# Decision

Making a positive difference for energy consumers

## Price cap- Decision on reflecting changes to BSUoS charges in the price cap

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| Publication date: | 17 February 2023 |
| Contact: | Dan Norton, Deputy Director Price Protection |
| Team: | Retail Price Regulation |
| Telephone: | 020 7901 7000 |
| Email: | Retailpriceregulation@ofgem.gov.uk |

We consulted in November 2022 on how to modify the price cap if Ofgem made the decision to approve CMP361, which changes how Balancing Services Use of System ('BSUoS') charges are recovered from electricity network users.

In December 2022, Ofgem decided to approve the CMP361 modification, which will come into effect from April 2023. This document sets out our decisions on the price cap following the approval of CMP361.

We have carefully considered all responses to our November 2022 consultation. We have published non-confidential responses alongside this decision.

Any enquiries related to the text of this publication should be sent to Ofgem at:

10 South Colonnade, Canary Wharf, London, E14 4PU.

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# Contents

# Executive Summary

## Context

On 19 July 2018, the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the 'Act')[1] came into force. This legislation requires the Gas and Electricity Markets Authority (GEMA) to design and implement the default tariff cap. We 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'). The cap ensures that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy.

The Energy Price Guarantee (EPG) is a scheme where the government will pay energy suppliers the difference between what can be charged to customers through their bills, with the unit price of electricity and gas capped by the EPG, and what would otherwise be payable under the cap. This means that the costs in this decision will be covered by the government if the cap level remains higher than the EPG. If the cap level falls below the EPG level at any time before March 2024, then some of these costs would be borne by customers.

## Balancing Services Use of System ('BSUoS') charges and decisions

BSUoS charges are how the National Grid Electricity System Operator ('ESO') recovers costs associated with balancing the transmission network. These charges currently vary half hourly and are collected ex-post. In December 2022, we decided to approve Connection and Use of System Code (CUSC) modification CMP361[2], which changes these variable ex-post charges to a flat, ex-ante charge. This change will come into effect in April 2023.

We published a consultation in November 2022 on whether to modify the cap, if Ofgem decided to approve CMP361 (including whether to implement a transitional adjustment).[3]This document sets out our decisions.

When making these decisions we have considered three major elements:

[1]Domestic Gas and Electricity (Tariff Cap) Act 2018. https://www.legislation.gov.uk/ukpga/2018/21/contents/enacted
[2] Ofgem (2022), CMP361 and CMP362 Decision https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision
[3] Ofgem (2022), Price cap: Consultation on reflecting potential changes to BSUoS charges in the price cap. https://www.ofgem.gov.uk/publications/price-cap-consultation-reflecting-potential-changes-bsuos-charges-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) 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.

- Because of the lagged recovery methodology, 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 over the lifetime of the price cap, making it more likely that suppliers will not fully recover costs at the time of change.

## Our decisions

Below are the decisions we have made:

(i) We have decided to reflect CMP361 in 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). This change in cap methodology will ensure that future BSUoS charges incurred by suppliers are more accurately reflected in the cap, providing a fair price to customers, and enabling greater efficiency and competition among suppliers.

(ii) We have decided to introduce a transitional adjustment of an estimated £23.55 per typical electricity customer[4] at the cap benchmark consumption. This adjustment is intended to ensure that the transition to the new charging structure allows the ESO to finance its activities ensuring the safe and secure operation of the electricity system (eg winter contingency contracts), and does not threaten supplier stability. We consider this to be in the best interest of customers.

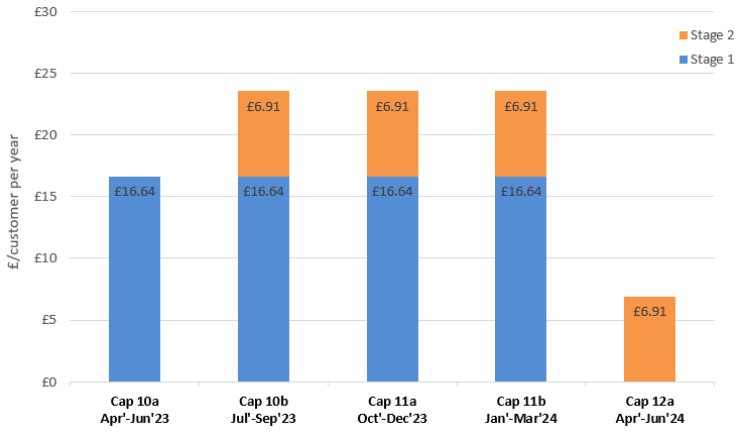
(iii) We have decided to calculate the transitional adjustment by offsetting the costs incurred by suppliers between January 2022 and March 2023 against the

[4] We note that this value remains uncertain due to BSUoS costs this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin.
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). The benchmark annual consumption value for gas is 12,000 kWh.

inflation-adjusted costs recovered under the first three cap periods (January 2019 to March 2020). We consider this to protect customers by ensuring costs already recovered by suppliers are not included in the adjustment.

(iv) Since the BSUoS charges for the entire period have not yet been set, we have decided to implement the transitional adjustment in two stages (cap period 10a and cap period 10b, July 2023-September 2023), with each stage lasting 12 months. (Figure 1 presents how each stage would be reflected in the cap allowances). This means suppliers would recover the full transitional costs by the end of cap period 12a (April 2024- June 2024). We consider this approach to be consistent with the current BSUoS methodology in the cap, which protects customer interests while ensuring that suppliers can recover costs within a reasonable timeframe.

Figure 1 Implementation of transitional adjustment in the cap.




Accessible format

Bar graph showing the implementation of the transitional adjustment in two stages from cap period 10a through to cap period 12a. The graph is divided into five periods, showing how each adjustment would be presented in the cap considering we have decided to recover each stage over a 12 month period. We note that the stage 2 adjustment is an estimate.

# 1. Introduction

**Section summary**

This chapter provides the background for this decision, highlights our key decisions and the structure of the document.

## Background

1.1 The default tariff cap ('the cap') protects approximately 27 million domestic customers on standard variable and default tariffs (which we refer to collectively as 'default tariffs'), ensuring that they pay a fair price for their energy that reflects the underlying costs to supply that energy.[5] We set the cap by considering the different costs notional suppliers face. The cap is made up of a number of allowances which reflect these different costs.

1.2 The Energy Price Guarantee (EPG) is a government scheme where suppliers are paid the difference between what can be charged to consumers through their bills and the cost of supply. If the cap level falls below the EPG level at any time before March 2024, then some of the costs resulting from this decision would be borne by customers.

1.3 The National Grid Electricity System Operator ('ESO') is responsible for ensuring electricity supply meets demand, second by second. This process is called balancing the grid. This also includes having winter contingency contracts in place to ensure security of electricity supply.

1.4 The ESO recovers costs associated with balancing the electricity transmission system through BSUoS charges. Historically, Final Demand[6] and liable generators 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

[5] The cap is one of the key activities which fall within the outcome "deliver fair prices for consumers" within our draft Forward Work Programme for 2023-24.
Ofgem (2022), Consultation on Ofgem's draft Forward Work Programme for 2023/24.
https://www.ofgem.gov.uk/publications/consultation-ofgems-draft-forward-work-programme-202324

[6] Final Demand is currently defined in the Connection and Use of System Code as electricity consumed other than for the purposes of generation or export onto the electricity network.
Ofgem (2019), CUSC direction,
https://www.ofgem.gov.uk/sites/default/files/docs/2019/11/cusc_direction_1.pdf

after the period during which the balancing services have been provided. BSUoS costs are recovered through the cap on a lagged basis.

1.5 In May 2022, we approved Connection and Use of System Code (CUSC) modification (CMP308) which removed generator liability for BSUoS charges from April 2023, meaning that BSUoS charges will be levied solely on Final Demand.[7] In December 2022, we approved a further CUSC modification which modifies how BSUoS charges are recovered from electricity network users.[8] The modification (CMP361[9]) replaces the ex-post charge which varies in each half-hour period, with a flat volumetric charge set in advance. The approved modification (Workgroup Alternative Code Modification or 'WACM' 3) introduces a fixed tariff for a period of six months, set ex-ante with a nine month notice period[10]. Further details on the modification can be found in the CMP361 decision documents[11].

1.6 As BSUoS costs are recovered through the cap on a lagged basis, we have considered whether and how to update the cap methodology to reflect these changes to BSUoS charging. Given recent observations and forecasts indicate that BSUoS costs are now significantly higher than when the cap was first introduced, we have also examined whether a transitional adjustment is required, and if so, how best to implement it.

## Our key decisions

1.7 We have decided to update the BSUoS allowance in the cap to reflect the new ex-ante fixed tariff volumetric charge. This will be in time for cap period 10a (April 2023-June 2023).

1.8 We have decided to use a cost-based offsetting approach to assess whether a transitional adjustment is needed as a result of the above change.

[7] Ofgem (2022), CMP308: Removal of BSUoS charges from Generation. https://www.ofgem.gov.uk/publications/cmp308-removal-bsuos-charges-generation
[8] Ofgem (2022), CMP361 and CMP362 Decision. https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision
[9] CMP361 is accompanied by a further modification, CMP362, which facilitates the implementation of the CMP361 solution by introducing and updating required definitions into CUSC section 11. Given that it is a consequential modification that will not have an impact on the price cap, it is not the main subject of this decision.
[10]The Notice Period is how far in advance of 1 April in any given charging year the fixed BSUoS tariff is set and shared with industry. Example charges which apply from month M are set and published in month M-9.
[11] Ofgem (2022), CMP361 and CMP362 Decision https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision

1.9 Following this approach, we have decided to implement a transitional adjustment of an estimated £23.55 per electricity customer at typical benchmark consumption level.[12]

1.10 We have decided to implement this adjustment in two stages, with each stage applied over a duration of 12 months. A proportion of this cost (Stage 1: £16.64) will be implemented from cap period 10a and the remainder (Stage 2: £6.91, estimated) will be implemented from cap period 10b (July 2023-September 2023).[13] This means the full transitional adjustment will be recovered by the end of cap period 12a (April 2024-June 2024).

1.11 This adjustment will be implemented in the 'Annex 3 Network cost allowance methodology elec' cap model (the 'Price cap Annex 3 model').

## Structure of this decision document

1.12 This decision document has the following structure:

- Chapter 1 sets out the scope of our decision and provides context.
- Chapter 2 explains our decision-making process.
- Chapter 3 covers our decision on whether and how we will update the cap on an enduring basis.
- Chapter 4 covers our decision on how we calculate the transitional adjustment.
- Chapter 5 covers our decisions on how we will implement the transitional adjustment.
- Chapter 6 covers our impact assessment on introducing a transitional adjustment.

[12] This is the figure for single rate metering arrangements after accounting for regional electricity losses. We also estimate the transitional adjustment for multi-rate metering arrangements (after accounting for regional electricity losses) to be £30.88 per typical electricity customer at cap benchmark level. We note that the difference between the single rate and multi-rate estimates is due to differences in benchmark annual consumption values. We note that these values remains uncertain due to BSUoS cost this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin.
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). The benchmark annual consumption value for gas is 12,000 kWh.
[13] We note that stage 2 value remains uncertain due to BSUoS cost this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin.

# 2. Decision-making process

**Section summary**

This section summarises our decision-making process and related publications.

## CMP308: Removal of BSUoS charges from Generation

2.1 In April 2022, we published our decision on CUSC modification CMP308 which will change the way that BSUoS charges are collected from electricity network users.[14]

2.2 We decided to implement CMP308 in April 2023.

## CMP361 consultation

2.3 In September 2022, we consulted on our minded-to decision on CMP361.[15]

2.4 In our CMP361 consultation, we said that we were minded-to approve CMP361 WACM5 and consider that implementation would take place in April 2023.

2.5 We also received feedback relevant to this decision in response to this consultation.

## CMP361 supplementary consultation

2.6 In November 2022, we published a supplementary consultation to reconsider the viability of our CMP361 minded-to position, WACM5 and options with a P99 risk level.[16]

2.7 We considered it appropriate to re-consult with industry and invited views as to how this would affect stakeholders' assessment of the options under CMP361.

[14] Ofgem (2022), CMP308: Removal of BSUoS charges from Generation. https://www.ofgem.gov.uk/publications/cmp308-removal-bsuos-charges-generation
[15] Ofgem (2022), CMP361/362 - Minded-to decision and draft impact assessment https://www.ofgem.gov.uk/publications/cmp361362-minded-decision-and-draft-impact-assessment
[16] Ofgem (2022), Update 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 The P-level 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 to remain certain. P99 represent a 1 in hundread year probability of a tariff reset within a fixed period.

## CMP361 decision

2.8 In December 2022, we approved CMP361 WACM3 and concluded that this would best facilitate the achievement of the Applicable CUSC Charging Objectives and be consistent with our principal objective and statutory duties.[17]

## September 2022 Call for Input

2.9 We published a Call for Input in September 2022 ('September 2022 Call for Input') to seek stakeholder input on how to amend the cap if the CMP361 modification is approved.[18]

2.10 In our Call for Input, we said we were minded to reflect the new ex-ante fixed tariff in the cap. However, we did not set out a minded-to position in relation to whether a transitional adjustment is needed and, if so, how to implement it.

2.11 We received ten responses to this Call for Input. We have published non-confidential responses on our website.

## November 2022 consultation

2.12 We published a consultation in November 2022 ('November 2022 consultation') to seek stakeholder views on our consideration and proposals on whether (and if so, how) to reflect the proposed CMP361 modification from cap period 10a.[19] Our proposals in this consultation built on our initial thinking in the September 2022 Call for Input, considering stakeholders' responses.

2.13 We received seven responses to this consultation. We have published non-confidential responses on our website.[20]

2.14 We respond to stakeholder comments through the main body of this decision document and the appendices.

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[17] Ofgem (2022), CMP361 and CMP362 Decision
https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision
[18] 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
[19] Ofgem (2020), Price cap: Consultation on reflecting potential changes to BSUoS charges in the price cap
https://www.ofgem.gov.uk/publications/price-cap-consultation-reflecting-potential-changes-bsuos-charges-price-cap
[20] Please refer to the following link for non-confidential responses
https://www.ofgem.gov.uk/publications/price-cap-consultation-reflecting-potential-changes-bsuos-charges-price-cap

## Other engagement with stakeholders

2.15 We hosted a number of calls with stakeholders following our September 2022 Call for Input. Additionally, in January 2023, we wrote to stakeholders to seek their views on the treatment of inflation when computing the transitional adjustment.

## Related publications

2.16 The main overview documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: https://www.legislation.gov.uk/ukpga/2018/21/contents
- 2018 decision on the cap methodology ('2018 decision'): https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
- Energy Prices Act 2022: https://www.legislation.gov.uk/ukpga/2022/44/enacted

2.17 The main documents relating to this decision are:

- 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: 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 to 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
- November 2022 Consultation reflecting potential changes to BSUoS charges in the price cap: https://www.ofgem.gov.uk/publications/price-cap-consultation-reflecting-potential-changes-bsuos-charges-price-cap

- December 2022 CMP361 and CMP362 Decision: https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision

## The default tariff cap

2.18 We set the cap with reference to the Act (Tariff Cap). 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.

2.19 Under the Act, 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;
- the need to set the cap at a level that takes account of the impact of the cap on public spending.[21]

2.20 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 customers 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 judgement. Often, a balance must be struck between competing considerations.

2.21 Following the passing 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'.[22] This

[21] 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)).
[22] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(d) as inserted by Schedule 3 to the Energy Prices Act (2022).
https://www.legislation.gov.uk/ukpga/2022/44

consideration reflects the fact that while the government's Energy Price Guarantee (EPG) is in place and is lower than the price cap level, the cap level directly affects the levels of payment from government to energy suppliers.

2.22 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.

## General feedback

We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this decision. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
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. Are its conclusions balanced?
5. Did it make reasoned recommendations?
6. Any further comments

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

# 3. Enduring changes to the cap

**Section summary**

We explain decisions related to updating the BSUoS allowance on an enduring basis following the decision on CMP361. We also set out our decision on our approach in the event of the BSUoS tariff changing within the fixed period.

## Changing the cap methodology

### Context

3.1 Under the status quo, the BSUoS allowance for a particular cap period is estimated by calculating the weighted average of BSUoS charges in £/MWh in each half-hourly period across the preceding calendar year, 1 January to 31 December, (for summer cap period), and preceding year running from 1 July to 30 June (for winter cap period). These charges are passed on to customers on a lagged basis.

3.2 Through the CMP361 modification, Ofgem has decided to change how BSUoS costs are charged, replacing the ex-post variable charge which varies in each half-hour period, with a flat volumetric charge set in advance.[23]

3.3 By introducing an ex-ante fixed tariff, the ESO would set the BSUoS charges using forecast charges rather than actual costs to balance the system. Future forecasts would then be adjusted to account for any over-allocation or under-allocation by the ESO.

3.4 In our November consultation, we proposed to update the BSUoS allowance methodology if CMP361 was approved.

### Decision

3.5 We have decided to update the BSUoS allowance within the network allowance to reflect the new ex-ante fixed tariff volumetric charge in time for cap period 10a. This is intended to minimise suppliers' potential cashflow issues due to the lagged costs recovery. This decision is unchanged from our November 2022 consultation proposal.

[23] Ofgem (2022), CMP361 and CMP362 Decision. https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision

3.6 We have decided to update the Price cap Annex 3 model to reflect the above decision.

## Overview of stakeholder responses

3.7 In response to the November 2022 consultation, three stakeholders agreed with our minded-to position.

## Our considerations

3.8 Allowances in the cap are generally set ex-ante, to avoid the risk of distorting competition in the wider market. However, the BSUoS component has been set ex-post. This is because BSUoS charges are particularly volatile and the forecasts available at the time of the 2018 decision[24] were not sufficiently accurate for our purposes.[25]

3.9 The implementation of the related modification CMP308 in April 2023 (the modification which established that only Final Demand - rather than Final Demand and generation - will be liable for BSUoS charges) would temporarily exacerbate the cashflow issues suppliers would face under the current lagged recovery mechanism.

3.10 For example, in cap periods 10a and 10b, suppliers would be liable to pay 100% of BSUoS charges, while they would only recover the share of the BSUoS charge that suppliers were liable for before CMP308 (approximately 50%). One respondent provided evidence of the potential impact on suppliers if no change is made.

3.11 By introducing an ex-ante fixed tariff, the ESO would set the BSUoS charges using forecast charges rather than actual costs to balance the system. Future forecasts would then be adjusted to account for any over-allocation or under-allocation by the ESO.

3.12 By implementing an ex-ante fixed tariff within the price cap, greater certainty would be achieved, reducing the risk of distorting competition and enabling greater efficiency. It will also reduce the risk of suppliers not recovering their costs, which in the most extreme scenarios can result in supplier failure.

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[24] 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

[25] Ofgem (2018), Default Tariff Cap: Statutory Consultation. Appendix 5 – Policy and network costs, para 3.12-3.15, page 19 https://www.ofgem.gov.uk/sites/default/files/docs/2018/09/appendix_5_-_policy_and_network_costs.pdf

Therefore, this methodological change is in customers' interest as it would minimise customers' exposure to cost volatility.

3.13 We consider that the changes to reflect the fixed ex-ante tariff in the cap, given CMP361 has been approved, would mitigate the temporary cashflow risks that might be caused by implementing CMP308 alone.

3.14 We include details on how we will update the Price cap Annex 3 model in the Appendix 3.

3.15 As noted in the CMP361 decision, we are open to the development of future proposals which might build upon the CMP361 solution.[26] Given our understanding of the current proposals in development, at this stage, we consider it likely that our changes to the price cap are compatible with future proposals which build on the CMP361 solution (if approved by us). We will continue to monitor developments and their interaction with the cap.

## The possibility of BSUoS tariff changing within the fixed period

### Context

3.16 The approved CMP361 option (WACM 3) carries a P-level of P77. A P77 level reflects a 23 in 100 year probability of tariffs needing to be reset within the fixed period.

3.17 Since balancing costs are highly volatile, it is possible that outturn and future expected BSUoS costs deviate from the tariff set in advance. Under the new model, the responsibility for financing any deviation will effectively move from suppliers to the ESO and thus potentially exposes the ESO to a cashflow risk. This means that where the ESO is unable to cover deviations within the fixed period through utilising their working capital facility[27], tariffs may have to be reset within the fixed period.

3.18 We therefore need to consider our approach to reflecting potential changes to BSUoS charges in the price cap, following a tariff reset within the fixed period.

### Decision

3.19 Given the possibility of a tariff reset during the fixed period, we have decided:

[26] Ofgem (2022), CMP361 and CMP362 Decision. https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision

[27] The 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.

- To update the BSUoS allowance on a quarterly basis, rather than updating it every six months, in line with the wholesale methodology decision.[28] Updating the allowance quarterly will reduce the amount of time the allowance may differ from the reset fixed price. This is intended to reduce any additional costs suppliers would face due to delayed cost recovery, and also to mitigate future customers paying for costs incurred by customers prior to the reset.
- To include any material adjustment (resulting from the difference between the initial and the revised tariff) 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.
- That it would be appropriate for the 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.

3.20 The above positions are unchanged from our November 2022 consultation.

## Overview of stakeholder responses

3.21 In response to the November 2022 consultation, four stakeholders agreed to a quarterly review.

3.22 Four stakeholders agreed to our proposal to apply any additional adjustment following consultation. One stakeholder specifically agreed on the need to consult while one stakeholder disagreed on the need to consult.

## Our considerations

3.23 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, where the efficient costs to be recovered are material, to protect existing and future default tariff customers.

### Moving to quarterly reviews of the BSUoS allowance

3.24 In our August 2022 decision on the frequency of cap updates, we said we would update the BSUoS components within the Price cap Annex 3 model every six months. This is because we considered that network costs are set using information published either twice yearly or annually only. Since there is a

[28] 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

possibility that the fixed tariff could lead to more frequent changes in costs, we consider more frequent updates (ie on a quarterly basis) to be beneficial.

3.25 We consider that 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 prior to a tariff reset. Moving to quarterly reviews also makes the whole system more robust and less likely to compound any market instability, which is in both existing and future customers' interests.

3.26 We consider that suppliers would also benefit from reviewing the allowance on a quarterly basis, as this would minimise the delay in suppliers recovering their incurred costs. One stakeholder stated that the move to a quarterly review is a sensible way to address the risks faced by suppliers. Another stakeholder also supported the move to a quarterly review, stating that it would also prevent the need for additional headroom to cover the risk of within-period tariff reset.

### Additional adjustment

3.27 There may be instances where the tariff would be reset following a cap level announcement, and thus we cannot immediatelyupdate the allowance (to reflect the tariff reset) until the next cap level announcement. In such circumstances, for a short period of time, suppliers might face a difference between the costs they incur and the costs they recover through the cap. If this difference was material, we would adjust the cap for the future cap periods.

3.28 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 a future cap period following consultation.

3.29 One stakeholder disagreed with our proposal to consult before including a catch-up adjustment to reflect additional BSUoS costs between the point of tariff reset and the allowance update. It argued that including a consultation stage would create a regulatory burden for Ofgem and stakeholders and would unnecessarily delay recovery of relevant costs. They also highlighted that this is of increased importance following the approval of CMP361 WACM3, which features a P-level of P77, as this brings a higher risk of BSUoS tariff resets than would have been the

case under our original CMP361 minded-to position, which set tariffs at P99 level.[29]

3.30 Instead, it suggested that we specify in advance how the catch-up adjustment will be calculated and incorporated within the Price cap Annex 3 model.

3.31 We consider that the form of an additional adjustment would, however, be unknown and dependent on numerous variables, making it complex to automate. This means that it would not be practical to set up the adjustment upfront. we would therefore need to consult on the changes to the cap models. In addition, we consider that there may be other policy decisions related to this adjustment, such as the duration of recovery, that would require our consultation prior to making a decision. We therefore need to consult on the changes to the cap models.

### Other Considerations

3.32 We expect ESO to monitor BSUoS costs and inform us and wider industry of the possible need for a tariff reset.

[29] Following our minded-to decision and consultation, we concluded that options which utilised P99 would increase customers' costs significantly, and that approval of such options would be inconsistent with our Principal Objective to protect the interests of customers. For further details on this, see the CMP361 decision document - https://www.ofgem.gov.uk/publications/cmp361-and-cmp362-decision

# 4. Transitional Adjustment

**Section summary**

We discuss our decisions related to the methodology on how to calculate a transitional adjustment and whether a transitional adjustment is needed.

## How we calculate the adjustment: the main approach

### Context

4.1 When moving from the current ex-post recovery mechanism to an ex-ante one, there are two considerations.

- 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 caps.
- Due to the lagged recovery mechanism, some BSUoS costs incurred prior to the cap's introduction (July 2017 to December 2018) are likely to have been recovered 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.

4.2 If BSUoS charges were flat over time, these two considerations would net out. However, given the increasing trend in BSUoS costs over time (see Appendix 2 for fuller discussion), it is unlikely that the costs incurred and recovered by suppliers under the cap will be equal.

4.3 As part of this decision, therefore, we assessed whether a transitional adjustment is required when moving from an ex-post to an ex-ante BSUoS recovery mechanism. In this section we consider how we would estimate this adjustment so that we understand the materiality.

4.4 In our November 2022 consultation, we said there are two main approaches to calculating the adjustment.

- The first approach takes the difference between BSUoS costs incurred and recovered by suppliers in each quarter between January 2019 and March 2023. 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) and offset them against historical BSUoS charges incurred prior to the cap's

introduction (July 2017 to December 2018) and recovered under the early cap periods (January 2019 to March 2020). We refer to this approach as the "offsetting approach".

4.5 As part of the offsetting approach, we also have the option of using either a revenue or cost-based perspective when calculating the adjustment.

4.6 In our consultation, we proposed to use a cost-based offsetting approach.

## Decision

4.7 We have decided to maintain our consultation approach, and to use an offsetting approach.

4.8 Under the offsetting approach, we have decided to calculate the adjustment using a cost-based perspective, rather than a revenue-based perspective. We consider the former to be more accurate.[30]

## Overview of stakeholder responses

4.9 Two stakeholders who commented on this area agreed with using the offsetting approach to calculate the adjustment.

4.10 Another stakeholder said they did not have any concerns about the proposed adjustment calculations.

4.11 In response to the September 2022 Call for Input, one stakeholder said that the true-up approach would be preferred for its simplicity.

## Our considerations

### Avoiding historical over-recovery

4.12 Allowances are generally set ex-ante in the cap. The BSUoS component, however, is set using ex-post data. As we move from an ex-post methodology to an ex-ante methodology, we must consider how to mitigate the risk that the transition between the two methodologies leads to under- or over-recovery.

[30] Following the cost-based offsetting approach, we estimated (using actual and forecast charges) that the adjustment would be £23.55 per typical electricity customer with single rate metering arrangement at the cap benchmark consumption. This is the figure after accounting for regional electricity losses. We have published a model alongside this document detailing our calculation steps. The model presents estimates excluding regional electricity losses. We note that this value remains uncertain due to BSUoS costs this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin.

4.13 In the event that we implemented a transitional approach that allowed suppliers to recover the costs incurred during the cap but so far unrecovered without creating an offset (against, above mentioned, costs incurred before the cap but recovered during it), we would expect suppliers to over-recover costs. We would like cap allowances to reflect the costs incurred during the cap. Therefore, it is logical to consider the historical costs (incurred before the cap and recovered during it) and offset them when calculating the adjustment.

4.14 One stakeholder agreeing to this approach said that this method would ensure that suppliers have recovered only their efficient costs for BSUoS through the price cap mechanism.

### Offsetting versus True-up approach

4.15 The scope of this decision is to ensure that neither a notional supplier nor customer loses as we move from an ex-post recovery to an ex-ante one. Therefore, we would logically only look at cases where the costs incurred during the cap are not reflected in the allowances recovered during the cap.

4.16 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 through the cap to date. Indeed, the lagged recovery mechanism has supported an accurate recovery because it makes use of historical data. The remaining uncertainties have been captured by a portion of the headroom allowance.[31]

### Cost versus revenue-based perspective

4.17 As noted earlier, we identified two possible perspectives (namely, a cost-based and a revenue-based perspective) for calculating the transitional adjustment under the offsetting approach. We need to understand the scale of BSUoS costs between January 2022 and March 2023. The revenue-based perspective would look at the allowances received in cap periods 10a to 12b (April 2023-September 2024) and work out what fraction of these allowances related to the period January 2022 to March 2023. The cost-based perspective would instead look directly at the costs for January 2022 to March 2023.

4.18 Since the revenue-based approach would look at allowances received in future cap periods, it would require us to use forecasts to calculate the required

[31] 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

adjustment in time for cap period 10a. It follows that this perspective would require us to decide between accuracy and timeliness.

4.19 We have, therefore, decided to use a cost-based offsetting approach, which in our opinion is more accurate and more compatible with an early recovery. We consider early recovery would help supplier financial stability and enable efficiency and competition among suppliers, which is ultimately in the best interest of the customer. Nevertheless, we note that the overall financial impact would be the same.

## How we calculate the adjustment: other decisions

### Context

4.20 There are various other decisions which influence the estimated scale of the transitional adjustment.

### Decisions

4.21 In Table 4.1, we outline all the other decisions we have taken in relation to estimating the transitional adjustment. Please see Appendix 3 for our considerations on these decisions. Further details of our methodology can be found in Appendix 4.

Table 4.1: List of other decisions.

| **We have decided:** | **Has this decision changed from our November 2022 consultation proposal?** |
|---|---|
| to account for default tariff customer number changes when calculating the adjustment. | Unchanged |
| to exclude customer numbers with suppliers who have exited the market since 2021 when accounting for changes in default tariff customer numbers. | Unchanged |
| not to account for changes in consumption over time when calculating the adjustment. | Unchanged |
| to account for inflation when calculating the transitional adjustment. | Raised separately with stakeholders in January 2023 letter |
| to allocate the historical offset equally between the months in which the costs would not be fully recovered as a result of the change. | Unchanged |

| We have decided: | Has this decision changed from our November 2022 consultation proposal? |
|---|---|
| to allocate the costs incurred between January 2022 and June 2022 and recovered over cap periods 9a (October 2022-December 2022) and 9b (January 2023-March 2023) to the month these costs were incurred. | Unchanged |

## Offsetting against headroom

### Context

4.22 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. Within this allowance, we explicitly considered residual uncertainties around the recovery of BSUoS charges.[32]

4.23 The move to a fixed charge would mitigate some of these uncertainties identified by stakeholders. Therefore, there is the possibility of offsetting the transitional adjustment against the headroom allowance, which would affect the amount to be recovered through the transitional adjustment.

4.24 In our September 2022 Call for Input, we said we could potentially offset the transitional adjustment against the relevant portion of the headroom allowance. However, in our November 2022 consultation, we proposed not to offset against the headroom allowance.

### Decision

4.25 We have maintained our November consultation position, and decided 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

4.26 Two stakeholders agreed with our proposal to not offset the transitional adjustment against a proportion of headroom allowance.

[32] 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

4.27 Assuming we were able to estimate an appropriate allowance related to BSUoS, one stakeholder argued that the amount included in the allowance for BSUoS-related uncertainty would be negligible.

### Our considerations

4.28 When setting the headroom allowance, we estimated the headroom figure 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 in response to the September 2022 Call for Input, stating that there is no objective and easy way to calculate the BSUoS share of the headroom allowance. Assuming we were able to estimate an appropriate allowance related to BSUoS, one stakeholder argued that the amount included in the allowance for BSUoS-related uncertainty would be negligible.

4.29 We consider that moving to a fixed ex-ante tariff would substantially reduce uncertainties around recovering BSUoS charges in the cap, while noting that this would not necessarily represent a large proportion of headroom allowance. However, given the complexity of estimating the BSUoS share of the headroom allowance outside of a holistic review, we have decided not to account for the substantial reduction in uncertainties at this time.

4.30 One stakeholder said the headroom allowance has been exceeded by costs not accounted for elsewhere in the price cap. We consider that further evidence and analysis would be required to support this point.

## Whether to introduce a transitional adjustment

### Context

4.31 Having established a method for estimating 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.

## Decision

4.32 We have decided to implement a transitional adjustment of £23.55 per typical electricity customer at cap benchmark consumption, as the costs to be recovered through the adjustment are material, systematic and unforeseen.[33]

## Overview of stakeholder responses

4.33 Two stakeholders explicitly agreed to the implementation of the transitional adjustment. They said the adjustment would allow suppliers to recover efficient costs that they would otherwise not be able to recover through the cap when moving from ex-post to ex-ante recovery.

## Our considerations

4.34 In our 2018 decision, we said that: *"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 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."*[34]

4.35 At the time of moving to an ex-ante methodology, a notional supplier would not have recovered all of its ex-post costs, leading to a consequential under-recovery. We consider that the BSUoS costs, which would be recovered through the adjustment, meet the requirements mentioned in our 2018 decision:

- **Material**: We have estimated the adjustment to be £23.55 per typical electricity customer at the cap benchmark consumption.[35] The total efficient costs that a notional supplier would recover through the adjustment is therefore substantial.

[33] This is the figure for single rate metering arrangement customers after accounting for regional electricity losses. We note that this value remains uncertain due to BSUoS cost this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin. We estimated the transitional adjustment for multi-rate metering arrangements (after accounting for regional electricity losses) to be £30.88 per typical electricity customer at cap benchmark level. We note that the difference between the single-rate and multi-rate estimates is due to differences in benchmark annual consumption values. We also note that these values remain uncertain due to BSUoS cost this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin.
[34] Ofgem (2018), Default Tariff Cap decision – Overview, paragraphs 3.14 and 3.16. https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
[35] We note that this value remains uncertain due to BSUoS cost this winter. The final amount will be known as of May 2023, enabling the second stage of recovery to begin.

- **Systematic**: BSUoS costs are a common cost faced by all suppliers and, as observed in Appendix 2, they have increased over time. In addition, the majority of the costs considered in the adjustment have already been incurred and present a shortfall in cost recovered. 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**: We consider the approved modification to be unforeseeable when the price cap was enacted.

# 5. Implementation of the transitional adjustment

**Section summary**

We discuss our decisions related to when we would reflect the adjustment, the length of time over which we would recover any amount, and how we would amend the cap model.

## When to reflect the adjustment

### Context

5.1 As mentioned in the previous chapters, a transitional adjustment would allow a notional supplier to fully recover the BSUoS charges incurred between January 2022 and March 2023. At the time we make this decision, the actual BSUoS charges for the period January 2023-March 2023 are not fully known.

5.2 In our November 2022 consultation, we took into consideration how to best implement the adjustment given the lack of comprehensive actual data. In doing so, we considered three options:

**Option A - Actual data method [Our proposed option]**

- 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.
- In stage two, actual data for January 2023-March 2023 is considered and any adjustment is reflected from cap period 10b.

**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.
- 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.

## Decision

5.3 We have decided to implement Option A as it allows for the most accurate calculations, is not complex and provides a timely recovery for a notional supplier[36]. It also has the benefit of being less resource intensive, and thus allows us to focus more on other areas of important change for customers. This is unchanged from our November 2022 consultation.

## Overview of stakeholder responses

5.4 Two stakeholders supported option A.

## Our considerations

5.5 We assessed options A to C against a set of desirable criteria. These are: accuracy, simplicity, timing, and minimising stakeholder resource impact. Table 5.1 below illustrates options A to C against the set criteria, and clearly demonstrates that option A is the most appropriate option.

Table 5.1: Summary of options A to C against desirable criteria

| | Option A | Option B | Option C |
|---|---|---|---|
| Accuracy | ✓ | × | ✓ |
| Simplicity | ✓ | × | ✓ |
| Timing | ✓ | ✓ | × |
| Minimises resource impacts | ✓ | × | × |

### Accuracy

5.6 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. One respondent supported this argument and said that, option A provides the most accurate data to inform the adjustments.

[36] This means that suppliers would start recovering a portion of the £23.55 per typical electricity customer at the cap benchmark consumption from cap period 10a whilst the rest from cap period 10b.

Simplicity

5.7 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.

Timing

5.8 We consider options A and B would allow suppliers to start recovering costs earlier than option C, which entails a deferral.

Stakeholder Resource Impacts

5.9 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. One respondent supported this argument saying that, option A would be less resource intensive for suppliers given that the follow on process for a true-up will not be required.

## The duration over which we apply the adjustment

### Context

5.10 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 how fast suppliers would recover them. It does not affect the total amount of costs to recover.

5.11 We could apply the adjustment at each stage over (for example):

- for six months;
- for 12 months; and
- for a period longer than one year.[37]

5.12 In our November 2022 consultation, we proposed to apply the adjustment at each stage over 12 months.

[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 immediate customer bills.

## Decision

5.13 We have decided to maintain our consultation position, and to apply the adjustment over a period of 12 months. This is consistent with the way BSUoS charges are recovered under the status quo methodology, and we consider that this protects customers better than a shorter recovery period, while ensuring that suppliers can recover costs in a reasonable timeframe.

## Overview of stakeholder responses

5.14 Two stakeholders proposed shorter recoveries of six and three months, while one stakeholder was neutral on our proposal.

5.15 One stakeholder agreed to a twelve-month recovery, but proposed that the total adjustment should be recovered in 12 months. This means, stage 2 would be recovered over nine months.

## Our considerations

### Precedent- Alignment with the existing BSUoS methodology

5.16 Currently, BSUoS charges are recovered in the price cap over 12 months. Based on this precedent, we therefore consider that applying the adjustment over twelve months would be appropriate.

5.17 A stakeholder proposed recovering the total adjustment within 12 months. It said that waiting for three months of actual data to become available (January 2023 to March 2023) is not sufficient to justify extending the duration over which we apply the adjustment beyond 12 months.

5.18 However, under the status quo, we note that the BSUoS costs incurred by suppliers between January 2023 and March 2023 would only be fully recouped by the end of cap period 12b. In light of the decision in this document to implement the stage 2 adjustment in cap period 10b, suppliers would be able to recover their costs sooner (ie by the end of cap period 12a). Further, recovering the stage 2 adjustment over nine months instead of 12 months would add complexity to our calculations. Therefore, we do not consider a nine month recovery for the stage 2 adjustment to be appropriate.

### Customer and supplier impact

5.19 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. Conversely, it would have a positive immediate

impact on suppliers' finances. Stakeholders said that it would allow them to recoup the incurred BSUoS charges in a timely manner, reducing cashflow and volume risks as well as working capital impacts. One stakeholder also said that a shorter recovery period is likely to deliver significant benefit to customers by reducing the risk of supplier exit from the market.

5.20 We recognise the above argument. Recovery over a shorter period would benefit suppliers, as all else being equal, it would help to improve their financial situation, with particular impacts on any suppliers experiencing financial constraints.

5.21 However, suppliers generally have better access to financing than customers, with many suppliers having significant access to working capital. Ofgem also monitors suppliers' finances, including by carrying out quarterly stress tests through which we test whether suppliers are robust to a range of scenarios, and by collecting monthly financial information to support financial monitoring.

5.22 We therefore consider that the scale of this adjustment should be manageable over 12 months and that a 12 month recovery period would better protect default tariff customers than a shorter one. Moreover, the network allowance (where we propose to include the transitional adjustment) is uplifted by EBIT, we consider suppliers would gain a small consequential allowance which would mitigate any further working capital costs related to the recovery.

5.23 We set a single cap based on a notional supplier[38], therefore some suppliers could be adversely affected than others. However, we consider an adverse impact on a minority of suppliers from a policy decision may not be sufficient to outweigh the impact on customers, given our overarching role of protecting existing and future default tariff customers.

5.24 One stakeholder said that, from a customer perspective, the impact of a shorter recovery would be neutral due to the Energy Price Guarantee[39] (the "EPG"). It proposed to recover the full adjustment over cap periods 10a and 10b based on its expectation that the price cap levels will be higher than the EPG level in these periods.

5.25 The EPG resembles a maximum price that default tariff customers would pay while the price cap is above the EPG level. However, if the price cap level falls

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

below the EPG level, the cap would become the maximum price that default tariff customers would pay.

5.26 Given the current EPG level (set at £3,000 per customer between April 2023 and March 2024) and current observations of the forward curve for 2023/24, it is possible that the price cap level may fall below the EPG during 2023/24. This would expose default tariff customers, particularly those in vulnerable situations, to the negative impact of an immediate increase in their bills. We therefore consider that a 12 month recovery period strikes an appropriate balance and protects customers better than a shorter one.

### Cap extension

5.27 The Energy Prices Act 2022 removed the 2023 end date for the cap, while providing a mechanism for the Secretary of State to give notice that the cap ceases to have effect. Given this, we consider it appropriate to assume that the cap will continue to exist until further notice, and therefore consider that a 12 month recovery would still be appropriate.

### Other considerations

5.28 One stakeholder requested clarity on how suppliers would be compensated for their losses if significant switching to fixed products occurs before June 2024.

5.29 We consider that in the event of significant switching, suppliers would have been at risk of not recovering costs incurred between January 2022 and March 2023 under the status quo. Therefore, this change does not introduce new market risk.

5.30 To minimise the impact of volume risk and protect suppliers, two stakeholders have proposed including the transitional adjustment in the Market Stabilisation Charge (MSC). We consider decisions in relation to the MSC to be out of scope for this decision. Whilst we note in our decision to extend the MSC and BAT measures beyond 31 March 2023, that Ofgem is currently undertaking analysis to support a parameter review and that we will consult on new parameters in spring[40]. At present, we do not intend to add allowances to the MSC.

[40] Ofgem (2023) Decision to extend the MSC and the BAT beyond 31 March 2023 https://www.ofgem.gov.uk/publications/decision-extend-msc-and-bat-beyond-31-march-2023

## How we would update the cap model

### Context

5.31 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).

5.32 We identified two main models to perform the adjustment:

- Price cap Annex 3 model (Annex 3 to SLC 28AD) – our November 2022 consultation proposal;
- The Adjustment Allowance (Annex 8 to SLC 28D – the 'Annex 8 model').

### Decision

5.33 We have decided that the adjustment will be included in the Price cap Annex 3 model, since this would be the most consistent approach. This remains unchanged from our November 2022 consultation.

### Overview of stakeholder responses

5.34 No feedback was received concerning this topic.

### Our consideration

5.35 BSUoS costs are currently part of the Network Costs allowance, which are estimated in the Price cap Annex 3 model. Therefore, we consider that the most appropriate model to include the adjustment to be the Price cap Annex 3 model, as it will also facilitate accurate comparisons of Network Costs across time.

5.36 We have published a revised version of the Price cap Annex 3 model alongside this decision. Appendix 3 describes the changes that we have made and other detailed stakeholder feedback.

# 6. Impact assessment

**Section summary**

In this section, we summarise how we assessed the impact of introducing a transitional adjustment.

## Context

6.1 As outlined in Chapter 2, we act with a view to protect existing and future consumers who pay standard variable and default rates. In doing so we must have regard to the five matters identified in section 1(6) of the Act in our decision-making process

6.2 In reaching our decisions, we have been mindful of the trade-offs between customers' interests in minimising the immediate impact on energy bills and their interests in ensuring resilient suppliers who can efficiently manage risks. As part of our decision-making, we conducted an impact and equalities assessment

6.3 We carried out three assessments of the impacts of introducing a transitional adjustment from cap period 10a:

- High-level qualitative analysis: we assess the potential impact of the transitional adjustment on default tariff customers and suppliers.
- Bill impact analysis: we assess the potential impact on bills for a number of different representative domestic users.
- Potential impact on public spending duty.

## High level qualitative assessment[41]

### Overview of policy rationale

6.4 If we made no change to the BSUoS methodology in the cap, BSUoS charges would continue to be passed through with a lag. Given the upward trend in BSUoS charges, suppliers would face a cashflow impact from this lag. When the cap reaches its expiry (upon notice from the Secretary of State, which is currently an unknown date) suppliers would also likely incur a permanent shortfall. This would be due to the likelihood that BSUoS charges incurred during the cap which

[41] We have already approved CMP361. We therefore include CMP361 implementation in all scenarios

were not passed through would exceed previous BSUoS allowances based on pre-cap BSUoS charges.

6.5 We therefore consider that it is appropriate to reflect the change to an ex-ante BSUoS charge in the cap BSUoS methodology. This ensures that the cap reflects the BSUoS charges suppliers face, and also eliminates the cashflow impact from lagged BSUoS charges.

### Assessment

6.6 We focus this assessment on the customer and supplier impacts of the factual scenario of moving to an ex-ante allowance and introducing the transitional adjustment. We compare this factual scenario against the two counterfactual scenarios:

- Do nothing: not move to an ex-ante allowance (ie maintain the the lagged BSUoS allowance) and as a result a does not introduce a transitional adjustment
- No transitional adjustment: move to an ex-ante allowance and does not introduce a transitional adjustment

Factual scenario versus 'do nothing' counterfactual

6.7 If we do not adopt an ex-ante BSUoS methodology in the cap and subsequently do not implement a transitional adjustment, the costs related to the transitional adjustment would eventually pass through the lagged recovery mechanism, and, therefore, be borne by future customers. This means the factual and 'do nothing' counterfactual scenarios yield similar impacts for customers as a whole over time.

6.8 In light of the above qualitative assessment, we consider the net benefits of a transitional adjustment to outweigh the costs.

Factual scenario versus 'no transitional adjustment' counterfactual

6.9 In the factual scenario, suppliers are able to fully recover the efficient costs of a notional supplier that they would otherwise not be able to recover (in the main counterfactual) via the transitional adjustment. We consider this would allow suppliers to manage financial risks and in extreme circumstances reduce the risk of exits.

6.10 Customers would experience a temporary increase in their energy bills (ie an increase in the cap level) relative to the counterfactual, although the impacts might be partly mitigated by the EPG. However, we consider that implementing a transitional adjustment would be beneficial to both existing and future customers

by potentially reducing the future additional costs that they would incur due to the Supplier of Last Resort ('SoLR') and/or Special Administration Regime ('SAR') processes.

6.11 Introducing a transitional adjustment therefore does not necessarily represent an incremental cost to customers in this wider context, and could ensure an appropriate balance of cost between current and future customers.

## Bill impact analysis

6.12 We have carried out a distributional analysis of introducing the transitional adjustment to customer energy bills. It is difficult to determine precisely how much customers would pay due to the uncertainty around the price cap level (resulting from wholesale price volatility) and its interaction with the EPG level (currently set at £3,000 between April 2023 and March 2024).

6.13 We note that BSUoS charges are applied to the unit rate of electricity customers and both the fixed BSUoS charge and transitional adjustment will be applied identically to Profile Class 1 and Profile Class 2 customers.[42] Therefore, customers who use more electricity, such as those using storage heaters, will pay a higher cost.

6.14 We have therefore assumed two extreme scenarios to assess the range of potential impacts:

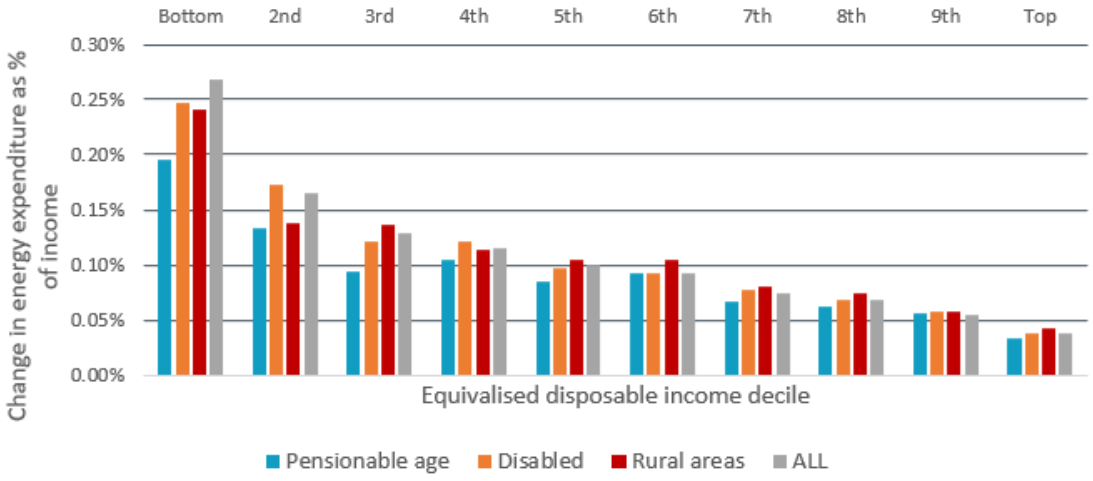
- Scenario 1: EPG is not in effect at any stage during the transitional adjustment. This could be due to the EPG level remaining above the price cap level.
- Scenario 2: EPG level is in effect for the current expected duration (ie up to March 2024) with the price cap above the EPG level.

### Scenario 1

6.15 Figure 2 shows the distributional analysis based on current estimates of the transitional adjustment against the counterfactual of not introducing one. We have had particular regard to the interest of the individuals who are disabled or chronically sick; pensionable age; of low incomes; and residing in rural areas.

[42] Profile 1 is standard domestic. Profile 2 is mainly derived from domestic customers with Economy 7 metering.

Figure 2: Estimated impact of introducing the transitional adjustment on electricity bills as a percentage of income, by categorical group, in comparison to not introducing one.




Accessible format

The bar graph shows the change in energy expenditures as a percentage of income following the introduction of a transitional adjustment for pensionable age, rural area, disabled, and all customers. It indicates that those in the equivalised bottom income decile will incur the highest costs.

6.16 The transitional adjustment costs customers at the lower end of the income distribution significantly more on a relative income basis, while it costs customers at the top of the income distribution less. Within each decile, the disabled group is impacted the most, while the pensionable group is impacted the least.

6.17 Under the Equality Act 2010 we are required to have regard to the public sector equality duty and consider how our policies or decisions affect people who are protected under that Act. Although the adjustment would be an increased cost for customers, including those with protected characteristics, these costs are efficient costs suppliers are yet to recover. Therefore, as noted earlier, if these costs are not recovered now, it could increase the risk of supplier failure and could lead to a later adjustment, to be borne by future customers, including with protected characteristics. In the event that we do not update the BSUoS allowance in the cap to reflect CMP361, these costs will eventually be passed on to customers through the lagged charges.

## Scenario 2

6.18 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. While 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 direct impact of the adjustment on customers' energy bills would likely be neutral until April 2024, since the recovery of BSUoS costs would not affect how much the customer would pay. We recognise, however, that while this scenario will have a relatively small impact on energy bills, any costs absorbed by the EPG will ultimately impact taxpayers who are also domestic energy customers as well.

6.19 The last three months of the second stage of the adjustment (April 2024-June 2024) will be after the EPG is expected to end. 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.

6.20 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 £1.58 per typical electricity customer at the cap benchmark consumption after accounting for regional electricity losses.[43].

6.21 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. However, we would expect the impact profile to remain the same, with customers at the lower end of the income distribution affected more on a relative income basis than those at the upper end.

## Impact on public spending

6.22 We are required to exercise our functions under the Act with a primary focus on protecting customers 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'.

6.23 That new consideration reflects the fact that, while the Government's EPG is in force, the cap level affects the levels of payments by Government to energy

[43] We estimated this value by multiplying the final stage two adjustment figure by the relevant demand share for the periods April 2024-June 2024. We note the value remains uncertain until all charges have been published

suppliers. While the EPG is in place, and the cap level remains above the EPG, the cost of this adjustment would be covered by the government. If the cap level falls below the EPG level at any time before March 2024, then some of these costs would be borne by customers.

6.24 We have therefore provided the opportunity for the Department for Energy Security and Net Zero (previously the Department for Business, Energy and Industrial Strategy (BEIS)) and HM Treasury to provide representations on the impact of any aspect of our proposed decision on public spending, having regard to the new consideration in the Act. We did not receive any representations from the Department or the Treasury. We therefore sought confirmation from both that they did not have any representations. The Department has confirmed that they do not have any representations to make. The Treasury has not provided such confirmation but we consider that they have been provided with appropriate opportunity to make representations.

6.25 Table 6.1 shows our estimate of the potential impact of this decision on government spending for each cap period which the EPG level remains below the price cap level.[44] We do however note, that even if this cost is paid for by the exchequer, then it will ultimately impact taxpayers who are also domestic energy customers as well.

Table 6.1: Estimated impact on public spending for cap periods where the cap level is above the EPG level

| **Cap period** | **Cost per individual cap period** |
|---|---|
| 10a (April 23 – June 23) | £93m |
| 10b (July 23 – September 23) | £120m |
| 11a (October 23 – December 23) | £161m |
| 11b (January 24 – March 24) | £165m |

6.26 If the price cap level were to fall below the EPG level between April 2023 – March 2024, then the cost to the exchequer would be £0 in each cap period, and the cost would instead be borne by default tariff customers.

[44] We estimated the costs per cap period by multiplying the relevant transitional adjustment recovered in that period (ie relevant stage 1 and stage 2 costs) with the relevant demand share for the period and recent electricity customer numbers. The customer numbers taken from the October 2022 customer account and tariff RFI.

6.27 We consider that this decision takes proper account of the impact the proposed changes may have to public spending. Overall, the adjustment being made is no more than reasonably justified having regard to the consideration of enabling suppliers to recover efficient costs of supplying energy. Furthermore, enabling suppliers to recover the efficient costs of their supply activities is likely to reduce the risk of suppliers failing and becoming insolvent, which may impact public spending (such as through the cost to the taxpayer of a special administration regime).

# Appendices

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# Appendix 1 – How to calculate the transitional adjustment: other decisions

## Accounting for changes in default tariff customers

### Context

A1.1 The aggregate number of default tariff customers changes as customers move between default and fixed tariffs. This means it is unlikely that suppliers will have the same aggregate number of default tariff customers every year.

A1.2 The cost-based offsetting approach that we have chosen to calculate the transitional adjustment considers charges that suppliers might fail to recover (ie charges incurred between January 2022 and March 2023). It then also considers historical BSUoS charges incurred prior to the cap's introduction (July 2017 to December 2018) and recovered under the early cap periods (January 2019 to March 2020).

A1.3 As customer numbers have changed between these periods, this will have affected the total amount suppliers have spent and recovered. Therefore, we considered whether we would account for this change between periods in our calculations.

A1.4 In our November 2022 consultation we proposed to account for changes in default tariff customer numbers when calculating the adjustment.

### Decision

A1.5 We have maintained our consultation position, and decided to account for default tariff customer number changes between calculation periods when calculating the adjustment, by weighting the costs incurred and recovered by suppliers against total default tariff customer numbers in different periods.[45] We consider this would improve the accuracy of the adjustment.

A1.6 We have decided to exclude customer numbers with suppliers who have exited the market since 2021. This ensures that the historical offset does not include benefits accrued by now-exited suppliers.

[45] We note that we have used the customer account as a proxy for customer numbers and is obtained from our regular customer account and tariff requests for information (RFI).

### Our considerations

Accounting for changes in default tariff customers

A1.7 In response to the September 2022 Call for Input, one respondent said that the offsetting approach would have disproportionate cost implications on those suppliers who have either acquired default tariff customers through the Supplier of Last Resort ("SoLR") process, seen significant growth over the past few years, or have only recently entered the market.

A1.8 Since under the status quo, BSUoS costs are recovered using a lagged mechanism, suppliers will face some changes in their aggregate default tariff customer numbers over time which could potentially impact the amount recovered by suppliers. As a result, the cap implicitly assumes that this impact will net out in the round, and any variances will be covered by existing uncertainty allowances, such as headroom.

A1.9 Nevertheless, we consider that there is a significant time difference between the historical and the most recent periods, as well as fewer default tariff customers during the historical period as opposed to the most recent period. Therefore, we consider it appropriate to account for default tariff customer number changes in our calculations specifically regarding the offset.

Excluding default tariff customer numbers with now-exited suppliers

A1.10 In response to the September 2022 Call for Input, while arguing against cost offset, one stakeholder said that some of the beneficiaries of the historical cost recovery were no longer in the market. In order to minimise the exposure of existing suppliers to costs recovered by now-exited suppliers, we have decided to exclude default tariff customers with now-exited suppliers when accounting for changes in customer numbers.

## Accounting for changes in consumption

### Context

A1.11 When calculating the transitional adjustment, we considered whether we would account for any changes in consumption levels, specifically, between the historical period (July 2017-December 2018) and the more recent period (January 2022-March 2023) considered under the adjustment.

A1.12 We proposed in our November 2022 consultation to not account for changes in consumption in our calculations.

## Decision

A1.13 We have decided to maintain our consultation position and not to account for changes in consumption over time when calculating the adjustment. This is primarily due to precedent in the cap (ie setting the BSUoS allowance at the benchmark consumption level), as well as its low materiality.

## Overview of stakeholder responses

A1.14 One stakeholder recommended to account for changes in consumption.

## Our considerations

A1.15 To calculate the transitional adjustment, we kept the domestic consumption value constant over time at 3.1 MWh, since this is the consumption assumption used to calculate the BSUoS allowance in the price cap.

A1.16 One stakeholder said the calculation should account for the changes in default tariff customer consumption values.They said that, in part due to the energy crisis, typical consumption could be lower for the most recent period than for the period considered under historical recovery. It said not accounting for such changes would risk overcompensation in the adjustment.

A1.17 Department for Energy Security and Net Zero (previously BEIS) publishes their energy consumption statistics annually in December. For electricity, the latest data is available from February 2021 to January 2022.[46]

A1.18 Therefore, at the time of this decision, we do not have data on domestic consumption for the full period relating to January 2022- March 2023 that is subject to the calculation. This means that we do not know how consumption has changed to reflect the current energy prices and the existence of government schemes such as the EPG and EBSS.

A1.19 We recognise that there might be a change in recent consumption in response to recent events. However, since we set the cap at the typical benchmark consumption level, we cannot change this assumption without wider consultation.

A1.20 As a sensitivity check, we have also estimated a counterfactual adjustment, holding recent consumption constant while adjusting the historical consumption assumption to account for changes in consumption over time. Our results showed that it

[46] BEIS (2022), Sub-national electricity consumption data
https://www.gov.uk/government/collections/sub-national-electricity-consumption-data

would likely have a very low materiality impact on the estimate, and as above, it would require the addition of assumptions that may reduce accuracy.

## Accounting for inflation in our calculation

### Context

A1.21 Given the length of time between the historical and recent cost periods considered under the cost-based offsetting approach, the real-terms gap in monetary values between the two periods will diverge significantly from the nominal-terms gap. Consequently, we considered the possibility of converting the historical costs to recent prices, to improve comparability.

A1.22 We did not consult on this issue in our November 2022 consultation. In January 2023, we notified stakeholders that we would consider this in our calculations when making this decision, and invited representations on this issue.

### Decision

A1.23 We have decided to account for inflation to improve the comparability of the costs considered when calculating the net transitional adjustment. We have decided to do this by uprating the historical costs using the Consumer Price Index including owner occupiers' housing costs (the 'CPIH Index').

A1.24 We have decided to account for inflation by multiplying each month of historical costs by the ratio of the recent price index and the historical price index for that month. The recent price index is calculated by taking the simple average of the index over the period of January 2022-December 2022. [47]

### Overview of stakeholder responses

A1.25 One stakeholder said that they had no concerns about our proposal to only uplift the historical offset while three stakeholders disagreed.

[47] Since the CPIH index does not forecast indices, we are unable to consider the index value for the last three months (ie January 2023-March 2023) when calculating the average recent index. For the historical costs, since we are using a cost-based offsetting approach to calculate the adjustment, we will use the index values for the months in which these costs were incurred (ie July 2017-December 2018) rather than using the index value for months in which these costs were recovered (cap periods 1-3).

## Our considerations

### General considerations

A1.26 Since we are comparing costs that were incurred in periods with a significant time difference, we consider it appropriate to adjust the historical costs to reflect recent prices. This would ensure that we compare the real terms value of costs incurred at different points in time. We have taken this approach elsewhere in the cap – for example when carrying out the true-up for COVID-19 costs[48].

A1.27 We consider that the most appropriate way of doing this is by uprating using the CPIH index, given that this is the inflation measure generally used elsewhere in the cap eg operating costs allowance.[49]

A1.28 One stakeholder said that the BSUoS allowance inherently is not adjusted for timing differences.

A1.29 We want to emphasise that the transitional adjustment is not comparable to the existing BSUoS methodology. The transitional adjustment is a one-off adjustment to facilitate the transition from a lagged ex-post recovery to an ex-ante one. It therefore goes beyond the scope of the existing BSUoS methodology. While the existing BSUoS methodology includes a lag, the time difference between the historical and recent costs included in the transitional adjustment is much greater. This makes it more important to adjust for time differences.

A1.30 One stakeholder said that BSUoS allowances in the cap were consistently lower than the actual BSUoS costs incurred in the same period, thus requiring additional working capital, and impacting cash flow. It said that if we adjust for inflation, we should include a similar adjustment for the in-period differentials in costs incurred and recovered over previous cap periods.

A1.31 Firstly, suppliers received a BSUoS allowance for each cap period, even though the allowance was based on previous charges. Any working capital requirement could therefore only relate to the differences between costs and allowances in a particular cap period (rather than to the entire allowance). Secondly, we consider that suppliers will have the tools to manage temporary cashflow issues in the normal course of their business. Thirdly, we also note the allowance is uplifted by EBIT, which is intended to

[48] Ofgem (2022), Price cap - Decision on the true-up process for COVID-19 costs https://www.ofgem.gov.uk/publications/price-cap-decision-true-process-covid-19-costs
[49] This does not prejudice the use of other inflation measures for specific cap allowances. For example, where we need to forecast future inflation or when the allowance is subject to specific scheme rules.

partly account for working capital requirements, and BSUoS uncertainty is also considered within the headroom allowance. We therefore do not consider that a working capital adjustment is necessary.

A1.32 One stakeholder said that if the historical costs are adjusted for inflation, we should also adjust the transitional adjustment for this over the duration of the adjustment. We do not consider the latter to be justifiable.

i) From the time costs are incurred, it would take suppliers at least 15 months to recover their costs under the current BSUoS recovery mechanism.[50] Inflation is not taken into account in the calculation of this allowance.

ii) We consider that the time differences are not similar between (a) historical costs and recent costs, and (b) when the transitional adjustment will be implemented and fully recouped. The former difference is much larger than the latter. This justifies adjusting for inflation in the former case but not the latter.

A1.33 One stakeholder said accounting for inflation would add complexity to the calculation. We have carefully considered this issue in light of the increased accuracy that an adjustment would provide. We consider that the accuracy gains outweigh any increase in complexity.

### Method on how we would account for inflation

A1.34 To account for inflation in our calculation, we multiply each month of historical costs by the ratio of the recent price index and the historical price index for that month. For the historical period, we have monthly data, so we would use this for accuracy purposes.

A1.35 The recent period considers the months between January 2022 and March 2023, so we need to construct an index value for this period. We have the option of using either a simple average or the weighted average (weighted based on the costs incurred in a given month) of the recent monthly CPIH index to construct this index value.

A1.36 We consider that the weighted average would give a slightly more accurate index than the simple average approach. Nonetheless, this accuracy is limited since there are no CPIH index values currently available for the last months of the transitional adjustment. Therefore, we would only consider the CPIH index for the period January 2022-December 2022 to calculate the average. We also evaluated the impact the

[50] For example, under the lagged recovery mechanism, costs incurred in June 2023 would first be reflected in cap allowance 11a and be fully recovered by the end of cap period 12b.

different approaches would have on the transitional adjustment and determined that it was negligible. We have therefore decided to use a simple average method.

A1.37 In Chapter 5, we discuss our decision to apply the adjustment in two stages, with stage 1 taking effect in cap period 10a and stage 2 in cap period 10b. This means that at the time we implement the stage 2 adjustment, we will have CPIH index values for January 2023 to March 2023. Since we have decided to equally allocate the historical offset between each stage (see next section for a discussion) considering these values in the adjustment would add further complexity to our calculation and would have a minimal materiality impact. Therefore, we have decided not to consider the CPIH index values for these periods in our calculation of the stage 2 adjustment.

## How we allocate the costs offsets

### Context

A1.38 We have decided to apply the adjustment in two stages (see Chapter 5 for discussion). This means we need to estimate the adjustment value for each stage.

A1.39 Therefore, there is a question of how we would allocate the costs incurred by suppliers before the cap and recovered in cap periods 1, 2, and 3 (henceforth referred to as the historical offset) and costs incurred between January 2022 and June 2022 and recovered in cap periods 9a (October 2022-December 2022) and 9b (January 2022-March 2022) (henceforth referred to as the cap 9 offset), between each stage.[51]

### Decision

A1.40 We have decided to allocate the historical offset equally across the months between January 2022 and March 2023. This means that this offset would be allocated to each stage proportionately.

A1.41 We have decided to allocate the cap 9 offset to the month these costs were incurred (ie January 2022-June 2022). This means that, this offset is only allocated to stage 1.

### Overview of stakeholder responses

A1.42 One stakeholder agreed with our approach to how we would allocate historical cost offset. One stakeholder disagreed with our approach to how we would allocate cap 9

[51] For avoidance of doubt, in earlier sections we discussed costs incurred and yet to be recovered in period January 2022-December 2023. We note that is the net of total costs incurred between January 2022-December 2022 and partly recovered in cap 9a&b (October 2022-March 2023) (cap 9 offset).

offset (ie allocate to only stage 1), instead suggested that this offset should also be allocated in the same manner as the historical offset.

### Our considerations

A1.43 We consider there is no direct way of linking costs incurred before January 2023-March 2023 to particular months within that period. Therefore, we consider it appropriate to allocate the historical offset equally to that period.

A1.44 However, since the cap 9 offset is based on costs incurred between January 2022 and June 2022, we consider it appropriate to offset it against costs incurred during this period.

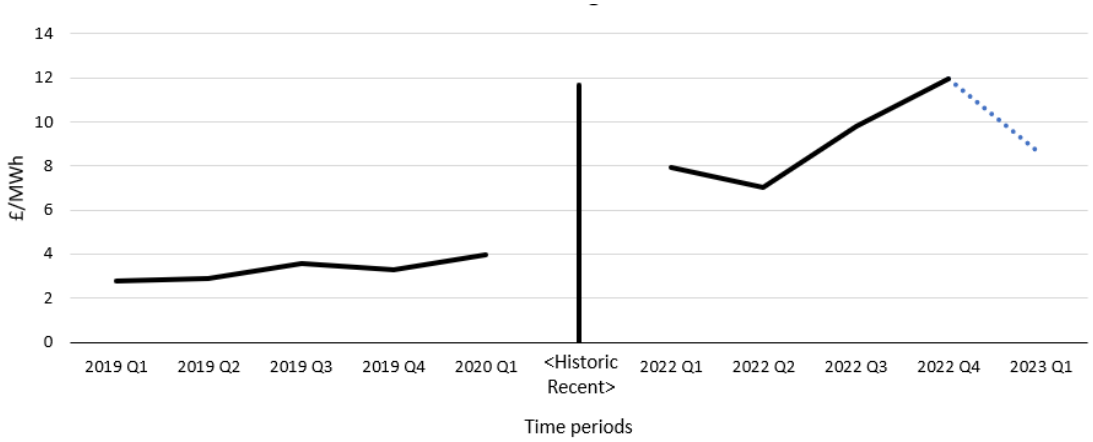
A1.45 Furthermore, this decision would not affect the amount collected. Instead, it would transfer a small portion of the costs to be recovered from stage 2 to stage 1. Since these stages are only implemented three months apart, we consider this to have a negligible impact on customers and suppliers.

# Appendix 2 – Trends in BSUoS

A2.1 Figure A1 compares historical and recent trends in average BSUoS charges. Average BSUoS charges 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, £3.30/MWh, while charges in recent cap periods (January 2022 - March 2023), are estimated to be, on average, £9.07/MWh.

A2.2 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 BSUoS costs continue to be high, albeit smaller than the previous quarter (as presented by the forecasted figures) over the winter period. This is because of the costs associated with policies undertaken by the ESO to maintain safe and secure operation of the electricity system throughout winter. BSUoS costs are also linked to wider energy costs, which could also contribute to these high costs.

Figure A1: Trends in BSUoS charges in £/MWh (historical and recent)




Accessible format

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. Last quarter does not fully account for the cap on BSUoS charges at maximum £40/MWh between 6th October and 31st March). [52]

[52]Ofgem (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

# Appendix 3 – Detailed modifications to the Price cap Annex 3 model

## Overview

A3.1 In this Appendix, we summarise the stakeholder responses to the model modification and the final modifications to Price cap Annex 3 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.

A3.2 In the revised Price cap Annex 3 model, published alongside this decision, the updated cells are highlighted in yellow. We note that, the yellow highlights will be removed in the version of Price cap Annex 3 model that we will publish alongside our scheduled cap update.

A3.3 We note that the current structure of the Price cap Annex 3 model only allows us to amend the model up until December 2023 (the initial end date for the cap). There is on-going work to extend these models beyond December 2023.[53]

## Stakeholder responses to model updates and our considerations

A3.4 Two stakeholders identified a potential error in the calculation of the BSUoS allowance in the Price cap Annex 3 model. The calculation sums the ex-ante BSUoS rate and the transitional adjustment, and multiplies both by the benchmark typical consumption with a losses uplift. We noted this error and consider that, the transitional adjustment should only be multiplied by the necessary losses and not by the typical benchmark consumption. We have since then corrected this error in our published model.

A3.5 One respondent said that the Price cap Annex 3 model should also include relevant inputs to streamline the additional adjustments (noted in Chapter 3). We have reflected this in our published Price cap Annex 3 model.

A3.6 The Price cap Annex 3 model published alongside the November 2022 consultation included a row to input the BSUoS fund component of the fixed tariff. Since the approved CMP361 modification does not include an a BSUoS fund contribution, we have removed this input.

[53] Ofgem (2023), Price Cap – Removal of the cap end date from licence conditions. https://www.ofgem.gov.uk/publications/price-cap-removal-cap-end-date-licence-conditions

## Enduring changes to the cap

### 3e BSUoS charges

A3.7 Added rows 8:9: to include 28AD charge restriction periods and the date at which the figures are updated.

A3.8 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.

A3.9 Added rows 13:21: We have created a table to add, as inputs, the ex-ante fixed volumetric BSUoS tariff, published by the ESO – row 19, and additional adjustment- row 20. As noted in the Chapter 3, we split these charges into quarterly periods to facilitate tariff update in the event of a tariff reset within the fixed period.

A3.10 Cells W11:Y11: We have updated the formulas in the cells to sum the main tariff, and additional adjustment from cells C19 and C20 onwards, rather than calculating the weighted average of the final settlement data (historical approach) in the row 23 and below.

A3.11 In addition, we have added a caveat in the tab description, stating that the data in step 3 (from cells B23 and below) are historical data, and is no longer used. We also include information regarding rows 19 and 20.

## Introducing a transitional adjustment

### 3g BSUoS trans arrangement

A3.12 New input tab '3g BSUoS trans arrangement' created to introduce the BSUoS transitional adjustment figures estimated in the 'Transitional adjustment calculations model v.2'.

A3.13 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 'Transitional adjustment calculations model v.2' model tab 'output' cells E13:E16.

### 2c BSUoS

A3.14 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.

A3.15 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 uplifted to account for losses and then are summed to the BSUoS allowance.

### 1a Network Cost Allowance-Elec

A3.16 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.

A3.17 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 4 Details on how we calculated the transitional adjustment

## Overview of the transitional adjustment calculation

A4.1 In this appendix, we provide the detailed stakeholder responses to our calculation model, and a detailed view of how we estimated the transitional adjustment, using the costs-base offsetting approach.

## Detailed stakeholder responses and our considerations

A4.2 One stakeholder said that there is an inconsistency in the source of the default tariff customer numbers when accounting for the changes in customer numbers. This was in relation to the Request for Information (RFI) used for costs recovered under cap 9a&b, and costs incurred between October 2022-December 2022 and between January 2023-March 2023. According to our proposed model, these were expected to use the October 2022 and April 2023 RFI. However, since April 2023 RFI data would not be available at the time we implement stage 2, we have decided to use only October 2022 RFI instead. This corrects the highlighted inconsistency.

## Calculation details

A4.3 The steps in the calculation address 4 main questions:

i) *Question 1*: How much will the suppliers' BSUoS costs be between January 2022 and March 2023?

ii) *Question 2, Cap 9 offset*: 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)?

iii) *Question 3, Historical offset*: 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)?

iv) *Question 4*: How much is the net transitional adjustment in stage 1 and 2 of implementation, when accounting for default tariff customer changes?

A4.4 Note that all the figures have been calculated for single rate and multi-register metering arrangements, at their respective benchmark consumption levels. Also, the

BSUoS input data published by the ESO and used in the calculations below are settlement final [54] data, the same data used to estimate the BSUoS price cap allowances.

A4.5 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.2' published together with this decision.

Table A1: 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 (refer for further details after the table) |
| Period BSUoS costs were incurred by suppliers | Jan-22 to Mar-23 | Jan-22 to Jun-22 | Jul-17 to Dec-18 | N/A |
| BSUoS costs weighted average (£/MWh) | =Ratio between BSUoS actual half-hourly charges per month/implied consumption per month[55] | As for Q.1 | =Inflation adjusted ratio between BSUoS actual half-hourly charges per month/implied consumption per month | N/A |
| 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 | N/A |

[54] Settlement Final is the initial part of a-two stage financial settlement related to the calculation and billing of BSUoS costs. This is calculated in accordance with the methodology set out in Chapter 9 using the latest available data, including data from the Initial Settlement Run and the Initial Volume Allocation Run.
NGESO (2019). Introduction to BSUoS
https://www.nationalgrideso.com/document/137681/download

[55] At the time of the publication, stage 1 values are final while stage 2 values are based on forecast data. Stage 2 value remain uncertain. Further details can be found in the model.

| Questions: | Q.1 | Q.2 | Q.3 | Q.4 |
|---|---|---|---|---|
| Monthly BSUoS costs incurred by suppliers (£/customer) | =BSUoS costs weighted average*monthly consumption | As for Q.1 | As for Q.1 | N/A |
| Demand share in the cap period suppliers are recovering BSUoS costs | N/A | =sum of the monthly demand share | As for Q.2 | N/A |
| BSUoS costs recovered by suppliers based on the monthly BSUoS costs incurred (£/customer) | N/A | =BSUoS costs incurred by suppliers*cap period demand share | As for Q.2 | N/A |

### Steps to calculate Q.4

A4.6 To reflect changes in default tariff customer numbers, we multiplied the costs recovered and incurred by suppliers (estimated in Q.1, Q.2 and Q.3) by the default tariff customer numbers, from the biannual RFI for customer account and tariffs.[56]

A4.7 As mentioned in chapter 5, we propose to calculate the adjustment over two stages. We estimated the net adjustment for each stage by calculating the delta between the costs incurred (estimated in Q.1 and adjusted for default tariff customer number changes) and recovered (estimated in Q.2 and Q.3 and adjusted for default tariff customer number changes) under each stage.

[56] We estimated the seasonal total default tariff 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.