

To – all stakeholders

Email: Retailpriceregulation@ofgem.gov.uk

Date: 30 June 2023

Dear Stakeholders,

Consultation on technical changes to the price cap methodology - June 2023

In this letter we¹ are consulting on a number of technical changes to the way in which we process modelling inputs used in the calculation of the price cap. These changes relate to:

Annex 2 – Wholesale cost allowance methodology:

- timing of input updates for Contracts for Difference (CfD) cost allowance;
- calculation of Unidentified Gas (UIG); and

Annex 4 – Policy cost allowance methodology:

- accounting for inflation in the Great British Insulation Scheme (GBIS)

This letter and its appendices set out the background to the issues relevant to each area and the changes we propose to implement from charge restriction period 11a (commencing 1 October 2023), due to be announced in August 2023.

We want to ensure transparency with stakeholders and provide this opportunity to comment on the intended changes set out in this letter ahead of the August 2023 price cap announcement. Please provide any relevant responses by 28 July 2023 via email to Retailpriceregulation@ofgem.gov.uk.

¹ The terms “we”, “us”, “our”, “Ofgem” and “the Authority” are used interchangeably in this document and refer to the Gas and Electricity Markets Authority. Ofgem is the office of the Authority.

Summary

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

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

We continually review the inputs used in setting these allowances and where necessary consider amendments to the methodology to ensure our calculations continue to accurately reflect broader policy changes and therefore the costs to a notional efficient supplier.

To ensure that default tariffs continue to reflect the efficient costs of supplying energy we consider it necessary to implement a number of technical adjustments to our methodology. This letter sets out our intention to implement the following changes from charge restriction period 11a (commencing 1 October 2023).

Contracts for Difference (CfD)

Proposal: We propose an amended input publication timing schedule to facilitate improved certainty and transparency regarding the inputs used in calculating the CfD cost allowance methodology. We intend to continue using the LCCC (Low Carbon Contracts Company) determination run forecast of CfD payments. However, we propose to account for any before-period adjustment to this forecast, which LCCC have committed to provide at least 30 working days prior to the start of the period. We do not intend to include in-period adjustments as part of the calculation of the CfD cost allowance.

Rationale: We have been engaging with the LCCC on this issue and consider this change will help to provide suppliers with more certainty and transparency on the CfD cost allowance input. We consider this change should help to mitigate supplier exposure to CfD hedge timing risks, where suppliers have made a commercial decision to hedge CfD cost exposure.

Great British Insulation Scheme (GBIS), Formerly ECO+

Proposal: We propose to use the GDP deflator on a calendar year basis, rather than a financial year basis, when accounting for inflation.

Rationale: This is to align with government's intended costs and budgeting for the scheme, in line with the final stage impact assessment (dated 17 May 2023)², and our treatment of inflation in the ECO4 scheme.

Unidentified Gas (UIG)

Proposal: We propose to update our approach to calculating UIG for use in Annex 2 – wholesale cost allowance methodology in such a way that both prepayment meter (PPM) and non-prepayment meter (non-PPM) UIG values are equalised.

Rationale: Our decision to approve Uniform Network Code (UNC) 840: Equalisation of pre-payment and non-prepayment Allocation of Unidentified Gas (AUG) factors³ means that we must update the way in which we calculate UIG using the Allocation of Unidentified Gas Statement to accurately reflect the policy intent in the price cap.

Feedback

We have set out the background to, and rationale for these changes, including how we intend to implement them in appendices to this letter. We welcome views on the approaches set out in this letter and ask stakeholders to send any comments to RetailPriceRegulation@ofgem.gov.uk by close of business on 28 July 2023.

Notification of republication of Annex 2 – Wholesale cost allowance methodology

We are also using this opportunity to signal to industry and wider stakeholders that today, we have also published an updated version of Annex 2 - wholesale cost allowance methodology (v1.171) on our website.⁴ The reason for this is to correct for an error in the calculation of the backwardation allowance relating to future cap periods. It does not impact published cap levels in any way, however, stakeholders who use our models for their own forecasting purposes may wish to ensure that they are using the latest published version of this model.

² DESNZ (2023), GB Insulation Scheme (formerly ECO+) Final IA, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1157227/gb-insulation-scheme-final-stage-ia.pdf

³ Ofgem (2023), Decision to approve Uniform Network Code (UNC) 840: Equalisation of prepayment and non-prepayment AUG factors, <https://www.ofgem.gov.uk/publications/decision-approve-uniform-network-code-unc-840-equalisation-prepayment-and-non-prepayment-aug-factors>

⁴ Ofgem (2023), Default Tariff Cap level: 1 July 2023 to 30 September 2023, <https://www.ofgem.gov.uk/publications/default-tariff-cap-level-1-july-2023-30-september-2023>

Yours sincerely,

Dan Norton

Deputy Director, Retail Price Protection

Appendix I – Changes to the data and timing of CfD inputs

Background

The default tariff cap allows suppliers to recover the costs associated with their obligations under different social and environmental schemes. One such allowance within the price cap is the Contracts for Difference (CfD) cost allowance. This allows suppliers to recover the costs associated with funding this government mechanism for supporting low-carbon electricity generation.⁵

The CfD scheme is administered by the Low Carbon Contracts Company (LCCC). They publish forecasts of the Supplier Obligation Levy that funds CfD payments, on their website. When determining the price cap for a given period, the current methodology requires us to use their publicly available estimates to determine an expected levy payment which in turn sets the CfD allowance in the price cap. This is in keeping with how we use the latest publicly available information to estimate supplier costs when setting the price cap level in other parts of the model.

The current CfD methodology uses a forward looking view of CfD costs, which relies on a mixture of forecasting and actuals. This forward view allows for more accurate matching of the timing of costs incurred to recovery, compared to using historical data. The allowance within the price cap is calculated at the time the cap is set, based on the latest LCCC forecasts of CfD payments for the financial year within which the cap period falls. For the summer price cap (February & May price cap announcements), the CfD allowance is solely based on forecast CfD payments for the April-March CfD year. For subsequent price cap updates this is based on a mixture of both forecast and reconciled CfD payment figures. Combining these figures with expected eligible demand allows us to calculate an expected levy payment.⁶

Issue

The CfD methodology effectively forecasts the costs associated with the CfD scheme over the period of a year and can therefore be used by suppliers to hedge their exposure to risk within the CfD market. As the CfD cost allowance methodology relies on forecast inputs

⁵ Further information on the CfD scheme can be found at the LCCC website:

<https://www.lowcarboncontracts.uk/contracts-for-difference>

⁶ Further information on our CfD methodology can be found in our June 2022 'Decision on the Contracts for Difference (CfD) allowance methodology in the default tariff cap':

<https://www.ofgem.gov.uk/publications/decision-amending-methodology-setting-contracts-difference-cfd-cap-allowance>

published by LCCC, adjustments to these forecasts can impact suppliers' ability to hedge their CfD cost exposure effectively.

LCCC publish their determination of CfD payments three months before the start of a quarter. However, between the time when they publish this figure and when the price cap is announced (25 working days before the start of a price cap period), there could be significant changes in market prices and/or in generator start dates. Subsequently, LCCC can adjust these already published figures in the event that changes to market conditions indicate there will be either a material over-collection from suppliers and obligations should be reduced, or there's an increased risk that LCCC would not be able to make generator payments in the period. This is a typical example of why LCCC may need to make an adjustment, however other reasons may apply. Ofgem uses the latest available inputs at the time of determining the price cap, so would therefore capture these adjusted figures in the price cap announcement.

This lack of clarity on the potential for an adjustment to the CfD forecast published by LCCC limits the extent to which suppliers can mitigate their CfD cost exposure via hedging. We note that any adjustment to the CfD forecast could either represent a benefit or cost to a supplier (relative to their hedged position) depending on wider wholesale market movements. However, we consider that improving the clarity and transparency of CfD inputs (by ensuring suppliers have more clarity on what input is going to be used in the CfD allowance at a fixed point in time for a given period), should encourage greater supplier certainty and control over their CfD risk exposure. We therefore consider facilitating greater clarity on the CfD hedge timing risk to be an important element in fostering a prudent approach to risk management, in consumers' broader interests.

Intended approach

Ofgem recognise the risks faced by suppliers in this space and appreciate the interaction between LCCC forecasting and the price cap methodology has the potential to raise challenges for suppliers when managing their hedging strategy. Although we do not have control over the timing of CfD input publications, we are keen to facilitate beneficial change, where feasible and appropriate, to help industry better manage the risks they face where this is likely to have clear benefits to consumers.

Ofgem have been working closely with LCCC with the aim of ensuring the publication timings and certainty of the inputs used in the CfD allowance better aligns with the methodology in the price cap. Both have agreed an approach we believe will allow greater certainty for suppliers by significantly mitigating this timing risk.

We intend to use the original determination of CfD payments which is published 3 months in advance of the quarterly period. Broadly, LCCC can make two different types of adjustment to the original determination; one for the current quarter at the time of adjustment (referred to as an in-period adjustment), and one for the subsequent quarter (referred to as a before-period adjustment). LCCC will continue to use in-period adjustments when required as per their existing approach, however they have agreed to ensure that any before-period adjustments will be made at least 30 working days prior to the start of that quarter. This will allow the existing price cap methodology to capture the before-period adjustment in time to include in the price cap announcement for that subsequent quarter. Our proposals to account for before-period adjustments are specific to adjustments published at least 30 working days prior to the subsequent period. Following discussions with LCCC, we do not expect that a before-period adjustment would be published within 30 working days of a subsequent period. However, in the event that a before-period adjustment were to be published within 30 working days of the subsequent period, we would not account for this.

For example, for the forthcoming price cap announcement in August 2023, we intend to use a mixture of reconciled data, determination runs (or a before-period adjustment to that determination run) and advanced forecasts. The use of these inputs is dependent on availability at the time of determining the price cap.

The below table represents an example of which LCCC data sources we intend to use over the next year, dependant on availability.

Inputs: CfD payments forecast	28AD Charge Restriction Period: Oct 2023 - Dec 2023 Update calculated as of: August 2023 CfD year: 2023/2024	28AD Charge Restriction Period: Jan 2024 - Mar 2024 Update calculated as of: November 2023 CfD year: 2023/2024	28AD Charge Restriction Period: Apr 2024 - Jun 2024 Update calculated as of: February 2024 CfD year: 2024/2025	28AD Charge Restriction Period: Jul 2024 - Sep 2024 Update calculated as of: May 2024 CfD year: 2024/2025
Apr to Jun of Cfd year	R	R	DR/BPA	DR/BPA
Jul to Sep of Cfd year	DR/BPA	R	AF	DR/BPA
Oct to Dec of Cfd year	DR/BPA	DR/BPA	AF	AF
Jan to Mar of Cfd year	AF	DR/BPA	AF	AF

R = Reconciled data

DR/BPA = Determination run or before-period adjustment made at least 30 working days prior to the start of the relevant quarter

AF = Advanced forecast

We consider that by including the determination run, set 3 months prior to the start of the cap period, and not incorporating in-period adjustments, will allow for more certainty of which inputs are being used to form the price cap allowance. We consider it important for consumers and wider industry, that suppliers implement a prudent hedging strategy to manage their risk. While we recognise that the hedging decisions of suppliers are entirely their own commercial choices (subject to compliance with the financial responsibility principle, whether by hedging or otherwise) and that there will always be risk associated with non-systematic issues such as changes in wholesale prices and generation volume, we consider that our intended approach set out above will assist suppliers with their risk management strategies and in turn help to de-risk the market.

Considerations on forecast error reconciliation

In our June 2022 CfD Decision,⁷ we set out the considerations and supplier feedback regarding supplier CfD hedging and implications for CfD forecast error reconciliation. We set out our response to these considerations in sections 3.41 – 3.46 of the June 2022 CfD decision. We maintain our position (in line with our 2018 decision and the June 2022 CfD Decision) that the price cap does not include mechanisms for correcting previous forecast errors, particularly if these are non-systematic (including CfD forecast error).

We consider the proposals set out in this consultation strike the appropriate balance between facilitating greater clarity on CfD forecast inputs to hedge against, and is consistent with our 2018 decision (and June 2022 decision) not to introduce a reconciliation for CfD forecast error. As such, our proposals do not include accounting for in-period adjustments, which we consider would constitute a forecast error reconciliation mechanism.

Question – Do you agree with our proposals in this section?

⁷ Ofgem (2022), Decision on the Contract for Difference (CfD) allowance methodology in the default tariff cap, <https://www.ofgem.gov.uk/sites/default/files/2022-06/Decision%20on%20the%20Contract%20for%20Difference%20%28CfD%29%20allowance%20methodology%20in%20the%20default%20tariff%20cap.pdf>

Appendix II – Accounting for inflation in the GBIS policy cost allowance

Background

On 27 February 2023, we published our decision to include an allowance in the price cap to reflect the government’s planned expansion of the Energy Company Obligation (ECO) scheme, ECO+, from cap period 10a (April 2023 – June 2023) onwards.⁸ Our methodological approach to calculate the allowance uses the government’s latest publicly available annualised cost estimate of the scheme as an input, and is intended to adjust for inflation in line with the government’s approach to adjusting the overall scheme costs to account for inflation. This uses a GDP deflator value.

Our February decision set out our rationale for including an allowance in the cap ahead of the government’s legislation for the GBIS scheme.⁹ The legislation for the scheme is progressing broadly to the timescales anticipated at the time of our decision. The government expects the scheme to be established in law in summer 2023, following the laying in Parliament of the draft Statutory Instrument on 24 May 2023.

Issue

At the time of our decision, we understood the government intended the scheme base year to be 2022/23, and therefore the relevant GDP deflator to be used in the cap was based on financial years. The government has now published its final stage impact assessment¹⁰, and has confirmed to us that the scheme base year is the 2022 calendar year. This means that energy suppliers’ notional annual bill savings targets for GBIS were modelled based on a £1 billion scheme in 2022 prices. Therefore, the cap methodology no longer aligns with the Government approach to modelling and budgeting for this scheme.

Intended approach

We therefore consider it appropriate to amend the methodology of inflationary adjustment for GBIS to use the GDP deflator values based on **calendar year** rather than **financial year**. This change does not materially impact the level of the price cap, but we consider the

⁸ Ofgem (2023), Decision on the planned ECO+ scheme, <https://www.ofgem.gov.uk/publications/price-cap-decision-planned-eco-scheme>

⁹ Ofgem (2023), Decision on the planned ECO+ scheme, paragraphs 3.9- 3.14, pages 16-18. <https://www.ofgem.gov.uk/publications/price-cap-decision-planned-eco-scheme>

¹⁰ DESNZ (2023), GB Insulation Scheme (formerly ECO+) Final IA, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1157227/gb-insulation-scheme-final-stage-ia.pdf

principle of ensuring alignment with government accounting for inflation to be sufficient reason to implement this minor change.

For the avoidance of doubt, the OBR GDP deflator would remain the relevant source data¹¹, but we intend to use the relevant **calendar year** GDP deflator value, rather than **financial year** value.

Using a calendar year deflator is consistent with our approach to the existing ECO4 scheme and we intend to implement updates and changes to deflator values during the course of the GBIS scheme in the same way as we do for ECO4. However, the relevant GDP deflator value for ECO4 and GBIS will continue to be determined separately given the different base calendar years for each scheme.

Question – Do you agree with our proposals in this section?

¹¹ We use the most recent OBR Economic and Fiscal Outlook, Table 1.7, Supplementary economy tables – for cap period 11a (October 2023 – December 2023) this is expected to be <https://obr.uk/efo/economic-and-fiscal-outlook-march-2023/>

Appendix III – Equalisation of PPM and non-PPM AUG factors (UNC 840)

Background

Unidentified gas (UIG) is the gas that is off taken from the Local Distribution Zone (LDZ) System, but not attributed to an individual Supply Meter Point or accounted for as Shrinkage. Each year the Allocation of Unidentified Gas Expert (AUGE) conducts analysis and produces a report on the causes of UIG and from this produce an Allocation of Unidentified Gas Statement for the relevant gas year.¹² We use values from the AUG statement to determine the UIG allowance in Annex 2 – wholesale cost allowance methodology when setting the price cap.

In February 2022 we published a decision¹³ to set separate UIG allowances for PPM and non-PPM customers (the “**February 2022 Decision**”), in line with the latest end user classifications (EUCs). In that decision we also set out that we would use both Class 3 and 4 meter data in the calculation of the UIG allowances to allow for a more complete representation of meter types and that the UIG allowance would be set at a level consistent with the ‘Final Allocation of Unidentified Gas table’. The decision set out the existing method for calculating the UIG uplift, by separately dividing the total UIG for EUC bands 1PD (PPM) and 1ND (non-PPM) for classes 3 and 4 meters by the forecast consumption in the target gas year for the same EUC band and classes to arrive at a percentage UIG allowance.

Issue

On 21 April 2023, we published our decision to approve uniform network code (UNC) modification 840: equalisation of prepayment and non-prepayment AUG factors.¹⁴ This modification removes the differentiation in AUG weighting factors for PPM and non-PPM customers in the same sector and product class (EUCs 1 and 2), equalising the amount of UIG that is apportioned between these two categories. This will have the effect of equalising the amount of UIG allocated to each, thereby reducing the costs for PPM customers. This will be implemented from 1 October 2023.

¹² The Gas Year runs from 1 October – 30 September

¹³ Ofgem (2022), Decision on reflecting prepayment End User Categories in the default tariff cap, <https://www.ofgem.gov.uk/publications/price-cap-decision-reflecting-prepayment-end-user-categories-default-tariff-cap>

¹⁴ Ofgem (2023), Uniform Network Code (UNC) 840 (Urgent): Equalisation of prepayment and non-prepayment AUG factors (UNC840), <https://www.ofgem.gov.uk/publications/decision-approve-uniform-network-code-unc-840-equalisation-prepayment-and-non-prepayment-aug-factors>

The implementation of this modification requires us to change the methodology that we originally set out in the February 2022 Decision for calculating the UIG allowance, to ensure that its intent can be accurately reflected in the cap.

Intended Approach

Implementation of UNC 840 in the price cap requires us to adjust the way in which we calculate the allowance for UIG that we previously set out in the February 2022 Decision. We will continue to use the same data from the Final AUG statement for the relevant gas year. However, we intend to combine the total volumes of UIG for PPM and Non-PPM class 3 and 4 meters and the total forecast demand in the target gas year for PPM and Non-PPM class 3 and 4 meters to arrive at a single percentage UIG allowance that will apply to both PPM and non-PPM customers.

Using the values for Gas Year 2023-24 in the Final Allocation of Unidentified Gas Statement published on 25 April 2023¹⁵ we therefore intend to use a value of 1.92% UIG allowance for both PPM and non-PPM customers as an input in annex 2 wholesale methodology in the August price cap publication which comes into effect on 1 October 2023. The details of this calculation are set out below.

$$UIG(\%) = \frac{\text{Total UIG}}{\text{Total forecast consumption}} * 100 = \frac{559 + 3455 + 27 + 1194}{53623 + 208054 + 798 + 10290} * 100$$

Where:

Total UIG = sum of UIG for EUC bands 1ND & 1PD for both class 3 & 4 meters (GWh)

Total forecast consumption = sum of the total forecast consumption in the target gas year for EUC bands 1ND & 1PD for both class 3 & 4 meters (GWh)

We think this accurately implements the policy intent of UNC 840 to equalise the allocation of UIG for PPM and non-PPM customers.

Question – Do you agree with our proposals in this section?

¹⁵ Joint Office of Gas Transporters (2023), Final Allocation of Unidentified Gas Statement, <https://www.gasgovernance.co.uk/sites/default/files/ggf/book/2023-04/Final AUG Statement 2023-2024 1.5.pdf>