Consultation Appendix

Default Tariff Cap: Statutory Consultation

Appendix 3 – Updating the cap methodology

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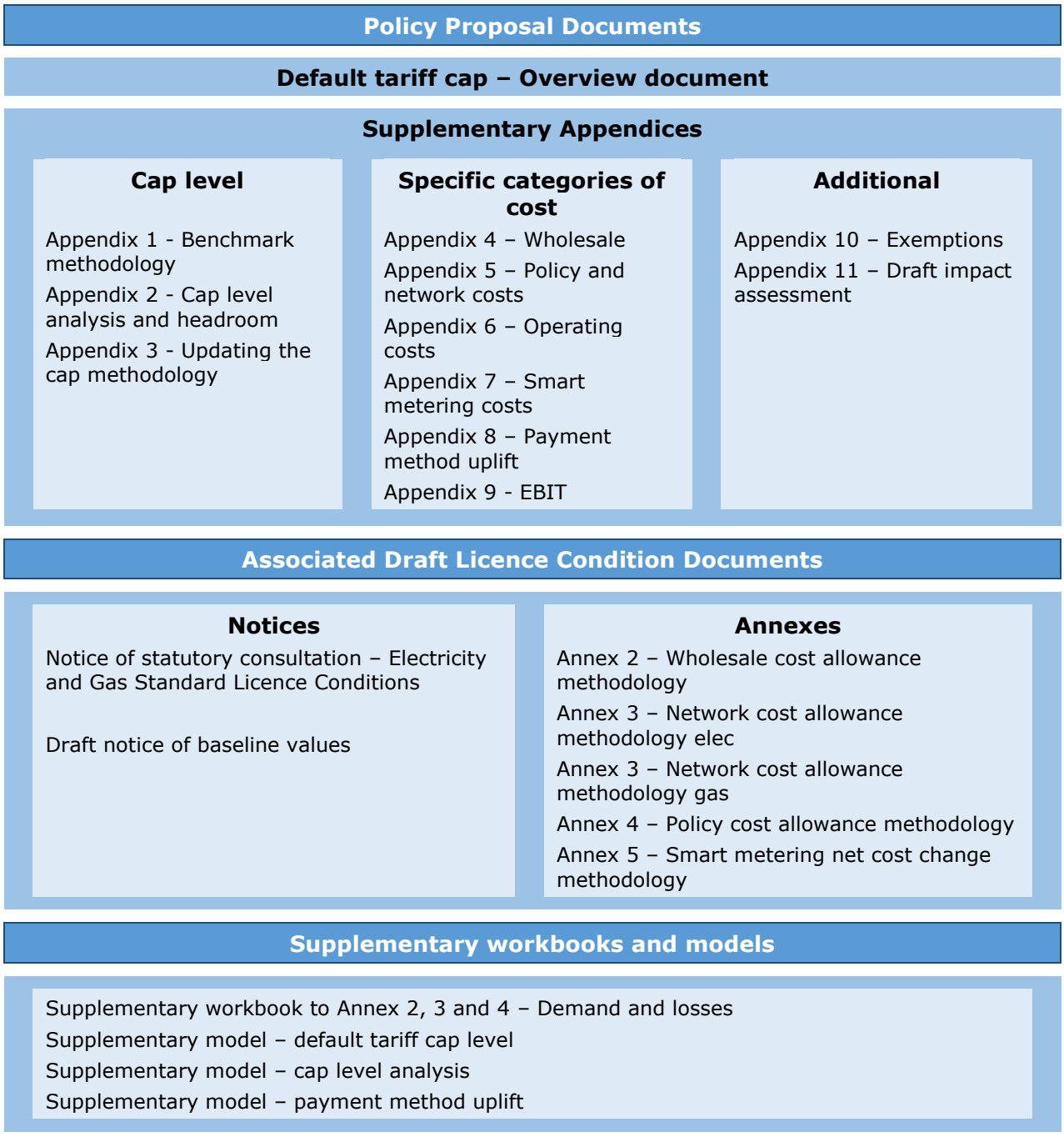
We are consulting on our proposals for setting and updating a default tariff cap in accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018. This supplementary appendix provides details of the proposals and methodology in relation to the methodology for updating the cap over time. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the Default tariff cap – Overview document.

We welcome views from stakeholders on all of our proposals set out within this document. Please see the Default tariff cap – Overview document for instructions on how to respond to the consultation.

Document map

Figure 1 below provides a map of the default tariff cap documents published as part of this statutory consultation.

Figure 1: Default tariff cap – statutory consultation document map



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1. Introduction

Overview

1.1. Many of the costs of supplying energy vary significantly over time, often for reasons outside of suppliers' control. For this reason, we propose to design the default tariff cap in a way that allows it to be updated periodically to reflect trends in efficient costs. The Act requires us to review the level at which the cap is set at least every six months.

1.2. Given the objective of the Act to protect customers on default tariffs[1], and the matters set out in section 1(6) of the Act, our key considerations in designing the process for updating the cap are to ensure:

a) **that the cap tracks changes in efficient costs over time.** This will ensure that where costs rise, suppliers that operate efficiently are able to finance their activities – and where costs fall, that customers on default tariffs are protected from excessively high prices. Because an efficient level of costs cannot be directly observed, and must be estimated, the appropriate level of the cap will be subject to some uncertainty. We will take this into account when designing the update process (and particularly the need for any reviews).

b) **that the cap does not create unintended incentives for suppliers that are detrimental for consumers**. This includes ensuring that the mechanism used to update the cap does not reduce the incentive for suppliers to improve their efficiency by cutting costs, or their incentive to compete for new customers by reducing their prices or offering higher levels of customer service.

1.3. In addition, we have had regard to the predictability of our intended update process, as well as the level of administration required. This is because where an approach creates undue risk for companies or leads to disproportionate administration costs, we would expect this to ultimately lead to higher prices (and so less protection) for customers on default tariffs.

Routine updates to the cap

1.4. In Chapter 2, we discuss our proposed approach to making routine updates to the default tariff cap, in light of these considerations. We describe our intention to update the level of the cap to a regular schedule using a range of "exogenous" cost indices: ie information on trends in costs that is not produced by the suppliers themselves. The exception is in relation to the costs associated with the smart meter rollout, where we propose an alternative approach which partly draws on supplier data, given the uncertainty surrounding some of the costs of the rollout.

1.5. We propose to set the default tariff cap on a forward-looking basis, based on our expectation of efficient costs. The update process will be specified in detail in the licence condition, increasing predictability for suppliers.

[1] ie to introduce a cap with a view to protecting existing and future customers who pay standard variable and default rates.

1.6. Updates will be made every six months using information on the most recent trends in costs. These updates will take place in April and October, with the level of the cap for the forthcoming price cap period published no later than the fifth working day in February and August, respectively. The first price cap period will run for a shorter period, for three months to the end of March 2019, while the final price period will run from the start of October to the end of December (with the year in which the cap is removed depending on when the necessary conditions for competition are determined to be in place).

Accounting for unforeseen trends in efficient costs

1.7. In Chapter 3, we discuss the approach we will take to accounting for unforeseen trends in efficient costs. This includes both how we will deal with the risk that limitations of the cap design cause it to be set at a level that is too high or too low, and the risk that outturn costs depart from the forecasts used when setting the level of the cap in advance.

1.8. In our view, our proposal to update the level of the cap twice a year should minimise the risk of setting the cap too high or too low for a sustained period. We do not propose to include any provision to modify the level of the cap between reviews (given this frequency of updates that will in any event be taking place) - nor a mechanism to retrospectively correct for forecast error (which would risk distorting competition in the wider market).

1.9. If we consider it necessary to make changes to the cap to amend any systematic features of the design which might cause the cap to depart from the intended level, we can use the power to modify the tariff cap conditions in the Act to do so. We also propose to include a provision within the licence condition to allow us to, subject to consultation, make changes to the models used to update the wholesale, policy, networks and smart metering components of the cap.

1.10. Finally, as discussed in Appendix 2 - Cap level analysis and headroom we propose to include a headroom allowance in the cap above our estimate of efficient costs, which will provide some additional protection against the risk that the cap is inadvertently set below an efficient level of costs.

Context and related publications

1.11. Ofgem (2018), Default tariff cap working paper – setting the level of the cap. https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-setting-level-cap

1.12. Ofgem (2018), Default tariff cap: policy consultation. Appendix 5 – Updating the cap. https://www.ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf

2. Routine updates to the cap

In this chapter, we discuss our proposed approach to making routine updates to the cap

Updating the cap to reflect trends in efficient costs

Proposed decision

2.1. Broadly speaking, we propose to update the level of the default tariff cap to a regular schedule using a range of "exogenous" cost indices: ie information on trends in costs that is not produced by the suppliers themselves, and cannot be influenced by suppliers' actions.

2.2. In particular, for wholesale, policy and network costs – which account for the majority of a default tariff customer's bill - we propose to base our updates on third party information on trends in wholesale prices, government programme costs, and network charges respectively. In some cases, costs will be known in advance with a high degree of certainty. In other cases, we propose to base our updates on forecasts (we discuss our approach to dealing with uncertainty in our estimates of cost trends in Chapter 3).

2.3. For operating costs, the allowance included in the cap would be indexed to inflation. To this we propose to add an adjustment to reflect trends in the costs associated with the smart meter rollout. While we are able to calculate part of this smart metering costs increment with reference to industry body charging statements and budgets, the remainder is more uncertain. For this reason, we propose to set the "non-pass through" element in advance for the first two periods of the cap (running up to end September 2019), and then review its level in 2019 to ensure that it is set appropriately for later periods. In contrast to other parts of the update process, this review will - in part - draw on supplier data.

2.4. Finally, we propose to calculate both the EBIT allowance and headroom as a fixed percentage of suppliers' costs (with headroom not applying to network charges). The payment method adjustment would partly be set as a fixed proportion of total costs, and partly indexed to inflation.

2.5. We intend to specify the update process in detail in the licence conditions (SLC28D), increasing predictability for suppliers.[2] The licence condition includes annexes comprising the models that we propose to use to calculate the wholesale cost allowance, policy cost allowance, networks cost allowance and smart metering net cost changes. We have also published an illustrative model showing how the different inputs will be combined to calculate the overall level of the default tariff cap for a given price cap period, available on our website.[3]

[2] We are consulting on the draft licence conditions alongside this document – see https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-overview-document.
[3] Ofgem, *Supplementary model - default tariff cap level* - https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-overview-document

2.6. We propose to make a number of refinements to the specific cost indices used to update the level of the cap compared to the proposals that we set out in our May consultation.[4] These include:

- Greater reflection of trends in forecast distribution and transmission losses when calculating the updated level of the cap for electricity.
- Greater account of the proportion of domestic customers' demand which takes place in different time periods, using data on the profiles for domestic customers that are used in settlement.
- Aligning the wholesale price index for the first price cap period with that used for later periods.
- Changes to the periods that our estimates of Capacity Market and Contracts for Difference costs relate to.

2.7. This list is not exhaustive: full details of our proposed approach to updating costs can be found in the specific appendices relating to each component of the cap.

What we consulted on

2.8. In our May consultation, we set out three options for the overall approach we could take to updating the level of the default tariff cap:

a) The level of the cap could be updated to reflect trends in **a basket of market tariffs**. The principle here would be that rivalry in the competitive market segment would ensure that movements in tariffs over time reflect trends in an efficient level of costs.

b) The level of the cap could be updated based on **a periodic review of suppliers' realised costs**. This would involve periodically collecting historic cost information from different groups of companies, making any efficiency adjustments that were required, and then using this to set the revised level of the cap.

c) The level of the cap could be updated based on **trends in exogenous cost drivers** – linked to third party data and/or a pre-specified allowance for certain cost items. An approach of this type is used under the existing safeguard tariffs, which are updated with reference to an index of wholesale prices, forecasts of policy costs and inflation.

[4] Default tariff cap: policy consultation May 2018 https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-policy-consultation-overview

2.9. We described that our preferred option was to update the cap with reference to trends in exogenous cost drivers. The approach had a number of advantages over the alternatives:

- The accuracy of this approach is not sensitive to trends in the intensity of competition in the market, nor on the quality of supplier data. It will to a greater extent allow costs to be recovered in the period in which they are incurred, avoiding unintended distortions to competition.
- It avoids creating unintended incentives in relation to how suppliers price, and their efforts to cut costs. This is because suppliers cannot influence the indices via their actions in the market.
- It provides the greatest predictability to suppliers, and minimises the administrative burden.
- The key exogenous drivers of trends in suppliers' costs – accounting for the largest part of the bill – can be estimated accurately using third party data.

Stakeholder feedback

2.10. Most stakeholders were broadly supportive of our proposal to update the level of the cap to reflect trends in a set of exogenous cost drivers.

2.11. One stakeholder told us that an approach based on a periodic review of costs would not distort suppliers' incentives to cut costs, because suppliers would continue to have incentives to become more efficient so as to be able to compete on fixed tariffs. However it did consider that such an approach would be very onerous.

2.12. Another stakeholder supported updating the level of the cap using a periodic review of costs, so as to ensure that all relevant cost trends were taken into account. It argued that while an exogenous indexation approach would be a sound approach (subject to the right indices being selected), it may nevertheless be necessary to periodically benchmark actual costs to ensure these remained accurate.

Rationale for proposed decision

2.13. Broadly speaking, our proposed approach is to update the cap to a regular schedule using a range of exogenous cost indices. We favour this approach because it minimises the risk of creating unintended incentives, as suppliers are unable to influence these indices via their behaviour in the market. It also enables us to set the cap on a forward-looking basis, with reference to expected costs for the forthcoming price cap period. Finally, it increases predictability and reduces the administrative burden of the cap.

2.14. We will take a slightly different approach when updating the cap to reflect trends in the costs of the smart rollout that are not specifically related to industry charges. Here we only propose to publish in advance the level of the smart metering costs increment for the first two periods. We will carry out a review of the adjustment in 2019 to ensure that it is set at the correct level for later periods. In contrast to the rest of the update process, this review would - in part - draw on supplier data. The reason for taking this different approach to smart metering costs is due to the much greater uncertainty

associated with these costs. We discuss this in more detail in Appendix 7 – Smart metering costs.

2.15. Finally, in response to the points raised in response to our May consultation and summarised above:

- While we agree that competition on fixed term tariffs should continue to provide an incentive for suppliers to keep their costs low in the presence of the cap, we remain concerned that using a periodic cost assessment to update the overall cap would reduce this incentive at the margin.

- We do not intend to include within the cap design a formal review of overall outturn costs, for the reasons set out in our May consultation (and noting the temporary nature of the cap). Nevertheless, as discussed in Chapter 3 we will continue to keep the design of the cap under review to ensure that it is meeting its objective, and will be ready to use our licence modification powers under the Act if any changes to the design of the cap are required

Frequency and timing of updates

Proposed decision

2.16. We propose that the initial period of the default tariff cap will be approximately three months to the end of March 2019.

2.17. Thereafter, we propose to update the cap every six months according to a regular schedule. Price cap periods will run from 1 April to 30 September (summer), and 1 October to 31 March (winter). We will publish the level of the cap for the forthcoming price cap periods no later than the fifth working day in February and August, for April and October respectively.

2.18. The final price cap period will run for a shorter three month period, from 1 October to 31 December. The cap will end in 2020, unless the Secretary of State determines that the conditions are not in place for effective competition on domestic supply contracts. The Act allows the cap to be extended on three separate occasions, up to the end of 2023.

2.19. We propose to set the level of the cap based on our expectation of costs in the coming price cap period. This will ensure that – so far as possible – the cap reflects costs in the period covered by the cap, avoiding distorting competition in the wider market.

2.20. Given we now propose to use a bottom up methodology to estimate efficient costs (see Appendix 4), we no longer propose to calculate updated levels of the cap by taking the baseline value for wholesale costs or policy costs and indexing these. Instead, similar to the approach taken for networks costs, the allowances for each of these components would be calculated directly using our models.

2.21. For operating costs and the fixed component of the payment method adjustment, our proposed approach is the same as set out in our May consultation – ie estimating a baseline for 2017 (the most recent full year for which information on costs is available), and then indexing this to update the level of the cap in later periods.

What we consulted on

2.22. In our May consultation, we set out our proposal to update the level of the cap twice a year in April and October. These periods were chosen as they align most consistently with seasonal wholesale contracts for gas and electricity, network charging years, and the obligation periods of a number of environmental and social obligations.

2.23. We discussed our intention to publish the level of the cap for the subsequent summer period no later than the 5th working day in February. The level of the cap for the subsequent winter period would be published no later than the 5th working day in August. This would allow us to use the most up-to-date information available on expected costs in the relevant period (reducing the risk of forecast error), subject to providing sufficient time for suppliers to make the necessary changes to their systems.

Stakeholder feedback

2.24. In response to our consultation, most respondents broadly agreed with our proposal to review the level of the cap every six months, and for updates to take place in April and October. We received a number of specific comments in relation to the frequency with which the wholesale component of the cap is updated, which are discussed in more detail in Appendix 4 – Wholesale costs.

2.25. One stakeholder highlighted the material costs incurred when making a change to SVT prices, and said that the Act only requires Ofgem to review the cap every six months, not necessarily update it. Therefore, consideration should be given to skipping an update after a review, perhaps subject to a materiality threshold of, eg 1%.

2.26. Another stakeholder argued that a 12-month review period should be used, to avoid causing consumers price disruption. A six-month review period could result in customers' prices changing part way through a default fixed term contract – which isn't what customers expect, and could cause confusion. Another stakeholder argued that suppliers should also be permitted to increase the price of default fixed tariffs, were costs to increase, requiring an exemption from SLC22C.9.

2.27. One stakeholder stated that there was no need for a baseline under a bottom up approach, because costs could be calculated directly for each period.

2.28. One stakeholder asked that changes to the cap were communicated earlier than the two-month period under the prepayment price cap. It said that even notification a week earlier would help relieve the major logistical challenges involved in implementing a price change. It also requested that provisional confirmation be provided when all elements of the cap other than the wholesale component were known.

Rationale for proposed decision

2.29. We continue to take the view that twice annual updates in April and October provide the best balance in terms of allowing changes in suppliers' costs to be passed through without undue delay (reducing risk to suppliers), while avoiding a significant increase in the number of price changes that consumers see compared to the status quo.[5]

2.30. We do not consider that using a materiality threshold for making changes to the cap is required. We note that the overall scale of administration costs associated with price changes are relatively small (see Appendix 11 - Draft impact assessment). Where the level of the cap is increased, suppliers are not required to increase their prices – and may choose not to do so even if their costs have gone up, if the increase is sufficiently small that the increase in revenues would be outweighed by the administration costs.

2.31. We consider that publishing the updated level of the cap no later than the fifth working day in February and August allows us to use the most up-to-date information possible to set the level of the cap for the forthcoming price cap period, while still providing suppliers sufficient time to make the necessary preparations for any resulting price change. Given the time required to calculate and quality assure the level of the cap, publishing the level of the cap a week earlier would – for example - mean that it would not always be possible to use the final network charging statements for the February update, with significant potential consequences for the accuracy of the cap.

2.32. Under the existing safeguard tariffs, where the inputs that will be used to update the cap are available in advance, we send suppliers provisional details of these around two weeks prior to the cap being set, so as to reduce uncertainty. We intend to continue this practice where possible with the default tariff cap, including providing confirmation of those inputs which are and are not expected to change in advance of the level of the cap being formally published.

2.33. Given our proposal to use a bottom up methodology, we no longer propose to calculate updated levels of the cap by taking the baseline value for wholesale costs or policy costs and indexing these – instead, these components can be calculated directly. While this does not affect the level of the cap in practice, it does reduce the complexity of the update process, requiring fewer parameters to be published.

2.34. We continue to propose to calculate a baseline level of the operating costs allowance for 2017, and index this when updating the level of the cap. This is because we consider historic data on operating costs to provide the most reliable basis for our benchmarking analysis (the details of which are discussed in Appendix 6 – Operating costs).

2.35. We considered the impact of the frequency of updates to the cap on default fixed tariffs. The Act requires that suppliers' default fixed tariffs are set below the level of the cap. Therefore, suppliers will be required to make reductions to their default fixed tariff prices in the event that we reduce the level of the cap below the level of those fixed tariffs. For example, a supplier that set the unit rate or standing charge of a default fixed term tariff in January at a level equal to the maximum allowed under the cap would be required to reduce those charges in the event that the level of the cap

[5] On average, the large suppliers have updated their SVT prices between once and twice a year since market liberalisation, although the frequency varies between supplier.

fell when it was updated in April. Note that such reductions would be required even if the level of the cap were only changed once a year, with the exception of default tariffs with terms that exactly matched the period of the cap.

2.36. At the same time, SLC22C.9 means that a supplier would not be able to increase the price of a fixed default tariff in the event that the level of the cap increased. For example, a supplier that set the unit rate or standing charge of a default fixed term tariff in January at a level equal to the maximum allowed under the cap would not be able to increase those charges in the event that costs rose and the level of the cap was increased in April. This creates an asymmetric risk for suppliers offering default fixed tariffs.

2.37. We note, however, that suppliers may choose to avoid this risk by indexing the price of a default fixed tariff to the default tariff cap (as provided for under SLC22C.11(a)(i)). In doing so, suppliers are required to make clear in their communications with their customers the way in which the prices of the tariff would vary over time.

3. Accounting for unforeseen trends in efficient costs

In this chapter, we discuss the approach we propose to take to dealing with unforeseen trends in efficient costs. This includes both the risk that limitations of the default tariff cap design cause it to be set too high or too low, and the risk that outturn costs depart from the forecasts used when setting the level of the cap in advance.

Proposed decision

3.1. As explained in Chapter 2, we propose to use a mechanistic approach to make routine updates to the level of the default tariff cap, with the process described in full in advance in the licence condition and associated annexes. This will increase predictability.

3.2. In general, we consider that the detailed approach we are proposing to use to estimate different elements of costs, combined with our proposal to carry out regular six monthly updates, should minimise the risk that the default tariff cap is set too high or too low.

3.3. However, in the unlikely event that the cap were to materially depart from the intended level, we have some flexibility to review the design:

- First, if we consider that we need to amend the update process to reflect any systematic limitations of the design, we are able to use the powers in the Act to modify the tariff cap conditions to do so.

- Second, we also propose to include a provision within the licence condition to allow us to, subject to consultation, make more urgent changes to the models used to update the wholesale, policy, networks and smart metering components of the cap.

3.4. We do not intend to include any mechanism to allow the level of the cap to be modified mid-period (given this frequency of updates that will in any event be taking place) - nor a mechanism to retrospectively correct for forecast error (which would risk distorting competition).

Types of uncertainty

3.5. If we materially overestimated efficient costs for the purposes of setting the cap, then this could mean that customers on default tariffs do not receive the protection intended under the Act, paying higher prices. If we materially underestimated efficient costs, then efficient suppliers may not be able to finance their activities.

3.6. Differences between efficient costs and those included in the cap could arise due to:

- **Limitations of our cap design.** Efficient costs cannot be directly observed, and we must make simplifications and assumptions when estimating the costs an efficient supplier incurs in supplying different types of customers. This creates the possibility that there may therefore be systematic features of the methodology we use which cause it to be too high or too low for a given price cap period.

- **Outturn costs departing from forecasts.** We propose to set the level of the default tariff cap in advance to reflect our expectation of costs in each price control period, to avoid distorting competition in the wider market. However, in some cases, there will be uncertainty about elements of suppliers' costs for the coming price cap period at the point in time when the level of the cap is set. This means that even if our cap design accurately reflects expected costs, outturn costs may nevertheless depart from this forecast level. Table A3.1 sets out some key sources of residual uncertainty that will exist when we set the level of the cap, a number of which were raised in response to our May consultation.

Table A3.1: Examples of possible drivers of costs which are not known at the point at which the level of the default tariff cap is set

Wholesale costs	Policy costs	Network costs	Operating costs
• Short term trends in wholesale prices – for instance as a result of commodity market shocks – which will affect the cost of any shaping and balancing a supplier carries out • Unexpected weather, causing demand to depart from forecast • Attrition in capacity market contracts	• Unexpected trends in total demand, impacting upon the demand base across which scheme costs are recovered • Wholesale prices departing from forecast, affecting CfD costs • Unanticipated over- or under-spend on FiTs or ECO	• Mid period changes to network charges • Changes to BSUoS costs between initial and final settlement runs	• Unanticipated shifts in indebtedness, due to factors outside of suppliers' control • Efficiency savings of 'frontier' companies • Impact on costs of changes to suppliers' obligations under the licence condition

3.7. Systematic issues with the cap design or residual uncertainty when setting the cap could lead to outturn costs being either above or below the level allowed for within the cap. Uncertainties may act in opposite directions and balance out, or could reinforce each other. Note that, absent any systematic issue, we'd expect inaccuracies in forecasts to even out over time – and so would be less concerned with this type of uncertainty (unless the scale of the error was particularly large).

3.8. In some cases we may be able to observe the extent to which efficient costs depart from the level included in the cap immediately (eg if there is a mid-period change to network charges). In other cases we may become aware that efficient costs are likely to have departed from those included in the cap, but not know the materiality (eg if there were a large demand spike due to unusually cold temperatures, accompanied by an increase in wholesale prices). In other cases, we may not be able to determine whether efficient costs are materially higher or lower than the level included in the cap until a significant time later (eg after final settlement runs are complete).

What we consulted on

3.9. In our policy consultation we set out our provisional view that if there were any aspects of the design of the cap that caused it to materially and systematically over- or under-state efficient costs (eg a significant and unanticipated change to suppliers' environmental obligations), we would be able to resolve these via a modification to the relevant licence conditions. We would only seek to make such a change were the effect material, given the risk of otherwise creating unintended incentives for how suppliers' operate in the market.

3.10. We also proposed not to include a mechanism in the cap to correct for forecasts that were observed retrospectively to have departed from costs. We were concerned that doing so could risk distorting competition in the market, and – because the same cap would be set for all suppliers, and suppliers' customer bases are not static – it would not be possible to ensure that recovery in one period matched benefits/costs in the preceding period.

3.11. We noted that under a reference price approach, we would expect the expected costs of forecast error to already be reflected in suppliers' prices. Under a bottom-up approach to setting the cap, we would consider including a specific upfront allowance to reflect any material risk faced by suppliers where this would be expected to systematically lead to higher costs.

3.12. Finally, we set out our view that one factor that we would take into account in considering whether to include a headroom allowance in the cap – and if so, at what level - was whether there is a need to provide any additional allowance for uncertainty beyond that already captured in our estimate of efficient costs.

Stakeholder feedback

3.13. In response to our policy consultation, a number of suppliers argued that the licence modification process could be cumbersome and slow, and most respondents supported including an additional mechanism in the cap to allow its level to be adjusted for changes in suppliers' cost base beyond the licence modification process:

- Some stakeholders supported including a mechanism that could be used to revise the level of the cap under exceptional circumstances – potentially mid-period - for example if there were unanticipated spikes in wholesale prices.

- Other stakeholders supported including a mechanism to retrospectively correct for forecast error. One argued that not doing so would result in a deadweight cost to suppliers, and ultimately customers.

- Some stakeholders argued that not only Ofgem, but also suppliers, should be able to initiate a review or adjustment.

3.14. At the same time, one respondent highlighted the disadvantages of including an additional mechanism within the cap that allowed its level to be adjusted by Ofgem outside of the routine updates. This included the investment risk and uncertainty that this could create.

3.15. One respondent argued that if a reopening mechanism were included, the conditions under which it would be used – for instance, materiality thresholds - should be set out clearly.

Rationale for our proposed decision

3.16. Suppliers already take on risk when setting their prices. Default tariffs have rarely been changed more than twice in a year in the period since liberalisation, and suppliers commonly offer fixed price tariffs with a duration of one year or more (indeed for a number of suppliers, half or more of their customers are on such tariffs). This gives us confidence that a twice annual review of the level of the cap should in general be

sufficient to allow cost trends to be fed through to the level of the cap, and avoid undue risk for suppliers.

3.17. We continue to take the view that our powers under the Act to modify the default tariff cap conditions provide the most appropriate mechanism to make changes to the cap to reflect any systematic features of the design which are causing it to be set too high or too low.

3.18. Having considered responses about the length of time required to make modifications to the licence conditions, we also propose to include a provision within the licence conditions to allow us to, subject to consultation, make changes to the models used to update the wholesale, policy, networks and smart metering net cost components of the cap. This will provide us some additional flexibility to carry out any urgent changes to the way that trends in the key categories of exogenous costs are passed through to suppliers if required.

3.19. Our proposal is that – in line with our general preference for updates to be mechanical so as to avoid unnecessary uncertainty – we would only use these powers to make changes to the models where either:

a) There were significant and unanticipated changes in factors determining suppliers' wholesale, policy, networks or smart metering costs, which were expected to cause the allowance included for these costs within the cap to materially depart from the efficient level, looking across the market as a whole. For example, a change to the way a supplier was charged in relation to a government obligation which had a material impact on costs, or a significant change to the network charging regime.

b) There were minor changes that could be made to the models to improve transparency and avoid error (eg formulae error).

3.20. The mechanism would not be used to reopen any other aspects of the default tariff cap – for example the initial baseline values – nor to retrospectively correct for over- or under- recoveries in previous periods. The length of the consultation we carry out would depend on the urgency and scale of the change being considered.

3.21. We do not intend to include any provision to modify the level of the default tariff cap mid-period. We do not consider this necessary given that we will be updating the cap at six monthly intervals.

3.22. We continue to take the view that a mechanism designed to retrospectively correct for forecast error would not be appropriate, given the risk this would distort competition in the competitive market segment, and the fact that it would not be possible to ensure that the correction reflected the level of over- or under- recovery in the previous period. In part, we would expect the potential short term risks associated with forecast error to be offset by the headroom allowance included in the cap (see below).

3.23. In response to the view that suppliers should be able to initiate a review, we note that suppliers or other stakeholders are free to make submissions to us if they believe there to be a systematic issue with the design of the cap, and that we will consider any such representations – suitably evidenced - carefully. Therefore, we do not consider that any further provision is required.

3.24. Finally, we have also built some specific allowances into the cap to reflect the uncertainty affecting our estimates of efficient costs. First, we have included specific allowances for the wholesale costs associated with forecast error, imbalance and shaping to demand (see Appendix 4 – Wholesale costs). Second, we have set the allowance for operating costs at a level significantly above the lowest cost suppliers in the market, in order to allow for uncertainty about the extent to which these companies' lower costs are driven by efficiency versus more favourable customer bases (see Appendix 6 – Operating costs).

3.25. In general, our view is that the extent of residual risk should be relatively limited, given the update process we have designed, and the mechanisms set out above which allow us to respond to any fundamental changes in suppliers' cost base.

3.26. Nevertheless, we propose to set the default tariff cap above the level of costs that we would expect to be incurred by an efficient supplier with standard operating conditions. This will provide further comfort that efficient suppliers will still be able to finance their activities, in the event that forecast costs turn out to be materially below true actual costs, for a sustained period. We discuss the level of headroom we propose to include in the cap in Appendix 2 – Cap level analysis and headroom.