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13 October 2025

Dear Daniel

CONTRACTS FOR DIFFERENCE ALLOWANCE IN THE DEFAULT TARIFF CAP

We welcome the opportunity to respond to Ofgem's call for input on the Contracts for Difference (CfD) allowance methodology within the default tariff cap. We believe the current approach, where CfD allowances are based on forecast levy rates and demand, without reconciliation against outturn costs, no longer reflects the scale, volatility, and financial impact of CfD payments on suppliers.

In our letter of 14 May 2025 we set out our concerns regarding the lack of a reconciliation mechanism for CfDs, noting that a number of recent developments since Ofgem's last decision on CfDs make it appropriate for Ofgem to reconsider the case for a reconciliation mechanism in its forthcoming review of wholesale allowances in the price cap. These include:

- heightened market volatility driven by increased renewable penetration and geopolitical uncertainty;
- a significant increase in CfD-supported generation capacity and associated levy payments resulting in substantially higher CfD costs; CfD Allocation Round 7 is expected to procure more capacity than any previous round to meet Clean Power 2030 targets.

On 1 August 2025 Ofgem published a policy update confirming that, from October 2025, it will begin using a new dashboard published by the Low Carbon Contracts Company (LCCC) to source CfD inputs, improve transparency and provide earlier certainty and stability for suppliers.¹ While this change improves forecast accuracy, it does not remove the need for reconciliation.

Our updated analysis indicates that under-recovery remains systematic and material, even after methodology improvements. Under the new approach of using In-Period Tracking rates, the risk of significant over/under-recovery of costs remains. This indicates

¹ [Policy Update: Warm Home Discount and Contracts for Difference | Ofgem](#)

that if Ofgem does not take action there will be increased financial strain on suppliers serving default tariff customers. A reconciliation mechanism is essential to ensure cost-reflectivity and sector stability.

We welcome Ofgem's decision to revisit the case for reconciliation as part of its review. However, we disagree with several aspects of the current consultation and have set out our concerns in response to Ofgem's questions in Annex 1.

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive, flowing style.

Richard Sweet
Director of Regulatory Policy

**CONTRACTS FOR DIFFERENCE ALLOWANCE IN THE DEFAULT TARIFF CAP
– SCOTTISHPOWER RESPONSE**

Question 1. What are your views on the current CfD price cap allowance methodology? Please provide evidence in support of any issues raised.

We consider the current CfD allowance methodology to be increasingly misaligned with the actual costs faced by suppliers. While the recent shift to In-Period Tracking (announced by LCCC on 23 July and Ofgem on 1 August) improves accuracy by incorporating more timely data, it does not resolve the fundamental issue: the methodology remains forecast-based and unreconciled, leaving suppliers exposed to material and systematic cost recovery gaps.

Evidence from recent cap periods shows that actual CfD costs have exceeded the allowance and our analysis indicates that very significant price risk remains following the LCCC changes (see our response to Question 7 below). This gap in cost recovery places financial pressure on suppliers, especially those serving a high proportion of default tariff customers. While the unreconciled price cap approach may have been appropriate when CfD costs were lower and less volatile, it is increasingly misaligned with actual supplier CfD costs, especially as:

- CfD-supported capacity is expected to substantially increase from 2026/27 onward;² and
- LCCC's forecasts are subject to both price and volume uncertainty, which suppliers cannot fully hedge.

The current methodology appears to systematically underestimate supplier costs and does not provide a robust basis for setting allowances in a rapidly evolving energy system. In the longer term, this mismatch undermines financial resilience in supply markets.

We recognise that Ofgem may have concerns about CfD reconciliation setting regulatory precedents for other cost recovery mechanisms. However, we consider that the CfD scheme is fundamentally distinct from other policy schemes in both structure and risk profile. CfD costs are determined by market-driven strike price differentials and are subject to significant volatility in both price and volume factors that are not present in more predictable schemes such as the Capacity Mechanism or Renewables Obligation. Moreover, the increasing scale and systemic nature of unreconciled CfD levy exposure creates a unique financial risk that warrants bespoke treatment. Accordingly, we do not believe that introducing a reconciliation mechanism for CfD costs would set a real precedent for other schemes, nor would it undermine Ofgem's broader regulatory framework.

Question 2. Do you have any views on potential amendments to the CfD allowance methodology? Please include considerations of pros, cons and unintended consequences of any option.

We support the introduction of a reconciliation mechanism to align the CfD allowance with actual outturn costs. This would represent a material improvement over the current forecast-based approach, which, even with the July 2025 In-Period Tracking update, continues to expose suppliers to unrecoverable costs due to forecast error.

² [Contracts for Difference forecast drivers: supplementary forecast information release](#)

Pros and cons of a reconciliation mechanism

Pros	Cons
• Cost recovery alignment: Reconciliation would enable suppliers to recover efficiently incurred CfD policy costs for price cap customers, fulfilling a core objective of the price cap framework. • Improved financial resilience: Reducing uncertainty around cost recovery would strengthen the financial stability of suppliers, particularly those with a large proportion of their customer portfolio on default tariffs. • Greater transparency: Consumers would benefit from clearer visibility of policy costs and their impact on bills, supporting trust and engagement.	• Complexity: Introducing reconciliation would add operational and regulatory complexity to the price cap setting process.

We do not support maintaining the current methodology without adjustment. It fails to reflect the growing materiality of CfD costs and does not provide a robust basis for cost recovery. Our analysis shows that even with the July 2025 methodology change that incorporates In-Period Tracking data, forecast error persists and remains material. In several recent quarters, the use of In-Period Tracking data would have increased the variance between expected and reconciled levy rates. While the change improves accuracy in general, it does not eliminate the need for reconciliation.

Reconciliation design options

We see two viable approaches to reconciliation:

- **Direct reconciliation to outturn payments:** Align the price cap CfD allowance with actual levy payments incurred by suppliers.
- **Reconciliation from a price hedged position:** Adjust the price cap CfD allowance based on a defined hedging methodology that reflects how suppliers generally manage CfD price risk.

Both approaches require a clearly defined starting point and transparency regarding how the CfD allowance is calculated within the price cap. For reconciliation from a price hedged position, transparency regarding the defined hedging methodology would be essential to ensure consistency and fairness.

[3<]. We recommend that Ofgem engages directly with suppliers who hedge CfD price risk to explore whether a common methodology can be established as the basis for reconciliation.

Given the expected growth in CfD-supported capacity from 2026/27 onwards and the increasing volatility in wholesale prices, a reconciliation mechanism is essential to ensure the CfD allowance remains fit for purpose.

Question 3. Do you consider reconciliation to be an appropriate measure for the CfD allowance? Please provide supporting evidence explaining how CfD costs meet the systematic and material test or what specific characteristics of CfD costs could justify the need for a reconciliation mechanism.

Yes, we consider reconciliation to be an appropriate and necessary measure for the CfD allowance. CfD costs meet both the systematic and material criteria that Ofgem applies when assessing whether an adjustment to the price cap is justified.

Systematic nature of CfD cost variance

The divergence between forecast and actual CfD costs is driven by a range of factors that would not necessarily give rise to a systematic bias:

- **Wholesale price volatility:** CfD payments are highly sensitive to fluctuations in wholesale electricity prices, which remain fundamentally unpredictable.
- **CfD scheme design:** The mechanism links generator payments to market reference prices, creating a dynamic and uncertain cost profile that cannot be forecast with precision.
- **Growth of intermittent renewables:** The increasing penetration of variable renewable generation amplifies price volatility and contributes to greater variability in CfD levy settlements.

However, whilst many of these factors may give rise to broadly symmetric variations over time, recent data (see Figure 2 below) shows that in eight of the last eleven quarters, supplier actual costs have been greater than the price cap allowance (calculated under the new LCCC methodology) – in some cases by a wide margin. Although this is too short a time series to conclude with confidence that there is a systematic bias, it would seem reasonable for Ofgem to proceed on the basis that a systematic bias may well exist, even if the precise cause of that bias has not yet been fully identified.

In our letter of 14 May, we highlighted a significant asymmetry in the way that LCCC makes in-period adjustments to levy payments. LCCC has been making upwards adjustments in response to declines in power market prices, however when power market prices increase, LCCC has not made corresponding downwards adjustments. This has meant that suppliers have been exposed to asymmetric in-period adjustments resulting in systematic financial risks.

The recent shift to use of LCCC's latest In-Period Tracking partly mitigates this issue, by providing a more current view of costs for the Current and Upcoming Quarter. However, any quarters that are still based on the most recent Interim Levy Rate or Before Period Adjustment remain vulnerable to the same asymmetry. There is, as yet, no clear evidence that the underlying bias has been resolved.

Material impact on suppliers

The financial exposure of suppliers to unrecovered CfD costs has grown significantly with the expansion of the CfD portfolio. As more projects come online, the volatility and scale of the CfD-related costs faced by suppliers are both increasing, posing a growing challenge to supplier resilience. This is particularly concerning because:

- Energy supply is a low-margin business, and suppliers have limited capacity to absorb large, unexpected cost swings.

- The current approach places unhedgeable risk on suppliers, especially when actual volumes and costs deviate materially from forecasts.

Our response to Question 7 below provides supporting evidence for the materiality of the gap and that it is likely to persist under the new approach to inclusion of LCCC information in the price cap.

Consumer benefit and market stability

A reconciliation mechanism would not only protect suppliers from structural cost mismatches but also benefit consumers:

- During any future energy price crisis, a reconciliation mechanism would enable downward adjustments, effectively passing back over-recovered CfD costs to consumers.
- This would have acted as a natural hedge for domestic consumers against wholesale price spikes, supporting affordability during a cost-of-living crisis.

Compatibility with hedging incentives

We do not believe that CfD reconciliation would necessarily disincentivise supplier hedging:

- The mechanism could be designed to target only the non-hedgeable components of CfD costs, preserving incentives for prudent risk management.
- Suppliers would remain incentivised to hedge their exposure to forecastable elements, while being protected from structural mismatches beyond their control.

Ofgem would need to publish where it would reconcile from and how it would expect suppliers to reconcile price and how the reconciliation mechanism would cover the variance in outcome due to volume effects. This would allow suppliers to assess independently the best approach to hedging in that context.

Question 4. Do you hedge for CfD costs, and if so, what approach do you take (e.g. reference price, frequency of hedging)?

[§<]

Question 5. Do you take a different hedging approach for CfD costs of customers under the price cap vs fixed tariff customers?

[§<]

The inability to fully hedge CfD cost risk under the price cap creates residual exposure that cannot be mitigated through standard trading strategies. This undermines financial resilience and creates a misalignment between regulatory allowances and actual supplier costs.

Question 6. Would your hedging strategy change if a reconciliation mechanism for CfD costs was in place?

Yes. A reconciliation mechanism would allow us to reduce the need to over-hedge against forecast error, allowing more efficient and targeted hedging.

Question 7. Please provide evidence of the differences between the CfD cap allowance and outturn costs incurred for the CfD scheme. Please include evidence of the relative size of price vs volume effects on the differences.

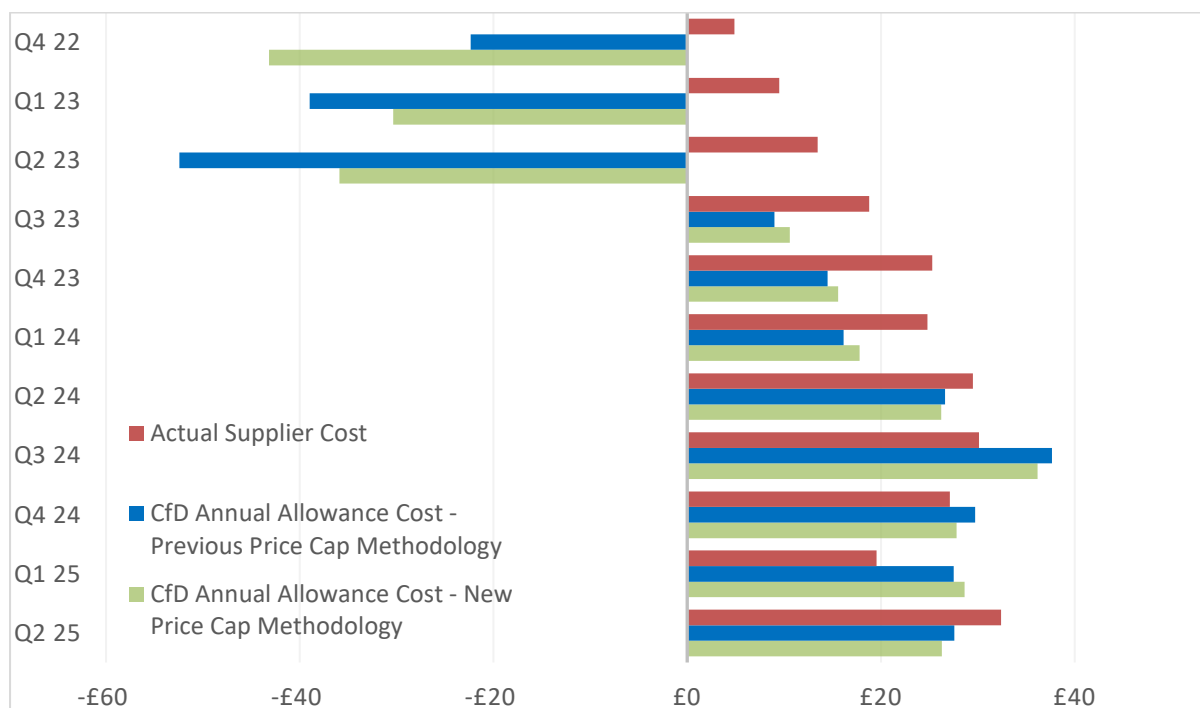
We have previously provided Ofgem with evidence showing the gap between the CfD allowance in the price cap and the actual costs incurred by suppliers.³ This analysis has now been updated to reflect the July 2025 methodology change, which introduced the use of In-Period Tracking rates.

Our updated analysis (Figure 2 below) shows that, while the new approach generally brings the allowance slightly closer to the reconciled levy payment rates faced by suppliers, it does not resolve the issue. In fact, in 4 out of 13 quarters (Q4 2022, Q2 2024, Q1 2025, and Q2 2025), the new methodology would have increased the variance between the expected levy payment rates and LCCC's quarterly reconciled rates. This demonstrates that forecast error remains a persistent feature of the current approach and that price risk remains.

Furthermore, although the sample is too small to demonstrate a systematic bias with confidence, it is notable that in eight out of eleven quarters, the actual supplier cost is greater than the price cap allowance under the new methodology – and in some quarters by a wide margin. Hence, we think it is reasonable for Ofgem to proceed on the basis that there may well be a systematic bias, even if it is unclear at present what the cause of that bias might be.

Although the July 2025 change results in a modest improvement to accuracy, it does not eliminate the need for a reconciliation mechanism of CfD allowances. Without reconciliation, suppliers remain exposed to systematic and material under-recovery of CfD costs, which cannot be fully mitigated through hedging strategies.

Figure 2 Updated view of CfD annual allowance vs actual supplier costs



³ Letter sent on 14 May 2025

Price vs volume effects

We recognise the importance of distinguishing between price and volume effects in explaining the variance between allowance and outturn costs. However, a precise breakdown is not currently feasible due to the structure of LCCC's published data:

- CfD costs are calculated as the product of levy rate (£/MWh) and demand volume (MWh).
- Both inputs, price and volume, are updated simultaneously in LCCC's forecasts, reflecting shared market drivers such as wholesale prices and renewable output.

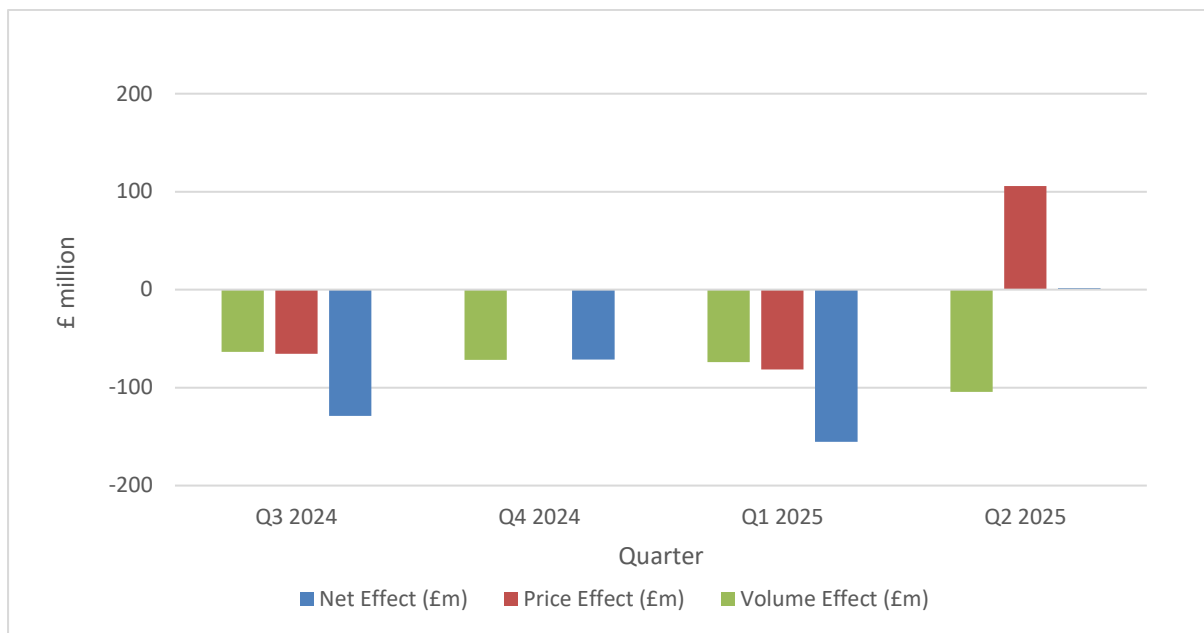
The aggregated nature of published data and the lack of granular settlement information prevent us from being able to set out a clean separation of price and volume contributions. Nonetheless, for illustrative purposes, we have estimated this separation for the four quarters Q3 2024 to Q2 2025 (see Figure 3 below). This analysis uses:

- ILR Forecast Volumes from LCCC's published Interim Levy Rate data;
- ILR Forecast Market Prices from our internal Daily Market Prices file (averaged over three months using the same curve date as LCCC);
- Actual Volumes, Market Prices, and Strike Prices from LCCC's "Actual CfD Generation and Avoided GHG Emissions" dataset.⁴

The price effect is calculated as $-\delta p * q$ where δp is actual minus forecast price and q is forecast volume. The volume effect is calculated as $(p_s - p - \delta p) * \delta q$ where p_s is the average strike price, p is forecast price and δq is actual minus forecast volume. The net effect is $(p_s - p - \delta p) * (q + \delta q) - (p_s - p) * q$. The combined price and volume effect ($\delta p * \delta q$) is included in our definition of volume effect, representing the non-hedgeable risks.

⁴ LCCC dataset available here: [Actual CfD Generation and avoided GHG emissions - Dataset - LCCC Data Portal](#)

Figure 3 Forecast v reconciled CfD costs: Price v Volume Effect



In each of the four quarters shown in the chart there is a negative volume effect, caused by the LCCC forecasting higher CfD generation than was actually delivered.⁵ Suppliers who had hedged for price effects remained exposed to volume effects, which in this case led to an over-recovery of costs relative to the price cap allowance, and an estimated customer detriment of around £3.35 per household.⁶ Conversely, when LCCC forecasts under-estimate the volume of generation, consumers benefit while suppliers incur unrecoverable costs.

As CfD capacity grows, so will the scale of volume risk for both consumers and suppliers. Introducing a reconciliation mechanism offers the most effective way to mitigate these risks and ensure fair outcomes across the market.

ScottishPower

October 2025

⁵ The volume effect is negative because the wholesale price was below the average strike price. If the wholesale price had been above the strike price, the volume effect would have been positive.

⁶ The total volume effect over the four quarters is £313m. Dividing by total CfD demand of 252TWh gives a cost of £1.24/MWh. Multiplying by TDCV of 2.7MWh gives a cost per customer of £3.35.