliers	BSUoS costs recovered by suppliers	BSUoS costs recovered by suppliers	Net adjustment (stage 1 and 2) = delta BSUoS costs incurred by suppliers minus BSUoS costs recovered by suppliers
Period BSUoS costs were incurred by suppliers	Jan-22 to Mar-23	Jan-22 to Jun-22	Jul-17 to Dec-18	<ul style="list-style-type: none"> To reflect changes in SVT customer numbers, we multiplied the costs recovered and incurred by suppliers (estimated in Q.1, Q.2 and Q.3) by the SVT customer numbers⁴², from the biannual RFI for customer account and tariffs.⁴³ As mentioned in chapter 2, we propose to calculate the adjustment over two stages. We estimated the net
BSUoS costs weighted average (£/MWh)	=Ratio between BSUoS actual half-hourly charges per month/implied consumption per month ⁴⁵	As for Q.1	As for Q.1	
Monthly consumption in the months BSUoS costs are incurred (MWh)	= Ofgem annual demand assumptions*Ofgem monthly demand share assumptions	As for Q.1	As for Q.1	
BSUoS costs incurred by suppliers (£/customer)	=BSUoS costs weighted average*monthly consumption	As for Q.1	As for Q.1	

⁴² Given the proposal to update the BSUoS allowance on a quarterly basis (rather than on a six month basis), if the April 2023 RFI and customer account data is not available in time for stage 2 (July 2023 onwards), we propose to use the closest RFI and customer account data available.

⁴³ We estimated the seasonal total SVT customer accounts on the market (number), excluding customer accounts with suppliers who exited the market since 2021. We have excluded those to avoid offsetting against costs recovered by beneficiaries who are no longer in the market. Further details can be found in the model.

⁴⁵ At the time of the publication, for both inputs, we have used are a mix of forecast and actual data published by the ESO. Further details can be found in the model.

Demand share in the cap period suppliers are recovering BSUoS costs	N/A	=sum of the monthly demand share	As for Q.2	adjustment for each stage by calculating the delta between the costs incurred (estimated in Q.1 and adjusted for SVT customer number changes) and recovered (estimated in Q.2 and Q.3 and adjusted for SVT customer number changes) under each stage. ⁴⁴
BSUoS costs recovered by suppliers (£/customer)	N/A	=BSUoS costs incurred by suppliers*cap period demand share	As for Q.2	

⁴⁴ There is a question of how we would allocate the costs suppliers recovered under cap periods 1, 2, and 3 over the two stages that we would implement this adjustment. We propose to divide these costs proportionately by the months considered under each stage. Note that we have allocated full costs recovered in cap period 9 (estimated in step 3) to stage 1.

Appendix 3 – Privacy notice on consultations

Personal data

The following explains your rights and gives you the information you are entitled to under the General Data Protection Regulation (GDPR).

Note that this section only refers to your personal data (your name address and anything that could be used to identify you personally) not the content of your response to the consultation.

1. The identity of the controller and contact details of our Data Protection Officer

The Gas and Electricity Markets Authority is the controller, (for ease of reference, “Ofgem”).

The Data Protection Officer can be contacted at dpo@ofgem.gov.uk

2. Why we are collecting your personal data

Your personal data is being collected as an essential part of the consultation process, so that we can contact you regarding your response and for statistical purposes. We may also use it to contact you about related matters.

3. Our legal basis for processing your personal data

As a public authority, the GDPR makes provision for Ofgem to process personal data as necessary for the effective performance of a task carried out in the public interest. i.e. a consultation.

3. With whom we will be sharing your personal data

(Include here all organisations outside Ofgem who will be given all or some of the data. There is no need to include organisations that will only receive anonymised data. If different organisations see different set of data then make this clear. Be as specific as possible.)

4. For how long we will keep your personal data, or criteria used to determine the retention period.

Your personal data will be held for ***(be as clear as possible but allow room for changes to programmes or policy. It is acceptable to give a relative time e.g. 'six months after the project is closed')***

5. Your rights

The data we are collecting is your personal data, and you have considerable say over what happens to it. You have the right to:

- know how we use your personal data
- access your personal data
- have personal data corrected if it is inaccurate or incomplete
- ask us to delete personal data when we no longer need it
- ask us to restrict how we process your data
- get your data from us and re-use it across other services
- object to certain ways we use your data
- be safeguarded against risks where decisions based on your data are taken entirely automatically
- tell us if we can share your information with 3rd parties
- tell us your preferred frequency, content and format of our communications with you
- to lodge a complaint with the independent Information Commissioner (ICO) if you think we are not handling your data fairly or in accordance with the law. You can contact the ICO at <https://ico.org.uk/>, or telephone 0303 123 1113.

6. Your personal data will not be sent overseas (Note that this cannot be claimed if using Survey Monkey for the consultation as their servers are in the US. In that case use “the Data you provide directly will be stored by Survey Monkey on their servers in the United States. We have taken all necessary precautions to ensure that your rights in term of data protection will not be compromised by this”.

7. Your personal data will not be used for any automated decision making.

8. Your personal data will be stored in a secure government IT system. (If using a third party system such as Survey Monkey to gather the data, you will need to state clearly at which point the data will be moved from there to our internal systems.)

9. More information For more information on how Ofgem processes your data, click on the link to our “[Ofgem privacy promise](#)”.