

Date: 31 January 2020

## Default tariff cap: January 2020 update letter

1. This paper updates stakeholders on our plans for consulting this year on proposals to modify to the default tariff cap (“the Cap”).
2. We intend to consult on three significant potential modifications to how we calculate the Cap. Those are:
  - a. the non-pass-through Smart Metering Net Cost Change (SMNCC) allowance
  - b. reassessing the wholesale allowance in the first cap period, and making any adjustment that we consider appropriate
  - c. preparing the Cap for prepayment customers with default tariffs, upon expiry of the prepayment meter cap (“PPM cap”).
3. We expect to publish statutory consultation of each issue in **mid-May 2020** and publish our decision on each consultation at the **end of July 2020**. Those decisions would have effect from cap period five (1 October to 31 March 2021).

## A summary of the issues

The SMNCC

4. In October 2019, we consulted on modifications to the SMNCC methodology in the Cap.<sup>1</sup> In December 2019, we decided to include a contingency allowance in cap period four (1 April 2020 to 30 September 2020) and consider our proposals for the ongoing methodology further.<sup>2</sup>
5. We intend to consult stakeholders on an updated methodology in mid-May, disclosing the appropriate model and underlying data alongside that consultation.

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<sup>1</sup> Ofgem (2019), Reviewing smart metering costs in the default tariff cap: October consultation.  
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-october-consultation>

<sup>2</sup> Ofgem (2019), Reviewing smart metering costs in the default tariff cap: Decision for cap period four.  
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-smart-metering-costs-default-tariff-cap-decision-cap-period-four>

6. We have published an update and response to our October 2019 consultation alongside this letter.<sup>3</sup>

#### Reassessing wholesale costs

7. In November 2019, the High Court concluded that Ofgem should reconsider the wholesale allowance for the first cap period of the Cap, and make such adjustments as we consider appropriate. We should conduct that reconsideration in the light of information we now have, or require, on suppliers' wholesale costs in the relevant period.<sup>4</sup>
8. We intend to consult stakeholders in mid-May on our reassessment of suppliers' costs, the appropriate wholesale allowance level for the first cap period, and proposals on any adjustment, if required. Any adjustment would be an additional and temporary adjustment to future cap periods, with effect from cap period five (1 October 2020 to 31 March 2021). For the avoidance of doubt, the ongoing wholesale methodology was not challenged and shall apply in future cap periods.
9. We propose bilateral discussions in February and March 2020 with a number of relevant suppliers to consider in detail their relevant wholesale costs for the first cap period.
10. There are a number of challenges involved in: estimating suppliers' relevant hedged costs for the first cap period; considering an appropriate level of allowance; and adjusting future cap periods, for a limited time, to account for past errors, if any.
11. Alongside this letter, we have published an initial consultation setting out our intended process, the main analytical challenges, and our initial views.<sup>5</sup> We welcome stakeholders' views on these issues.

#### Prepayment customers

12. At the end of 2020, the PPM cap will expire. In July 2019, the Competition and Market Authority recommended that Ofgem consider providing protection for prepayment customers after the expiry of the PPM cap.<sup>6</sup>
13. Most prepayment customers have default tariffs, so upon expiry of the PPM cap, they will be in scope of the default tariff cap. At present, those customers would be charged at the level designed for direct debit customers.

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<sup>3</sup> Ofgem (2020), Reviewing smart metering costs in the default tariff cap: Update and response to the October 2019 consultation. <https://www.ofgem.gov.uk/publications-and-updates/SMNCC-update-and-response-to-the-October-2019-consultation>

<sup>4</sup> [2019] EWHC 3048 (Admin): <https://www.bailii.org/ew/cases/EWHC/Admin/2019/3048.html>

<sup>5</sup> Ofgem (2020), Reassessing the wholesale allowance in the first default tariff cap period: January 2020 consultation. <https://www.ofgem.gov.uk/publications-and-updates/initial-consultation-on-reassessing-the-wholesale-allowance-in-the-first-cap-period>

<sup>6</sup> CMA (2019), Review of the Energy Market Investigation (Prepayment Charge Restriction) Order 2016. <https://www.gov.uk/cma-cases/review-of-the-energy-market-investigation-prepayment-charge-restriction-order-2016?cachebust=1564552389>

14. At a minimum, we propose to modify the Cap so that protection for PPM customers is in line with the status quo, the PPM Cap. In July 2019, the CMA aligned the PPM cap methodology with the default tariff cap methodology. On that basis, it is relatively straightforward to modify the Cap so that it provides a level of protection that is consistent with the current PPM Cap.
15. In addition, we will consider whether consistency with the PPM cap is appropriate, whether further modification are necessary. For instance, to recognise changes in the cost of serving PPM customers with a traditional meter, or to recognise the net cost of introducing smart meters.
16. We intend to publish an initial consultation on the key issues in late February 2020.
17. We intend to publish a statutory consultation in mid-May on the proposals that could have effect in Cap period five (1 October to 31 March). If we consider it necessary and appropriate to take additional time to develop further modifications, we may propose an interim allowance in that consultation based on the PPM cap – ensuring continuity for customers and suppliers.

### **Interaction with other proposals**

18. On 23 January 2020, we published a statutory consultation on the process for modifying the Cap.<sup>7</sup> We proposed to modify Standard Licence Condition (SLC) 28AD in the gas and electricity supply licences, so that when we calculate the Benchmark Maximum Charges ("Cap level") for an upcoming Charge Restriction Period ("Cap period") of the Cap, we would use the licence conditions that will have effect in that upcoming Cap period, notwithstanding that those conditions may not have effect at the time of the announcement.
19. The timelines in this letter are based on that proposal. We will decide whether to adopt that proposal in mid-March. If we decide to maintain the current arrangement we will update stakeholders on the new timetable for the modification proposed in this letter.

Kind regards

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<sup>7</sup> Ofgem (2020), Statutory Consultation on the process for modifying the Default Tariff Cap.  
<https://www.ofgem.gov.uk/publications-and-updates/statutory-consultation-process-modifying-default-tariff-cap>