To - all stakeholders

Email: Retailpriceregulation@ofgem.gov.uk

Date: 25 August 2023

Dear Stakeholders,

Decision on technical changes to the price cap methodology

The default tariff cap ('the cap') protects households on standard variable and default tariffs (which we collectively refer to as 'default tariffs'). The cap protects default tariff customers by limiting the amount they can be charged for their gas and electricity. We set the level of the cap to ensure that default tariff customers pay a fair price for their energy that reflects the efficient underlying cost to supply that energy.

The level of the cap is set based on a detailed calculation of how much it costs a notional efficient supplier to provide gas and/or electricity services. We currently update the level every three months, reflecting changes in underlying costs. For each component of a customer's bill, we set an efficient allowance. In total, these allowances ensure that default tariffs reflect the efficient costs of supplying energy.

On 30 June 2023, we consulted on proposed technical changes to the price cap methodology to ensure that the cap continues to reflect the efficient costs of supplying energy[1]. In this consultation we proposed amending the methodology in three areas:

- **Contracts For Difference (CfD):** we proposed to calculate the CfD allowance by including any before-period adjustments LCCC (Low Carbon Contracts Company) make to the determination run forecast of CfD payments at least 30 working days prior to the commencement of the cap period and not to include any in-period adjustments made to the determination run forecast of CfD payments.

[1] Ofgem (2023), Price cap – Consultation on technical changes to the price cap methodology – June 2023, Price cap – Consultation on technical changes to the price cap methodology – June 2023 | Ofgem

- **Great British Insultation Scheme (GBIS, formerly ECO+):** we proposed to amend the methodology used to calculate inflation in the GBIS using the GDP deflator values based on calendar year rather than financial year.

- **Unidentified Gas (UIG):** we proposed to amend the UIG input to equalise the allocation of UIG for PPM and non-PPM customers, in line with UNC Mod 840[2].

Across all three areas, we set out our intention to implement these changes from charge restriction period 11a, commencing 1 October 2023.

Decisions

We have carefully considered the feedback provided and have decided to implement the proposed amendments across all three areas in line with the consultation proposals. We set out further detail on our decision and stakeholder feedback below.

Contracts for Difference (CfD)

We have decided to proceed with the input changes as proposed. These can be summarised as follows:

- Include before-period adjustments (BPA) made available at least 30 working days prior to the start of the cap period. These are adjustments made to the Determination Run (DR) that are made for a subsequent period. LCCC will strive to produce, if required, a BPA in time for this to be accounted for in the relevant upcoming price cap announcement.

- Not to include in-period adjustments (IPA) in the calculation of the CfD cost allowance. These are adjustments that are made to the DR for the current period at the time of publication of the adjustment.

Great British Insulation Scheme (GBIS, formerly ECO+)

We have decided to proceed with our proposal to use the GDP deflator values based on calendar year rather than financial year when accounting for inflation in the GBIS scheme within Annex 4, policy cost allowance methodology of the price cap.

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[2] Ofgem (2023), Decision to approve Uniform Network Code (UNC) 840: Equalisation of prepayment and non-prepayment AUG factors, [Decision to approve Uniform Network Code (UNC) 840: Equalisation of prepayment and non-prepayment AUG factors | Ofgem]

Unidentified Gas (UIG)

We have decided to proceed with our proposal to amend the UIG input to equalise the allocation of UIG for PPM and non-PPM customers. To achieve this, we will use the Final Allocation of Unidentified Gas Statement for the relevant gas year, taking the sum of the total UIG for both PPM and non-PPM customers and divide this by the sum of the total forecast demand for both PPM and non-PPM customers to arrive at a single percentage UIG allowance that will apply to both PPM and non-PPM customers.

Responses to our consultation

Contracts for Difference (CfD)

We received five responses to the question on our proposals for CfDs, including four industry stakeholders and one consumer interest stakeholder. The consumer interest stakeholder that responded to our consultation considered the proposals were sensible, however, the four suppliers who responded raised concerns.

The suppliers that responded did not consider that our proposals went far enough in addressing the CfD related risks to which they are exposed, and most either stated or reiterated their preference for a reconciliation mechanism. Some stated that the discrepancies between LCCC forecasts and outturn had now become material and systematic, citing generator flexibility in delaying start dates as an example for why variations in outturn of CfD costs compared to forecast costs may not be symmetrical. One supplier also suggested that if we wished to provide the certainty that suppliers need to hedge, then we would use the original determination run, published three months in advance, or alternatively LCCC weekly updates published on a specified date, even though they are not formal determinations.

<u>Hedge Timing / Price risk</u>

Three suppliers raised concerns that our proposals did not address the risks they face because they do not know whether there would be a BPA. Another supplier suggested that the LCCC should commit to always publishing a BPA on an agreed date. It saw no reason why the LCCC could not make such a commitment and reasoned that it would materially improve suppliers' ability to risk manage the level of the CfD allowance in the price cap.

<u>Volume risk</u>

One supplier noted that the proposal does not address the risks that LCCC forecast are materially different to outturn rates. It cited differences in wind generation forecasts for 2022-23 as evidence that the risks across industry are material and systematic. Another, however, noted that whilst BPAs can have a negative impact on the effectiveness of its price hedge, they can have a positive impact on reducing risk associated with changes in generation volume, which cannot be hedged. Two suppliers referenced the deferral or exit of generators from the CfD scheme as sources of forecast uncertainty. With one considering that a reduction in the period that a BPA update could be incorporated in the cap may not in fact be helpful to suppliers.

One supplier also noted the Department of Energy Security and Net Zero (DESNZ) recognition of generators' behaviour and subsequent revision to the CfD contracts for allocation round 5, but noted these proposals would not resolve this issue for contracts awarded under previous allocation rounds.

Reconciliation mechanism

Three suppliers considered or reiterated that we should introduce a reconciliation mechanism as opposed to the proposed changes. One supplier asserted that a reconciliation approach would resolve both the price and volume issues associated with LCCC forecasts and the regular adjustments made to these due to market movements.

Another noted that a reconciliation mechanism would remove the need (and cost) to hedge against CfD volumes, and that this would be in the long-term benefit to consumers.

EBIT

One supplier considered that Ofgem did not sufficiently address the risk exposure of suppliers to CfDs as part of the EBIT review[3], and that the case for a reconciliation mechanism to allow recovery of efficiently incurred costs was all the more compelling.

Considerations

Following engagement with LCCC, our technical consultation proposed an amended approach to the CfD inputs used in the determination of the CfD cost allowance. We considered this proposal would improve suppliers' ability to hedge CfD costs. However, the purpose of our proposals was not to indemnify suppliers of all CfD related risks, considering a) hedging decisions are ultimately a matter for suppliers, b) these are risks suppliers are better placed than consumers to manage, and c) considering suppliers will need to manage such risks for all consumers, not just default customers. Our consultation did not consider or provide proposals on fundamental reform of the CfD allowance, including changing the overarching design to a reconciliation based mechanism.

[3] Ofgem (2023), Price Cap - Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance, Price Cap - Statutory Consultation on amending the methodology for setting the Earnings Before Interest and Tax (EBIT) allowance | Ofgem

In line with our 2018 decision[4], we do not include mechanisms in the cap for correcting forecast errors, particularly if these are non-systematic. On the issue of a potential introduction of a CfD reconciliation mechanism, we note that we considered this issue in 2022 and decided against the introduction of such a mechanism. We set out the rationale for this conclusion in para 3.44 – 3.46 of the 2022 CfD decision[5]. Although the introduction of a reconciliation was not within scope of the proposals set out in this consultation, we have given regard to stakeholders' views. However, we have not seen sufficient new and compelling evidence to suggest that our previous decision in this regard should be reviewed.

We note that some of the feedback relates to the timing of LCCC publication timings. We have provided this feedback to LCCC, but do not consider this to be a matter for Ofgem to decide.

Having considered stakeholder feedback in this area, we retain our minded to position that the proposals set out in the consultation strike the right balance between facilitating greater clarity on CfD forecast inputs to hedge against, and alignment with our 2018 decision and June 2022 decision. However, we also recognise that the LCCC are an independent organisation and the timing of the CfD cost allowance inputs is ultimately a matter for LCCC to consider, in line with their own business needs and requirements.

Outside of the proposals included within scope of this consultation, we also note that, following ongoing engagement between Ofgem, LCCC and industry, LCCC will shortly be implementing further changes to its processes and CfD publications which will seek to address some of the hedge timing risk concerns raised in this consultation.[6] We will continue to engage with the LCCC on this area, and where appropriate, will work together to deliver further improvements to the wider CfD cost allowance process where there is evidence this will serve consumers' interests.

Great British Insulation Scheme (GBIS, Formerly ECO+)

We received three responses to our question on our proposals for GBIS, from two energy suppliers and one consumer group. All agreed with our proposal to use a calendar year rather than financial year when accounting for inflation in the GBIS. However, one supplier was of the view that we should use the market-based CPIH[7] index rather than a GDP deflator.

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[4] Ofgem (2018), Default tariff cap: decision – overview, [Default tariff cap: decision - overview | Ofgem]
[5] Ofgem (2022), Decision on amending the methodology for setting the Contracts for Difference (CfD) cap allowance, [Decision on amending the methodology for setting the Contracts for Difference (CfD) cap allowance | Ofgem]
[6] [Supplier Obligation Levy Rate and Advanced Forecast Webinar Q4 2023 | Low Carbon Contracts Company]
[7] CPIH – Consumer Prices Index including owner occupiers' Housing costs

Considerations

We considered the suggestion of one supplier to use the market-based CPIH index rather than a GDP deflator. As set out in our Feb 2023 decision[8], for us to use a different inflation measure to that used by government (eg CPIH), the cap allowance could become materially misaligned with the intended cost profile of the scheme and bill savings targets.

We do not consider it appropriate to develop our own estimates of scheme costs and inflation impacts, and remain of the view that the principle of ensuring alignment with government accounting for inflation to be sufficient reason to proceed with the change as proposed.

Unidentified Gas (UIG)

Those who responded to our question on UIG were generally supportive of how we proposed to account for UNC Mod 840, the equalisation of PPM and non-PPM AUG[9] factors[10], in the price cap. However, one supplier raised concerns with the use of forecast values for UIG, noting that the AUGE suggests that UIG is below historical outturn values and likely misses some of the causes, therefore using forecasts compared to actual outturn values may lead to significant under recovery by suppliers.

Considerations

We consider that the proposed approach is consistent with the existing methodology with respect to the data source and inputs used and achieves the policy objective of UNC 840 to equalise the allocation of UIG for both PPM and non-PPM customers. Using forward looking data is also consistent with the 2018 decision in setting the level of the cap in advance to reflect our expectation of costs in each price cap period, and the decision not to include mechanisms for correcting forecast error, particularly if these are not material and systematic.

We addressed the use of the forecast values from the AUG statement in our 2022 decision on reflecting prepayment end user categories (EUC's) in the default tariff cap[11]. In this document we acknowledged the forecasts and potential fluctuations in UIG levels to be material and potentially systematic, necessitating the frequent review of trends to ensure

[8] Ofgem (2023), Decision on ECO+ scheme, Price cap – Decision on the planned ECO+ scheme | Ofgem
[9] AUG – Allocation of Unidentified Gas
[10] Ofgem (2023), Decision to approve Uniform Network Code (UNC) 840: Equalisation of prepayment and non-prepayment AUG factors, https://www.ofgem.gov.uk/sites/default/files/2022-02/Price%20Cap%20%E2%80%93%20Decision%20on%20reflecting%20prepayment%20End%20User%20Categories%20in%20the%20default%20tariff%20cap.pdf
[11] Ofgem (2022), Price Cap – Decision on reflecting prepayment End User Categories in the default tariff cap, https://www.ofgem.gov.uk/sites/default/files/2022-02/Price%20Cap%20%E2%80%93%20Decision%20on%20reflecting%20prepayment%20End%20User%20Categories%20in%20the%20default%20tariff%20cap.pdf

the accurate reflections of costs. We committed to regular updates based on the most up-to-date data to mitigate this. At this time we also rejected the option of a true up/down for actual UIG costs and this was with the intention to maintain the incentives to improve information on UIG and its management.

Implementation

These methodological changes will be implemented from charge restriction period 11a commencing 1 October 2023.

Yours Sincerely,

Dan Norton

Deputy Director, Retail Price Protection