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26 January 2023

Dear Dan,

**PRICE CAP: CONSULTATION ON REFLECTING POTENTIAL CHANGES TO
BALANCING SYSTEM USE OF SYSTEM CHARGES (BSUOS) CHARGES IN THE
PRICE CAP - INFLATION**

As a result of a move from ex-post to ex-ante BSUoS charges¹ Ofgem has consulted on replacing the lagged BSUoS allowance in the price cap with an ex-ante allowance with effect from April 2023. However, BSUoS charges from January 2022 to March 2023 that would not be reflected in the new ex ante charge require an additional transitional allowance. Ofgem's proposal is to offset these charges against BSUoS charges incurred outside of the cap periods (July 2017 to December 2018) but recovered under the first three cap periods (January 2019 to March 2020). The offsetting approach proposed by Ofgem is roughly equivalent to looking at the extent to which there was a shortfall to suppliers related to BSUoS recovery in the cap.

In its email of 23 January 2022, Ofgem says it is considering whether to include inflation when calculating the proposed transitional adjustment for BSUoS. Specifically, whether the historical offset should be adjusted by CPIH² in order to maintain consistency with how Ofgem calculates other ex-post adjustments within the price cap. Ofgem does not give any indication of the size of the amended adjustment it is proposing or any additional rationale.

We have two main points to comment on which are detailed further in annex 1 below:

1. We do not think that there is a comparable ex-post adjustment with which to be consistent and we think that Ofgem's question appears to confuse adjustments for 'time value of money' with adjustments to reflect inflation and is therefore not comprehensive about the costs that may need to be adjusted.

¹ December 2022 GEMA approved CMP361/362 introduce an ex-ante fixed volumetric BSUoS tariff to replace the existing variable charge. The change will be implemented in April 2023

²CPIH is the Consumer Prices Index including owner occupiers' housing costs

- a. The only ex-post adjustment that we can think of that includes an inflation adjustment is the ex-post FIT adjustment³. Unlike BSUoS, FIT tariffs themselves are indexed to inflation hence the justification for also increasing the lagged allowance by inflation. However, it is not an appropriate comparison here where BSUoS tariffs are not linked to inflation.
 - b. Whilst BSUoS allowances in price cap periods 1, 2 and 3 reflected BSUoS costs incurred before the price cap, both they, and later BSUoS allowances in the cap were consistently lower than the actual BSUoS suppliers were paying in the same period, thus requiring additional working capital and impacting cash flow. Indeed, more recently with BSUoS charges increasing substantially, the gap between cost and allowance has been more significant. As such, if Ofgem were to apply a time value of money adjustment to the historical offset, it would also need to include a time value of money adjustment for the lagged recovery to maintain a consistent approach.
2. As we have noted before, we support the inclusion of a transitional BSUoS adjustment in the price cap, but we reiterate our view that the two stages of recovery should each be spread over 3 months rather than 12 months. A shorter recovery period will have the positive effects for suppliers of reducing volume risk, as well as alleviating cashflow and reducing the need for working capital. It will therefore reduce risk of insolvency costs for consumers. Although the price cap may drop below the government EPG, we do not believe that smoothing of bill increases outweighs this. In particular, volume risk, as a result of customers moving off SVT and onto products means that suppliers are more at risk of not recovering the BSUoS adjustment. In the event that Ofgem proceeds with the 12 month implementation period, it is even more important to include the risk of non-recovery of the BSUoS adjustment allowance in the MSC methodology alongside the backwardation and unexpected SVT allowances. We note with some concern that a consultation on the parameters in the MSC appears to have been dropped from Ofgem's forward workplan.

Yours sincerely,



Richard Sweet
Director of Regulatory Policy

³ Operating costs, an ex-ante allowance, are increased by CPIH, however this also does not provide an example with which the BSUoS adjustment calculation should be consistent

PRICE CAP: CONSULTATION ON REFLECTING POTENTIAL CHANGES TO BSUOS CHARGES IN THE PRICE CAP: INFLATION – SCOTTISHPOWER RESPONSE

1. Introduction

We comment below on the following aspects:

- the use of CPIH to inflate the historical offset amount (related to Ofgem’s latest question); and
- the recovery period for the transitional allowance (related to Ofgem’s original consultation).

2. The use of CPIH to inflate the offsetting amount

Consistency with other ex-post adjustments in the cap

The only ex-post adjustment that we can think of that includes an inflation adjustment is the ex-post FIT adjustment⁴. Unlike BSUoS, FIT tariffs themselves are indexed to inflation hence the justification for also increasing the lagged allowance by inflation. However, it is not an appropriate comparison here where BSUoS cost recovery does not include CPIH, even though recovery is retrospective and has almost always led to a shortfall in previous cap periods (see table 1).

Using CPIH

Ofgem’s email says it is considering whether it should use CPIH to inflate the historical offset amount. The implication of the email was that this proposal relates to only 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)?”

Ofgem’s question appears to confuse adjustments for ‘time value of money’ with adjustments to reflect inflation and we use the term time value of money in the remainder of our response to this issue.

We consider that if Ofgem applies the time value of money to those historical periods of cap 1 to 3, then it should apply it to BSUoS in all periods up to 2022/2023. Table 1 shows that the BSUoS allowance in the price cap was, for the most part, consistently lower than the actual BSUoS suppliers were paying in the period, thus requiring additional working capital and impacting cash flow. Indeed, more recently with BSUoS charges increasing substantially, these gaps have been more significant. As such, if Ofgem were to apply a time value of money adjustment to the sums recovered in the early years (the ‘historical offset’), it would also need for consistency to include a time value of money adjustment for the lagged recovery in all years including the most recent. The net result would be a slight increase in the amount of the transitional allowance.

⁴ [Decision: Feed-in Tariffs \(FIT\) scheme allowance methodology in the default tariff cap | Ofgem](#)

Table 1: Estimated shortfall in BSUoS recovery between January 2019 and March 2023

	BSUoS cost (£m)*	BSUoS volume (TWh)*	BSUoS cost (£/MWh)	BSUoS allowance (£/MWh)	Consumption weight	Surplus/ (shortfall) (£/cust)
2019 Q1	364.8	131.8	2.77	2.30	28.8%	-£0.41
2019 Q2	313.1	108.8	2.88	2.61	21.9%	-£0.18
2019 Q3	374.2	104.5	3.58	2.61	21.0%	-£0.63
2019 Q4	429.6	130.9	3.28	3.01	28.3%	-£0.24
2020 Q1	497.5	125.0	3.98	3.01	28.8%	-£0.87
2020 Q2	483.4	89.6	5.40	3.11	21.9%	-£1.55
2020 Q3	449.2	100.6	4.46	3.11	21.0%	-£0.88
2020 Q4	541.4	123.9	4.37	3.97	28.3%	-£0.35
2021 Q1	546.3	125.3	4.36	3.97	28.8%	-£0.35
2021 Q2	495.2	116.7	4.24	4.49	21.9%	£0.17
2021 Q3	634.5	111.4	5.70	4.49	21.0%	-£0.79
2021 Q4	1,290.5	135.6	9.52	4.35	28.3%	-£4.53
2022 Q1	1,075.3	135.2	7.95	4.35	28.8%	-£3.21
2022 Q2	833.4	118.2	7.05	6.07	21.9%	-£0.67
2022 Q3	1,089.4	100.8	10.81	6.07	21.0%	-£3.10
2022 Q4	1,824.7	126.9	14.38	7.66	28.3%	-£5.90
2023 Q1	1,792.2	121.3	14.77	7.66	28.8%	-£6.34
Total						-£29.83

* BSUoS costs and volumes taken from 'Annex_3_-_network_cost_allowance_methodology_elec_v1.10', except the last three quarters which are taken from ESO October forecasts. These forecasts have since been updated and result in a slightly smaller total shortfall, as reflected in Ofgem's November consultation

3. Recovery period for transitional allowance

In the original consultations, Ofgem was considering the recovery period for the transitional adjustment. We continue to consider that a three month recovery period represents an appropriate timeframe.

We believe the main consumer benefit from a shorter recovery period is the reduced risk of supplier exits from the market, which have demonstrably led to increased consumer costs. A shorter recovery period will have positive effects for suppliers, principally of reducing volume risk but also of alleviating cashflow and reducing the need for working capital.

We note the analysis of the initial impacts of market stability measures, which are the positive benefits of giving suppliers the confidence to hedge appropriately, are estimated at £1 billion. We believe it likely that similar benefits to consumers, though perhaps not in scale, can be achieved with a shorter recovery period.

We note with some concern that a consultation on the parameters in the MSC is no longer on Ofgem's workplan. Ofgem should include the backwardation and unexpected SVT allowances in the MSC methodology and in the event that Ofgem proceeds with the 12 month implementation period the BSUoS adjustment allowance should also be included.

ScottishPower
January 2023