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Dear Dan,

CONSULTATION ON TECHNICAL CHANGES TO THE PRICE CAP METHODOLOGY

Thanks for the opportunity to respond to your statutory consultation on three technical changes to the price cap: timing of input updates for Contracts for Difference (CfD) cost allowance, calculation of Unidentified Gas (UIG) and accounting for inflation in the Great British Insulation Scheme (GBIS).

Our response to the consultation questions is in Annex 1. In summary:

- **CfD**: We do not consider that the proposed change will deliver the goal of helping to mitigate supplier exposure to CfD hedge timing risks. As such, we reiterate our preference for a reconciliation mechanism as proposed in the consultation on 14 April 2022. This approach would resolve both price and volume issues associated with LCCC forecasts and the reasonably regular adjustments to these that are made due to market movements.

- **UIG**: We agree with the proposed changes such that both prepayment meter (PPM) and non-prepayment meter (non-PPM) UIG values are equalised, so that the cap calculations reflect the policy intent of recent changes made to the allocation of UIG.

- **GBIS**: We agree with the proposal to align the inflation in the price cap with the accounting for inflation by the government for the scheme, by moving from a financial year to a calendar year inflation index. However, we continue to consider that Ofgem should use the market-based CPIH index rather than a GDP deflator.

Please do not hesitate to contact me or my colleague Dena Barasi to discuss this further.

Yours sincerely,

Richard Sweet

Richard Sweet
Director of Regulatory Policy

Annex 1

CONSULTATION ON TECHNICAL CHANGES TO THE PRICE CAP METHODOLOGY – SCOTTISHPOWER RESPONSE

1. Changes to the data and timing of CfD inputs

The issues associated with the CfD allowance in the price cap

Currently, the CfD allowance within the price cap is calculated at the time the cap is set. The expected levy payment is based on:

- the *latest* LCCC forecasts of CfD payments for the financial year within which the cap period falls; and
- the expected eligible demand.

In relation to the CfD allowance in the price cap, suppliers are exposed to the risk of wholesale prices changing between the allowance being set and the actual CfD payments being made to/from generators. To address this risk, suppliers may hedge their price risk. The same risk is associated with fixed term contracts (FTCs) and suppliers can also hedge this price risk.

If the LCCC updates its figures as a result of changes in market conditions, prior to the price cap announcement, Ofgem would reflect these adjusted figures in the price cap announcement. If suppliers have already hedged their CfD cost exposure they are exposed to this update leading to an ineffective hedge. This could either represent a benefit or cost to a supplier (relative to their hedged position) depending on wider wholesale market movements. We note that suppliers can only hedge for price risk relating to CfD payments but cannot hedge for changes in generation volume relative to forecast, or indeed changes in customer numbers.

Issues associated with Ofgem's proposed change

Ofgem has agreed with LCCC that any before-period adjustments (BPAs) in a quarter will be made at least 30 working days prior to the start of the quarter. This will allow the existing price cap methodology to reflect the BPA in the CfD allowance in time to include in the price cap announcement for the following quarter. Ofgem will only account for BPAs published at least 30 working days prior to the subsequent period. If a BPA were to be published within 30 working days of the start of a price cap period, Ofgem would not account for this.

We consider that the current status quo is as follows:

The below table represents an example of which LCCC data sources are currently being used 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/IPA
Jul to Sep of Cfd year	DR/BPA/IPA	R	DR/AF	DR/BPA
Oct to Dec of Cfd year	DR/BPA	DR/BPA/IPA	AF	AF
Jan to Mar of Cfd year	AF	DR/BPA	AF	AF

R = Reconciled data
DR = Determination run or
BPA = Before-period adjustment made at least 30 working days prior to the start of the relevant quarter

IPA = In period adjustment which occurs between 30 working days prior to the start of the relevant quarter and the start of the relevant quarter
AF = Advanced forecast

The proposed change is that in period adjustments (IPA) (highlighted in yellow above) would no longer occur. However, if an IPA did occur within the 30 working days, Ofgem would not use that adjustment in the price cap.

The rationale for the change is that "*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".*

From the perspective of price risk for which suppliers hedge, there remains uncertainty associated with the potential or not for a BPA. At the time of the LCCC's initial Determination Run (DR) announcement, suppliers must decide whether to hedge. The decision depends on their assessment of whether the DR will be superseded by a BPA. If there is no BPA, suppliers should have hedged three months before on the basis of the DR; if there is a BPA, suppliers should hedge at the time of the BPA. Not knowing whether there will be a BPA means that there remains uncertainty associated with hedging.

Of course, whilst BPAs can have a negative impact on the effectiveness of our price hedge, they can have a positive impact on reducing risk associated with changes in generation volume, which cannot be hedged. There continue to be changes to LCCC forecasts as a result of generators deferring entry into the CfD scheme or deferring market exit. To the extent that volume changes that we cannot hedge are incorporated into the cap by BPAs, reducing the period in which an update can be made may not help suppliers. As such, we reiterate our preference for a reconciliation mechanism as proposed in Ofgem's consultation of 14 April 2022[1] (discussed further below).

Reconciliation

The only way to address price, volume and customer number risk relating to the price cap allowance is to introduce a reconciliation process such that actual costs are reconciled to the forecast costs. This is because:

- It passes actual costs through more accurately and therefore customers pay a more cost-reflective price.
- Suppliers can avoid the risk of hedging CfD allowances for price cap customers.

CfD volume forecasts are becoming more difficult to forecast and as noted above we have seen late generator decisions that impact CfD costs compared to LCCC's forecast. As such, we consider that to address price and volume risk, reconciliation should be the preferred approach.

[1] Consultation on amending the methodology for setting the Contracts for Difference (CfD) cap allowance | Ofgem

2. Accounting for inflation in the GBIS policy cost allowance

We agree with the proposed changes such that both prepayment meter (PPM) and non-prepayment meter (non-PPM) UIG values are equalised, so that the cap calculations reflect the policy intent of recent changes made to the allocation of UIG [2].

3. Equalisation of PPM and non-PPM AUG factors (UNC 840)

We agree with the proposal to align the inflation in the price cap with the accounting for inflation by the government for the GBIS scheme, by moving from a financial year to a calendar year inflation index. However, we continue to consider that Ofgem should use the market-based CPIH index rather than a GDP deflator.

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[2] Uniform Network Code (UNC) 840: Equalisation of pre-payment and non-prepayment Allocation of Unidentified Gas (AUG) factors [Decision to approve Uniform Network Code (UNC) 840: Equalisation of prepayment and non-prepayment AUG factors | Ofgem]