

Decision Appendix

Default Tariff Cap: Decision

Appendix 3 – Updating the cap methodology

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In accordance with the Domestic Gas and Electricity (Tariff Cap) Act 2018, we are implementing the default tariff cap to come into effect from 1 January 2019. This supplementary appendix sets out our decision and the detailed methodology in relation to updating the cap methodology.

Please see the default tariff cap – decision overview document for an accessible summary of the complete methodology.

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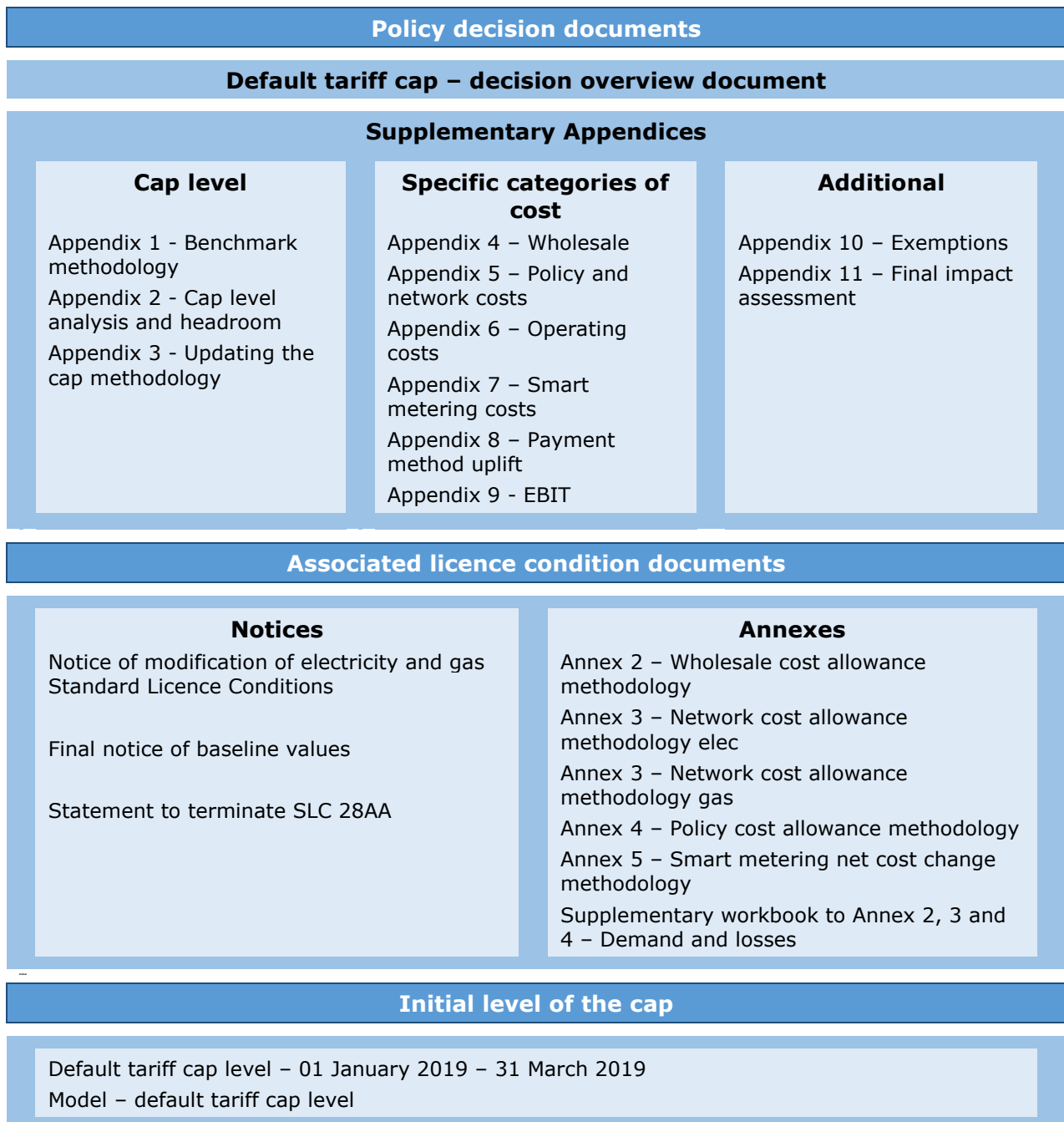
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Document map

Figure 1 below provides a map of the documents published as part of the decision on the implementation of the default tariff cap.

Figure 1: Default tariff cap – decision document map



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1. Introduction

Overview

- 1.1. Many of the costs of supplying energy vary significantly over time, in some cases for reasons outside of suppliers' control. For this reason, we have designed the default tariff cap in a way that allows it to be updated using a range of 'exogenous' cost indices every six months. 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 tariffs¹, and the matters set out in section 1(6) of the Act, our key considerations in designing the process for updating the cap have been:
 - a) **That the cap tracks changes in efficient costs over time.** This has the benefit, where costs rise, of more efficient suppliers being better able to finance their activities – and where costs fall, that customers on default tariffs are better 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 carefully consider this 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 describe our approach to making routine updates to the default tariff cap, in light of the considerations above. We describe how we will update the level of the cap to a regular schedule using a range of 'exogenous' cost drivers: ie information on trends in costs that is not produced by the suppliers themselves. The exception is in relation to certain costs associated with the smart meter rollout (see para 2.4).
- 1.5. We will 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. We will update the cap level 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 from 1 January 2019 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 Secretary of State decides to end the cap).

Accounting for unforeseen trends in efficient costs

- 1.7. In Chapter 3, we discuss the approach we will take in 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 twice-annual updates to the level of the cap should minimise the risk of setting the cap too high or too low for a sustained period. We have not included any provision to modify the level of the cap between reviews (given the 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 modify the tariff cap conditions as provided for by the Act. We have also included 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 in the unlikely event that the cap were to materially depart from the intended level.
- 1.10. Finally, as discussed in Appendix 2 - Cap level analysis and headroom we have included 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.
- 1.11. We have reviewed and considered stakeholder feedback on these areas and have decided to continue with our proposed approach, updating the cap using the methodology as set out in our September consultation. We set out further detail on this methodology and stakeholder views in this appendix. We have also have specified the update process in detail in the licence conditions (SLC28AD).

Key themes from consultation responses

- 1.12. The main themes stakeholders raised in response to our proposals for updating the cap were:
- general support for updating the cap on a six-monthly basis, using exogenous cost indices;
 - more clarity needed on the process and criteria against which Ofgem would determine when to make changes to the methodology to account for unforeseen trends in efficient costs; and

- whether or not Ofgem should allow a mechanism to allow retrospective corrections to be made to the cap under certain circumstances.

Related publications

- 1.13. 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>
- 1.14. 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
- 1.15. Ofgem (2018), Default tariff cap: policy consultation. Appendix 3 – Updating the cap methodology. https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_3_-_updating_the_cap_methodology.pdf

2. Routine updates to the cap

In this chapter, we describe our approach to making routine updates to the cap, as well as summarising the key issues raised in response to our statutory consultation.

Our approach

How we calculate updated levels of the cap

- 2.1. We have decided to include a mechanism for routinely updating the cap every six months (with the exception of the first and final cap periods, where these periods will be three months), using a range of 'exogenous' cost drivers: ie information on trends in costs that is not produced by the suppliers themselves.²
- 2.2. We will calculate the cap for each period on a forward-looking basis, based on our expectation of efficient costs. This approach ensures updates to the cap are based on reliable expectations of costs we expect suppliers to face for a given cap period. Using exogenous cost drivers provides predictability to suppliers without unnecessary administrative burden. This approach also minimises distorting competition in the wider market, by ensuring unintended incentives which could lead to detrimental impacts to consumers are minimised (for example, in relation to how suppliers price and their incentives to cut costs), and ensuring that the cap reflects the *current* cost of supplying energy, avoiding lags which could lead to the default cap being set a long way above or below current costs in the event of significant movements in, eg, wholesale prices.
- 2.3. In particular, for wholesale, policy and network costs – which account for the majority of a default tariff customer's bill - we have decided 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 will base our updates on forecasts (we discuss our approach to dealing with unforeseen cost trends in Chapter 3).
- 2.4. For operating costs, the allowance included in the cap will be indexed to inflation, using CPIH.³ To this we will add an increment for the additional net costs associated with the smart meter rollout above those in the baseline. The cap will be updated for the *pass-through* elements of smart costs mechanistically through the routine update process for every cap period (based on the latest published charging statements and budgets of the Data Communications Company (DCC) and Smart Energy GB (SEGB) as these become available). However, for the *non-pass-through* element of smart costs we have set the cost allowance in advance only for the first two periods of the cap (running up to end September 2019), due to the uncertainty associated with future costs, benefits and rollout profile. We have committed to review the level of non-pass-through costs in 2019 to ensure that the Smart metering net cost change (SMNCC) is set appropriately

² The exception is in relation to the costs associated with the smart meter rollout, explained in paragraph 2.4.

³ <https://www.ons.gov.uk/ons/guide-method/user-guidance/prices/cpi-and-rpi/introducing-the-new-cpih-measure-of-consumer-price-inflation.pdf>.

for subsequent periods. In contrast to other parts of the update process, this review will - in part - draw on supplier-submitted data.

- 2.5. Finally, we have set both the EBIT margin and headroom as fixed percentages of suppliers' costs (with headroom not applying to network charges). The payment method adjustment is set in two parts, a percentage of total costs, and a fixed element indexed to inflation.
- 2.6. In Table A3.1 below we have summarised how each cost component will be updated through the routine update. More detailed information on how each cost component will be calculated can be found in the relevant appendices listed in the table.

Table A3.1: Summary of default tariff cap update methodology

Cost Component	Summary of update methodology	Relevant decision appendix
Wholesale costs	Updates based on third party information of cost trends for relevant cap period	Appendix 4 – Wholesale
Network costs		Appendix 5 – Policy and network costs
Policy costs		Appendix 5 – Policy and network costs
Supplier operating costs	Updated costs indexed to inflation using CPIH	Appendix 6 – Operating costs
Smart meter costs⁴	We will include a separate specific mechanism to set and update Smart Metering costs (SMNCC) relying on both supplier and industry data	Appendix 7 – Smart metering costs
Payment method uplift	'Bad debt' and 'working capital' costs set as fixed percentages of supplier costs. Administrative costs indexed to inflation using CPIH	Appendix 8 – Payment method uplift
EBIT	Fixed percentage of supplier costs (ie not indexed)	Appendix 9 - EBIT
Headroom		Appendix 2 - Cap level analysis and headroom

⁴ Smart is included in the baseline operating cost allowance, to which we then add an increment based on trends in smart costs relative to inflation compared to that baseline.

- 2.7. We have specified the update process in detail in the licence conditions (SLC28AD), increasing predictability for suppliers.⁵ The licence conditions include 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.⁶

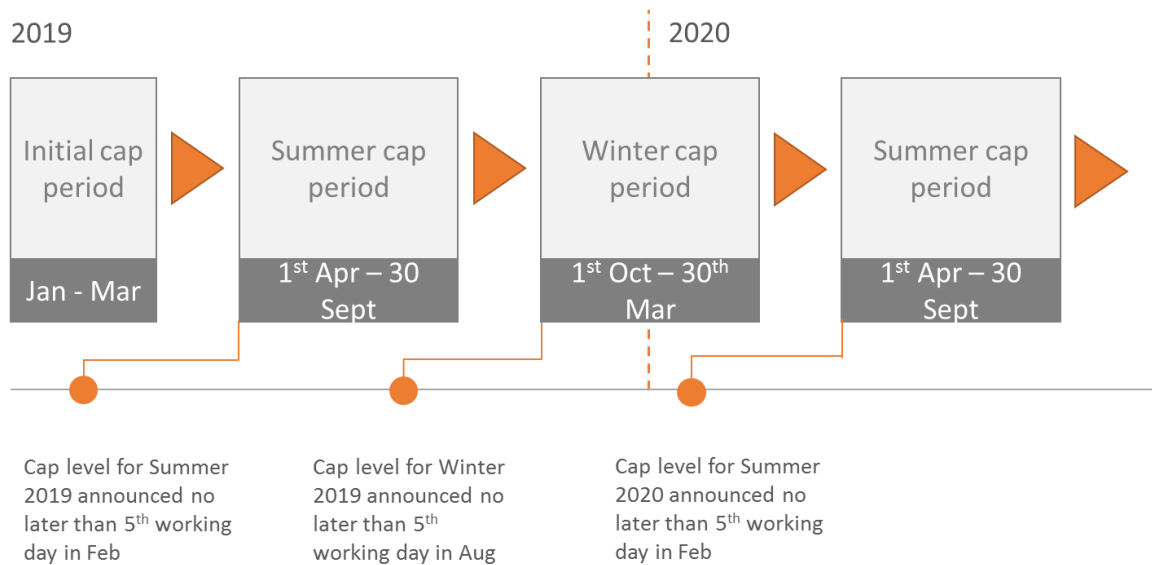
Timing and frequency

- 2.8. The initial period of the default tariff cap will be for three months from 01 January 2019 - 31 March 2019.
- 2.9. Thereafter, we will 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). 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.
- 2.10. 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. This 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. In reaching this decision, we have also factored in the time required to calculate and quality assure the level of the cap.
- 2.11. Under the existing safeguard tariff, 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 will 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.
- 2.12. 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.
- 2.13. A high level summary of the timing and frequency of cap updates can be seen in Figure A3.1 below:

⁵ We have published the new licence conditions alongside this document.

⁶ Model - default tariff cap level. www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview

Figure A3.1: Timeline for updating the default tariff cap (Note - as per paragraph 2.12, there is uncertainty around timing of the final, three-month cap period, which depends on a determination from the Secretary of State).



Key issues raised in response to our statutory consultation

2.14. We received responses from nearly half of respondents relating to aspects of our proposals for updating the cap over time.

Timetable of routine updates

- 2.15. Most of the respondents expressed general support for including a routine update every six months based on exogenous cost indices. One supplier highlighted that "... *six months is an appropriate time period to have the components reviewed.*" A non-supplier similarly noted it "*supports the methodology for updating the cap level and continuing the six month timetable for this*".
- 2.16. One respondent noted, "*its broad support for Ofgem's proposal to update the level of the cap in reference to trends in exogenous cost drivers every six months*".
- 2.17. Only one respondent expressed a view that periodic updates should be more frequent, contending, "*We believe it is necessary for Ofgem to issue more frequent updates in order that consumers avoid pricing shocks*". Another stakeholder noted that a six month update, "will distort liquidity more than an annual cap", but this does not reflect the requirement in the Act to review the cap at least once every six months.
- 2.18. One supplier emphasised the importance of timely information about routine updates and announcing the cap level. Commenting on our intention to provide suppliers with provisional notice of details relating to cap updates before formal publication, this response noted, "*This is a very important confirmation which we strongly welcome and on which we are placing reliance. We need as much advance notice of the likely update as we can have, to enable us to plan our business properly*".

- 2.19. One non-supplier noted the update *“should not be a ‘mechanical’ exercise, but rather require Ofgem to actively engage with the actual performance of the market in terms of long-term benefits and harm caused to all GB energy consumers”*.
- 2.20. Overall, we welcome the responses to the frequency of the cap, and are comfortable that our statutory consultation proposal was appropriate. As such there is no change to our proposal to update the cap on a six-monthly basis. 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. Provisions for routinely updating the level of the cap using the process described in the models are accommodated by SLC28AD, without the need for statutory consultation. This will further reduce the administrative burden placed on suppliers, but we expect to continue to engage closely with suppliers throughout the update process. While we view the update as a routine exercise, we will also continue to monitor the market and the impact of the cap on both suppliers and end users on a continuous basis.

Indexing and reviewing cost allowances

- 2.21. One stakeholder noted that Ofgem should seek to consider the impact on workforce resilience, seeking commitment from Ofgem *“... to consider the impact of the cap on workforce resilience at the time it updates the cap level every six months. This could straightforwardly be done, through regular, formal consultation with the workforce”*.
- 2.22. Another supplier noted that Ofgem should seek to use actual costs where at all possible, and that inflating historic costs using CPIH was ‘perverse’ in instances where actual and up to date cost information exists.
- 2.23. We welcome the responses to our proposals relating to indexing and reviewing cost allowances. On the first point raised, we will monitor the impact the cap has on suppliers’ businesses and welcome submissions from any affected parties as to the effects the cap is having on the market. On the second issue raised, we consider that using exogenous cost drivers provides predictability to suppliers without unnecessary administrative burden. This approach also minimises distorting competition in the wider market, by ensuring unintended incentives which could lead to detrimental impacts to consumers are minimised.

Concerns relating to updating specific cost allowances

- 2.24. Some suppliers expressed concerns about the methodology used to update specific cost allowances, such as ensuring elements of wholesale, network and policy costs remained reflective of suppliers’ costs over time. We do not seek to replicate these arguments in detail here, but further information on these can be found within the relevant appendices. In general terms however, the overarching approach for indexing and updating specific cost allowances broadly reflects the proposals we put forward in our statutory consultation.

3. Accounting for unforeseen trends in efficient costs

In this section, we discuss our approach to dealing with unforeseen trends in efficient costs. This includes both the risk that limitations of the default tariff cap design could 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.

Our approach

- 3.1. As explained in Chapter 2, our decision includes 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, minimising risk and uncertainty for suppliers.
- 3.2. In general, we consider that the detailed approach we will 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 either too high or too low overall. 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 update 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.
- 3.3. However, differences between efficient costs and those included in the cap (within a given cap period) could arise due to limitations of the cap design, or because outturn costs depart considerably from the forecasts used to set the level of the cap. This could result in 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.⁷
- 3.4. 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 this may not become clear until much later.
- 3.5. In the unlikely event that the cap was 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.
- 3.6. We have also included a provision within the licence conditions 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. In line with our general preference for updates to be as mechanistic as possible so as to avoid

⁷ 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).

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).

3.7. We have not included 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). In reaching this position, we have given regard to:

- the fact that forecast error is a risk that suppliers already face when setting their prices; and
- concerns that using an error correction mechanism would create a further distortion to the market. In particular, a negative adjustment (to correct for the cap being set too high in the previous period) could lead to a cap being set beneath an efficient level of costs. This would distort customers' incentives to engage in the market, suppliers' incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market.

3.8. A supplier's default tariff customer base is not static. One implication of this is that we would expect any correction mechanism to result in recovery that did not match benefits/costs in the preceding period – ie the correction would either be too high or too low:

- at the level of the market as a whole – this is because the correction would need to be set based on the expected number of default tariff customers, which will not be known in advance (and could be affected by the size of the correction).
- for individual customers – as customers flow between default tariffs and competitive tariffs, different customers will over- or under-pay to those that receive compensation.

3.9. In any single cap period, there is a small risk that the cap may be beneath efficient costs. Our approach to setting and updating the cap, including headroom allowance, will assist in mitigating the risk of this occurring on a systematic basis.

3.10. Finally, we have built specific allowances into the cap to reflect the uncertainty affecting our estimates of efficient costs: setting the default tariff cap above the level of costs that we would expect to be incurred by an efficient supplier with standard operating conditions. We discuss the level of headroom we propose to include in the cap in Appendix 2 – Cap level analysis and headroom.

Key issues raised in response to our statutory consultation

Support for mechanism to update the cap to account for unforeseen trends in efficient costs

- 3.11. Only a small number of responses explicitly mentioned the provisions which we may use in order to introduce updates to the methodology to account for unforeseen trends in efficient costs. Of these, stakeholders broadly welcomed our proposals to allow changes to the models subject to consultation to reflect miscalculations (such as formulae error) or significant and unanticipated changes in costs faced by suppliers. As such, we have decided to proceed with our proposal.
- 3.12. A small supplier further noted, *"We do agree that a clause within the Act should be implemented to allow the Authority to update and amend the cap and associated amounts at any time. We feel this will re-assure and protect suppliers and consumers that in the event there is an error or mis-calculation, it can be rectified if needed"*.
- 3.13. We welcome stakeholder views on this area, and recognise the broad support from industry. Consequently, we maintain our position set out in the statutory consultation that where 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. We have also included a provision within the licence conditions 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.

Retrospective correction

- 3.14. Suppliers who specifically mentioned our proposal not to allow for any retrospective adjustment generally agreed with the principal that it could distort competition in the market.
- 3.15. Another supplier noted they *"generally support this approach, noting its consistency with historic industry decisions"*. This supplier also noted, however, that a *"test of scale"* may be needed to consider materiality, and where massive shifts occur mid-period, an emergency re-opener or retrospection should apply.
- 3.16. One small supplier also highlighted the potential impacts to small suppliers, *"if the data is unclear or inconsistent, the result to the supplier can last up to 6 months. For suppliers with a smaller turn over, the error could be detrimental and potentially not rectified for 6 months"*.
- 3.17. One large supplier commented that the lack of a retrospective correction mechanism was a fundamental error in the cap mechanism, out of keeping with standard regulatory practice in price control (for example in network regulation in Great Britain). The same supplier also noted *"The lack of a mechanism in the cap to correct for under-recovery results in deadweight cost of risk to suppliers and ultimately customers. It is incompatible with Ofgem's duties to have regard to the need to finance activities..."*. The supplier noted potential market distortions, but claimed having a retrospective recovery mechanism was a 'win-win', not a zero-sum game, *"We do recognise that large Recovery adjustments can distort the competitive market because the regulated price is forced higher or lower than the prevailing market price. However, if the regulator's misforecast is small then the effect is small and if the regulator's*

misforecast is large then absence of Recovery puts the regulator in breach of EA89/GA86. Hence the need for recovery is overwhelming".

- 3.18. We are not including a provision for the correction of under-recovery within the cap; equally we do not have a provision to correct for over-recovery. As mentioned above, we consider that to do so would risk distorting competition and is therefore not appropriate or proportionate.
- 3.19. We have carefully considered stakeholder feedback on this proposal. Although a number of suppliers argued that a retrospective correction would be in consumers' interests we have not seen sufficient evidence to support this. We retain the view that the potential for detrimental consumer outcomes outweighs any marginal benefits, which would primarily be in reducing the risk faced by suppliers (many of which are risks that suppliers have always historically faced). For example, a negative retrospective adjustment (eg to correct for the cap being set too high in the previous period) could lead to a cap being set beneath an efficient level of costs. This would distort customers' incentives to engage in the market, suppliers' incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market.
- 3.20. We are required to put in place a tariff cap according to the Domestic Gas and Electricity (Tariff Cap) Act 2018. Forecast error is a risk that suppliers already face when setting their fixed tariff prices (and to some extent, their variable tariffs where 30 days' notice is required before they can update their price).
- 3.21. We do not consider that network price controls are an appropriate comparison. A supplier's default tariff customer base is significantly more variable than that of a network. One implication of this is that we would expect any correction mechanism to result in recovery that did not match benefits/costs in the preceding period – ie the correction would either be too high or too low:
- *at the level of the market as a whole* – this is because the correction would need to be set based on the expected number of default tariff customers, which will not be known in advance (and could be affected by the size of the correction)
 - *for individual customers* – as customers flow between default tariffs and competitive tariffs, different customers will over- or under-pay to those that receive compensation
 - *for individual suppliers* – this is because the number of default tariff customers served by a supplier will change from one period to the next. Suppliers gaining default tariff customers will therefore receive too large a correction, suppliers losing default tariff customers will receive too small a correction.

Offsetting of forecast error

- 3.22. One large supplier noted, *"We are also concerned by Ofgem's view that differences between actual and forecast policy costs will offset each other over the lifetime of the cap. We do not believe this to be a reasonable assumption (especially given the time limited nature of the cap, which may only be in operation for 2 years, and in the context of a market in which policy costs have been steadily increasing for a decade). [We] would expect Ofgem to keep this under strict review"*. We acknowledge that there is some degree of uncertainty affecting our forecasts of policy costs. However,

when we considered historic trends (see Appendix 5 to our statutory consultation⁸), we found that our methodology would have caused us to overstate the true level of policy costs faced by suppliers had it been in place in the period 2015/16 to 2017/18. This suggests that different cost components are likely to follow different trajectories (upward or downward), balancing each other out to some extent. Where costs do go up, on average, in a way that is not anticipated in the design of the cap, we consider that headroom provides for cover on these issues in a shorter timeframe. We will continue to monitor costs and all aspects of the cap for its duration to in respect to both end users and suppliers.

- 3.23. Another large supplier expressed a similar view, suggesting that our expectation that inaccuracies in forecasts (absent any systemic issue) to even out over time is flawed. They noted, for example, that over or underestimating volumes will both result in sub-optimal outcomes, and therefore additional costs; *“The relation between profitability and optimum tariff is concave, i.e. if a supplier overprices one year (and loses volume) and underprices the next year (and gains volume), the net effect is loss relative to optimum on both occasions”*. The supplier also expressed their view that there is also a strong incentive for Ofgem (and wider Government) to underestimate costs. In response, we would highlight that suppliers already face risk associated with volume forecast error. Suppliers have a clear incentive to procure the optimum volumes for their consumer base, and competitive pressure should help to ensure that their strategy minimises risk of forecast error (and associated costs) in the long term. This risk is not therefore unique to (or created as a result of) the default tariff cap. However, where inaccuracies in forecasts are such that suppliers may not be able to recover their efficient costs (absent any systemic issue) we have also included a headroom allowance to accommodate for this uncertainty.

Process for modifications

- 3.24. One supplier stated that any change to the level of the cap or underlying methodology would necessitate a statutory consultation: *“...any proposed changes to the level or methodology of the cap once implemented must be treated by Ofgem as full licence modifications”*. The six-monthly process for updating the cap is detailed in licence condition 28AD and associated annex models. Therefore we do not require a statutory consultation to change the cap level as part of this process. As we note in paragraph 3.6 above we have also included a provision within the licence conditions to allow us to, subject to consultation, make more urgent changes to the annex models. We would only use these powers to make changes to the models in specified circumstances, and do not consider a lengthy statutory consultation process would be appropriate.

Views on specific cost allowance areas

- 3.25. A number of suppliers provided examples of circumstances and / or regulatory interventions that might warrant changing the cap level in response to unforeseen trends in efficient costs. These include ECO3, the faster, reliable switching programme, Mi-data, potential changes to ‘supplier hub’ retail market model, extreme weather events, unidentified gas (UIG) volatility, the move to PAR1 imbalance pricing, potential suspension of the Market Making Obligation (MMO) and other changes relating to smart, all of which could lead to a material increase in costs faced by suppliers. We have addressed these points in the relevant appendices.

⁸ https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_5_-_policy_and_network_costs.pdf