Energy price cap wholesale adjustment decision

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Contact:	Dan Norton
Team:	Price Protection
Email:	priceprotectionpolicy@ofgem.gov.uk

In December 2023, we consulted on whether to make an adjustment to the default tariff cap ('cap') to account for differences between wholesale costs and allowances between October 2022 and September 2023. We have carefully considered all evidence and representations made by stakeholders. This document sets out our decision not to make an adjustment to the cap, reflecting our judgement that costs incurred by suppliers did not systematically differ from allowances over this period.

In addition to deciding not to make an adjustment, we also set out our decision to make technical changes to the Annex 2 model.

Any enquiries related to the text of this publication should be sent to Ofgem at:

10 South Colonnade, Canary Wharf, London, E14 4PU.

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Executive Summary

We introduced the default tariff cap ('cap') on 1 January 2019 to protect households on standard variable and default tariffs (which we refer to collectively as 'default tariffs'). The cap ensures that default tariff customers pay a price for their energy that reflects its reasonable underlying costs.

Wholesale costs are the costs suppliers face when buying the energy needed to meet customer demand and are the largest single contributor to customers' bills. Efficient wholesale costs are reflected in the price cap through allowances which are generally set ahead of time (ex-ante). We consider the case for making after the fact (ex-post) adjustments to the price cap if we identify material and systematic differences between allowances and costs over previous periods.

This review has sought to compare wholesale costs and allowances over the period October 2022 to September 2023. In undertaking it, we published an open letter in July 2023, circulated a Request for Information (RFI) to suppliers in August 2023, published an update letter in October 2023, shared our analysis with suppliers via a putback process, and most recently published a consultation in December 2023.

After careful consideration of stakeholder responses, our conclusion remains that wholesale costs incurred between October 2022 and September 2023 did not systematically differ from allowances. We therefore have decided not to make an adjustment to the level of the cap.

All supplier responses to our December 2023 consultation supported not making an adjustment. A consumer group objected, noting that the analytical approach used had changed compared to previous similar reviews. The change in methodology reflects the specific considerations of this review. We consider the analytical approach used in each review to be appropriate to the facts and circumstances of those reviews.

Beyond the decision to not make an adjustment, most suppliers raised concerns about our approach to ex-post adjustments in general, and ex-post downward adjustments in particular. We note these concerns and maintain our consultation position that any ex-post adjustment needs to be considered very carefully.

This document also summarises stakeholders' responses to questions asked in the December 2023 consultation regarding priorities for future reviews of wholesale allowances and methodologies. It is our current intention that these comments will help inform an update to the Price Cap Programme of Work to be published in spring.

Finally, we have also decided to go ahead with the proposed technical changes to the wholesale cost allowance (annex 2) model set out in the December 2023 consultation.

1. Introduction

Section summary

This chapter provides context on the default tariff cap and the wholesale allowances provided under the cap. It explains the motivation and scope of our decision, sets out the statutory framework, and provides a high-level summary of the engagement we have undertaken with market participants.

Subject of this decision

1.1 Following continued and unusually high volatility in wholesale prices over the past year, we have examined whether suppliers experienced material and systematic differences between wholesale costs and the allowances designed to allow suppliers to recover those costs, and consequently whether an adjustment to future cap periods to account for those differences was required.[1]

1.2 The focus of this review is cap periods 9a to 10b (October 2022 to September 2023). This follows similar reviews of costs incurred over cap period eight (April 2022 to September 2022) and cap period seven (October 2021 to March 2022).

1.3 In addition to deciding whether to make an adjustment (chapter 3), we also summarise stakeholder responses to the discussion in the consultation document on our approach to ex-post adjustments (chapter 2), and on areas for future wholesale reviews (chapter 4).

1.4 Finally, we set out our decision to make technical changes to the Annex 2 model (chapter 5).

Our decisions

Case for adjustment

1.5 **We have decided not to make an adjustment to the cap.** This reflects our judgement that suppliers' efficient costs were not systematically different to the allowances over the period October 2022 to September 2023.

[1] These allowances include the core direct fuel allowance and additional direct fuel allowances, which account for shaping and imbalance costs, transaction costs, additional risk and uncertainty and Unidentified Gas (UIG) and electricity losses.

Technical changes to wholesale costs allowance (annex 2) model

1.6 **We have decided to proceed with our proposal to incorporate into our Capacity Market Methodology the new measure called 'peak relevant demand'**, which the Low Carbon Contract Company (LCCC) will publish. This is in anticipation of the relevant legislation being in place to facilitate the change to Energy intensive Industry (EII) exemption.

1.7 **We have also decided to proceed with our proposed changes to the presentation of demand shares in the model to enhance transparency.**

Our decision-making process

1.8 In coming to the above decisions, we have undertaken several steps where stakeholders have been able to provide their views.

1.9 In response to our consultation, some stakeholders have provided views on the process used to come to the decisions outlined in this document. We summarise and respond to these in chapter three.

Decision-making stages

Date	Stage description
February 2023	Call for input on additional wholesale allowances review, asking for stakeholder views on the scope of a potential review of the additional wholesale allowances.
July 2023	Open letter on reviewing additional wholesale costs covering October 2022 – September 2023, setting out the case for and scope of a review; Draft Request for Information (RFI) sent to all in scope suppliers for comment.
August 2023	Final RFI sent to all in scope suppliers to gather data and information on incurred wholesale costs (October 2022 – September 2023).
October 2023	Open update letter on reviewing additional wholesale costs, seeking views of relevant considerations when assessing whether an adjustment to the cap is appropriate. Treatment of RFI data putback to relevant suppliers for transparency and comment.

December 2023	Consultation setting out minded-to positions related to review of additional wholesale costs (October 2022 – September 2023) and proposed technical changes to Annex 2 model.

Related publications

1.10 The main general documents relating to the cap are:

- Domestic Gas and Electricity (Tariff Cap) Act 2018: https://www.legislation.gov.uk/ukpga/2018/21
- 2018 decision on the cap methodology ('2018 decision'): https://www.ofgem.gov.uk/publications/default-tariff-cap-decision-overview
- Energy Prices Act 2022: https://www.legislation.gov.uk/ukpga/2022/4

1.11 The main documents relating to this publication are:

- August 2022 decision on changes to the wholesale methodology: https://www.ofgem.gov.uk/publications/price-cap-decision-changes-wholesale-methodology
- February 2023 call for input on additional wholesale allowances review: https://www.ofgem.gov.uk/publications/price-cap-call-input-additional-wholesale-allowances-review
- April 2023 update to the price cap programme of work: https://www.ofgem.gov.uk/publications/price-cap-programme-work-update
- July 2023 CEO letter on changes in the energy supply market and Ofgem's approach to regulation: https://www.ofgem.gov.uk/publications/changes-energy-supply-market-and-ofgems-approach-regulation
- July 2023 open letter on reviewing additional wholesale costs: https://www.ofgem.gov.uk/publications/price-cap-open-letter-reviewing-additional-wholesale-costs
- October 2023 update letter on reviewing additional wholesale costs: https://www.ofgem.gov.uk/publications/price-cap-update-reviewing-additional-wholesale-costs
- December 2023 call for input on power market liquidity: https://www.ofgem.gov.uk/publications/call-input-power-market-liquidity

- December 2023 consultation on additional wholesale costs: https://www.ofgem.gov.uk/publications/energy-price-cap-wholesale-costs-review

General feedback

We believe that consultation is at the heart of good policy development. We are keen to receive your comments about this decision. We'd also like to get your answers to these questions:

1. Do you have any comments about the overall quality of this document?
2. Do you have any comments about its tone and content?
3. Was it easy to read and understand? Or could it have been better written?
4. Are its conclusions balanced?
5. Did it make reasoned decisions?
6. Any further comments

Please send any general feedback comments to priceprotectionpolicy@ofgem.gov.uk

Statutory framework of the cap

1.12 We set the cap with reference to the 2018 Act which requires us to put in place and maintain the licence conditions which give effect to the cap.[2] The objective of the Act is to protect current and future default tariff customers. We consider protecting customers to mean that prices reflect underlying efficient costs. In doing so, we must have regard to five matters:

- the need to create incentives for holders of supply licences to improve their efficiency;
- the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- the need to maintain incentives for domestic customers to switch to different domestic supply contracts; and
- the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.[3]

[2] Domestic Gas and Electricity (Tariff Cap) Act 2018, sections 1(1) and 1(2). https://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted
[3] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6). https://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

- the need to set the cap at a level that takes account of the impact of the cap on public spending.[4]

1.13 The requirement to have regard to the five matters identified in section 1(6) of the Act does not mean that we must achieve all of these. In setting the cap, our primary consideration is the protection of existing and future customers who pay standard variable and default rates. In reaching decisions on particular aspects of the cap, the weight to be given to each of these considerations is a matter of judgment. Often, a balance must be struck between competing considerations.

1.14 In setting the cap, we may not make different provisions for different holders of supply licences.[5] This means that we must set one cap level for all suppliers.

[4] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 1(6)(e) as inserted by Schedule 3 to the Energy Prices Act 2022. In performing the duty under section 1(6)(e) we must have regard to any information provided by the Secretary of State, or any guidance given by the Secretary of State on this matter (section 1(6A)).

[5] Domestic Gas and Electricity (Tariff Cap) Act 2018, section 2(2). http://www.legislation.gov.uk/ukpga/2018/21/section/2/enacted

2. Framework for considering an adjustment

Section summary

In this section, we summarise and consider stakeholder comments made in response to the consultation discussion of our approach to assessing under which conditions an adjustment to the cap is justified.

Context

2.1 In the December 2023 consultation, we discussed our approach to deciding when an ex-post adjustment is warranted or not. This was not with a view to changing our existing approach or developing new tests, but to provide greater transparency to stakeholders about our thinking on this topic and the associated nuances.

2.2 In this chapter, we summarise the approach described in the consultation document, which remains consistent with the approach taken in previous reviews. We also summarise stakeholder responses to this discussion.

Approach to ex-post adjustments

2.3 We currently only consider ex-post temporary adjustments to the cap where we identify that efficiently incurred costs have differed from allowed costs over a period in a systematic way which was unforeseen, clear, material and necessitates a change. This is in line with our approach to previous adjustments.

2.4 We also acknowledge the potential for asymmetry in considerations between downward and upward adjustments. In line with the Tariff Cap Act 2018, we will have regard to the impact adjustments may have on supplier incentives to improve their efficiency and compete for customers and customer incentives to switch suppliers. Downward adjustments may have different impacts on these factors than upward adjustments.

2.5 As with our approach to any aspect of the price cap, our approach to ex-post adjustments can change; subject to the requirements of the Tariff Cap Act and following public consultation.

Summary of responses

2.6 Stakeholders commented on our approach to ex-post adjustments, specifically those which lower the cap level in recognition of allowances having exceeded costs in previous periods, so called downward adjustments.

2.7 Most energy suppliers and one industry body told us that the potential for downward adjustments represented a regulatory risk which damages investor confidence and reduces their incentives to compete under the cap. Those suppliers said that those combined impacts hinder competition and eventually harm customers. One supplier went further and argued that Ofgem does not have the legal powers to make ex-post adjustments.

2.8 In contrast to these views, one consumer group told us that an asymmetric treatment of upward and downward adjustments would harm customers and that the potential impacts of downward adjustments on competition are exaggerated.

Considerations

2.9 Where possible, allowances should be set ex-ante to provide certainty around recoverable efficient costs. In our November 2018 price cap decision, we decided not to introduce a mechanism for correcting forecasting errors associated with ex-ante allowances.[6] However, in subsequent reviews we set out that not all forecast errors have the same impact.

2.10 Correcting for errors which are likely to net out over time and are non-systematic would introduce unnecessary uncertainty. However, where there are clear, material and unforeseen errors which necessitate changes to protect customers, then we have consistently stated that will consider the case for correction, including retrospective correction.[7,8]

2.11 As we have set out above, and in our December consultation, we accept that retrospective adjustments which lower the cap may impact competition and could penalise suppliers who passed on savings to customers. Under the cap act, we already must have regard to the impact of our decision on such factors, but those factors will have to be assessed in the round against all other factors relevant to a particular decision, including protecting customers.

2.12 As in previous reviews, for any future consideration of the case for an ex-post adjustment we will continue to consider whether the cap allows for the recovery

[6] By forecasting errors, we mean instances where the value of allowances set ex-ante do not end up being equal to what we would assess the costs to have been ex-post.
[7] Ofgem (2020)," Reviewing smart metering costs in the default tariff cap: May 2020 statutory consultation", paragraph 3.18 https://www.ofgem.gov.uk/publications/reviewing-smart-metering-costs-default-tariff-cap-may-2020-statutory-consultation
[8] We have variously used the phrases "systematic and material" and "clear, material and unforeseen" in different publications. We consider the meaning of these two phrases to be identical and do not represent different tests.

of efficient costs over the medium-term and will also look at the overall level of the cap by considering potential offsetting errors.

2.13 In this case, we have decided not to make an ex-post adjustment in either direction. We will continue to consider any specific ex-post adjustment very carefully against all relevant factors.

3. Wholesale adjustment

Section summary

This section sets out our decision to not make an adjustment to the cap, summarises stakeholders' responses to this, and provides our considerations on those comments. A high-level summary of our methodology and the results is provided (for further detail, please refer to the December 2023 consultation document).

Context

3.1 We compared aggregate wholesale costs reported by suppliers in their RFI responses against the combined value of wholesale allowances (excluding the additional risk allowance). We did this by calculating £ per typical SVT customer values for costs and allowances, for each fuel, and subtracting costs from allowances. These calculations are set out in detail in Appendix 1.

3.2 This approach resulted in the outcomes summarised in table 3.1 and figure 3.1 below. These show the distribution of outcomes across the ten suppliers in our sample.

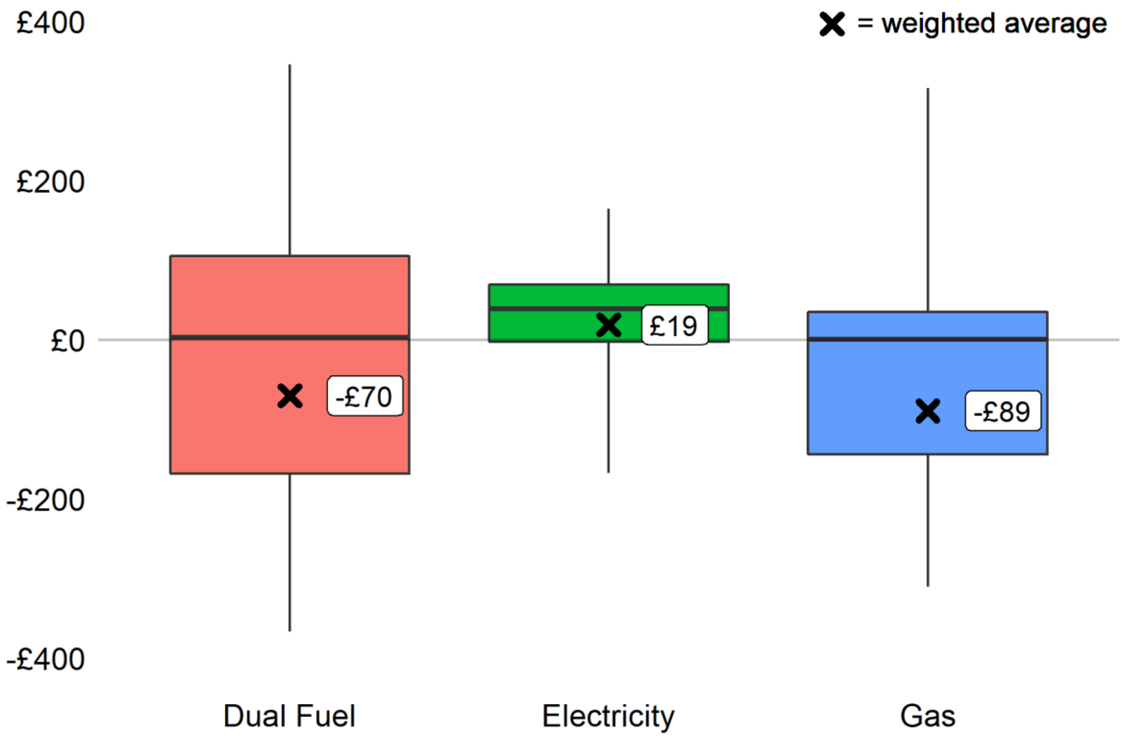
3.3 Suppliers' narrative responses to the RFI highlighted three main drivers of differences between wholesale costs and allowances:

- The role of reduction in customer demand in response to high retail prices and unseasonably warm weather (ie demand destruction);
- Unexpected SVT demand;
- Lack of liquidity for certain products, especially peak power.

Table 3.1: Wholesale allowances minus costs (per SVT customer at benchmark consumption) between October 2022-September 2023 (cap periods 9a-10b)

Measure	Dual fuel	Gas	Electricity
Weighted average	**-£70**	**-£89**	**£19**
Minimum	*-£367*	*-£311*	*-£167*
Lower quartile	*-£168*	*-£144*	*-£2*
Upper quartile	*£105*	*£35*	*£69*
Maximum	*£346*	*£316*	*£165*

Figure 3.1: Wholesale allowances minus costs, £ per SVT customer at benchmark consumption, total across cap periods 9a to 10b – dual fuel, gas & electricity (+ve indicates over-recovery, -ve under-recovery)



Notes: Boxes show the unweighted upper quartile, median and lower quartile values. Whiskers (vertical lines) show the maximum and minimum values among the 10 suppliers included. Bold crosses and labels show the customer weighted average values. Dual fuel weighted average calculated by summing gas and electricity weighted averages.

Decision

3.4 We have decided to make no adjustment to the cap for wholesale costs incurred between October 2022 and September 2023, in line with our consultation position. This reflects our assessment of the data provided by suppliers in response to the RFI, summarised above, which shows a wide range of realised wholesale costs across suppliers relative to allowances.

3.5 Of the ten suppliers in our sample, half recovered more from the allowances than their realised wholesale costs and half recovered less for a typical dual fuel customer. This suggests that supplier specific factors, such as individual risk management and hedging strategies, are more likely to explain the differences between costs and allowances over the period in question than any market wide factors or inadequacies in the allowances.

Summary of responses

3.6 We received responses from eight energy suppliers and one industry body, all of whom supported our proposal to make no adjustment for the difference between wholesale costs and allowances between October 2022 and September 2023. We note that one of the suppliers didn’t have a strong position. In addition, amongst these supportive responses, suppliers did also express some concerns and reservations about the approach taken to come to this position and the transparency of the decision-making process.

3.7 We also received one response from a consumer group. They opposed the proposal to not make an adjustment, stating that the change in assessment methodology made the conclusion reached inconsistent with previous adjustment reviews.

3.8 We summarise in detail these three areas of stakeholder feedback in the sub-sections below.

Review scope

3.9 A few stakeholders said that reviews of allowances should begin with a clear hypothesis of what caused costs to differ from the existing allowances. Potential adjustment reviews should not start by searching for material differences between costs and allowances, and then attempting to identify their causes.

3.10 One supplier added that having a clear starting hypothesis would enable Ofgem to perform targeted data requests and appropriate assessments. Another stakeholder stated that the lack of a clear hypothesis could lead to a constant search for deviations and causes, ultimately leading to repeated float and true-up adjustments.

Decision-making process

3.11 A few suppliers told us that they are concerned about the lack of transparency and robustness in this review. One said that this increases regulatory uncertainty for suppliers.

3.12 One supplier told us that confidentiality rings could have been used as part of this consultation as they have been used in the past and improve transparency. They also shared some criteria for assessing when confidentiality rings are appropriate.

Change in assessment methodology

3.13 One consumer group said that the methodology used to estimate the differences between wholesale costs and allowances differs from the one used in previous reviews. For cap period seven (October 2021 to March 2022) and cap period eight (April to September 2022), Ofgem considered suppliers' wholesale costs at a more granular level, disaggregating cost and customer types. Whereas, in this review (October 2022 to September 2023), Ofgem considered suppliers' costs at an aggregated total wholesale cost level.

3.14 This stakeholder suggested that Ofgem should either reopen the previous decisions (cap periods seven and eight) and apply the new aggregating methodology or disaggregate costs for this decision to ensure consistency in approach.

Other topics

3.15 One supplier disagreed with Ofgem's approach to estimating individual suppliers' costs. They told us that the types of activities that should be considered when calculating suppliers' costs are only those activities that the price cap explicitly assumes or even forces the notional supplier to undertake.

Considerations

Review scope

3.16 In the 18 July 2023 open letter, we informed all stakeholders about our intention to review suppliers' wholesale costs for default tariff customers between October 2022 and September 2023.[9] For each cap period considered, we set out a specific hypothesis as to why wholesale costs may have differed from the cap allowances.

3.17 For cap periods 9a (October 2022 – December 2022) and 9b (January 2023 – March 2023), we highlighted that wholesale prices remained volatile and that this may have led to higher shaping and imbalance costs than accounted for in the allowances.

3.18 For cap period 10a (April 2023 – June 2023), we noted that the extension of the Energy Price Guarantee (EPG) at £2,500 per year for a further three months with

[9] Ofgem (2023), "Price cap – Open letter on reviewing additional wholesale costs", https://www.ofgem.gov.uk/publications/price-cap-open-letter-reviewing-additional-wholesale-costs

limited notice may have left suppliers with unhedged SVT customers. In a declining price environment this may have led to a benefit for suppliers relative to the wholesale allowances. Similarly, for cap period 10b (July 2023 – September 2023), we noted the low switching to fixed tariffs and set out our intention to consider whether this had led to unexpected SVT demand.

3.19 We consider that the 18 July 2023 letter clearly laid out our starting hypotheses for this review. We gathered information to test these hypotheses, while ensuring that we had a full dataset for completeness. However, as with any review, we were also led by the evidence we received, including suppliers own accounts of the drivers of wholesale costs they faced, as provided in response to our RFI. We discuss in more detail the rationale for considering costs and allowances at an aggregate level when considering our change of assessment approach in a later sub-section (paragraphs 3.27-3.32).

Decision-making process

Robustness

3.20 In the 18 July 2023 letter, we said that, should our analysis of the data suggest that an adjustment is necessary, we would publish a consultation in late September. After collecting and analysing the RFI submissions, we decided to reschedule the consultation for late November/early December (see the October 2023 update letter). This change was made after we realised more time was needed to engage directly with suppliers to better understand their submissions and strengthen our confidence in the analysis.

3.21 In addition to adjusting the workstream timeline, we also introduced a putback process, which involved sharing individually with each supplier our calculations using the data they provided. This process gave suppliers the opportunity to comment on our calculations and refine their data to improve comparability. As part of this process, we had extensive dialogue with suppliers. This also allowed us to correct any identified inconsistencies in our calculations.

3.22 We consider that changes in the timeline, as well as the introduction of the putback process and consequential engagement with suppliers, demonstrates that the review process has been adaptable and robust.

Transparency

3.23 Ahead of the December consultation, suppliers had already expressed concerns about transparency, with one flagging that Ofgem should have shared underlying data through a confidentiality ring or by other means.

3.24 Through the putback process, we have shared with them our calculations using their data as well as a detailed and clear explanation of our relatively simple methodology for estimating the difference between wholesale costs and allowances. Following extensive further dialogue with suppliers, we have also used the consultation document to provide them with more clarifications and details on our methodology.

3.25 When taking into consideration the nature of this review, we consider that the steps above have provided suppliers with sufficient information for a meaningful consultation. There was likely to be minimal additional relevant information suppliers could have gained through a confidentiality ring. In addition, given the costs, time and resources required to run and participate in such process, combined with the increased risk of leakage of confidential data, we consider that it was not appropriate for this review.

3.26 Further detailed discussion of costs and benefits of a full disclosure process as it would have applied to this review can be found in the December 2023 consultation.[10]

Change in assessment methodology

3.27 In this review, we decided to consider suppliers' wholesale costs at an aggregated level, rather than to consider individual cost drivers such as bulk purchases, shaping and imbalance costs. We also did not seek to differentiate between expected SVT and unexpected and unhedged SVT customers, or by payment type (PPM and non-PPM customers).

3.28 Building on our experience of previous reviews, we gathered wholesale costs broken down by cost, customer and payment type, ensuring that we had a full dataset for completeness. However, after reviewing RFI submissions, it became apparent that suppliers had used materially different methods for allocating costs across bulk, shaping, imbalance, as well as across different customer categories and payment methods. This made comparing costs at a granular level difficult as variations between costs and allowances across suppliers could have been due to methodological differences. As a result, we decided to consider suppliers' wholesale costs at an aggregated level as it provided for greater comparability between suppliers compared to using this dataset at a disaggregated level.

[10] Ofgem (2023), "Energy price cap wholesale costs review", paragraphs 4.3-4.12 https://www.ofgem.gov.uk/publications/energy-price-cap-wholesale-costs-review

3.29 When considering the case for an adjustment, we seek to use the most relevant evidence to determine whether costs have materially and systematically diverted from the cap allowances. What constitutes the most relevant evidence will vary depending on the specifics of the review periods in question.

3.30 The decision to use aggregated costs and allowances in this review reflects both learnings from previous reviews and issues specific to the periods in question. This includes the increased role of demand destruction, which was not a material issue during cap periods seven and eight.

3.31 The presence of significant demand destruction increased the impact of methodological choices on suppliers' reported costs related to unexpected SVT demand. This reflects the difficulties in disaggregating unexpected changes in demand per customer from unexpected changes in number of SVT customers. In other words, the circumstances were different for this review, and our comparability concerns were even more acute, leading us to decide to focus on aggregate costs and allowances.

3.32 We consider that our approach to each review has been appropriate, and that we must be able to evolve and adapt our analysis methodologies to fit the circumstances of each case, as well as learn from previous reviews and decisions.

Other topics

3.33 A supplier raised that when comparing individual suppliers' costs and allowances, Ofgem included activities that are outside of the price cap (ie that are not covered by a particular allowance).

3.34 We would like to reiterate that we have considered excluding/including those activities on a case-by-case basis.

3.35 It was not our intention to adjust suppliers' costs to align with the purchasing approach implied by the wholesale allowances and only then compare them against those allowances.

3.36 Instead, we sought to compare the total wholesale costs suppliers faced in meeting customer demand against the level of the wholesale allowances available. We then considered whether any differences reflected systematic issues with the level of the allowances or whether they reflected other drivers, such as commercial decisions.

4. Review of enduring wholesale allowances and methodologies

Section summary

This section summarises stakeholders' responses to the questions posed in chapter five of the December 2023 consultation regarding the scope of any potential future reviews of the wholesale allowances and associated price cap methodologies.

Context

4.1 Our November 2022 Programme of Work first set out our intention to review the additional wholesale allowances. These allowances cover ancillary costs that suppliers incur when purchasing energy to meet SVT customer demand for each cap period. They include allowances for shaping bulk energy contracts into more granular products, cost associated with the balancing mechanism, transaction costs, costs related to unidentified gas and an additional risk allowance. They are applied as percentage uplifts to the direct fuel costs and backwardation allowances for each cap period.

4.2 In February 2023, we published a call for input seeking feedback on the case for, and the potential scope of, a review of these additional wholesale allowances. Overall, respondents expressed support for the review but offered mixed opinions on when the review should start. Respondents expressed concerns about wholesale costs incurred over the October 2022 – September 2023 period.

4.3 As a result, and as set out in our April 2023 updated Programme of Work, we decided to pause the review of the additional wholesale allowances. This allowed us to conduct a shorter-term review of wholesale costs incurred over the winter 2022/23 period, the culmination of which is the decision to not make an adjustment, as set out in this document.

4.4 Having now completed this shorter-term review, we intend to return to a review of the enduring wholesale allowances and methodologies. In addition to this, our Programme of Work sets out an intention to review the wholesale related decisions made in August 2022. These were to move to a quarterly cap, with associated reduction in notice period and to introduce an ex-ante allowance for backwardation costs outside of a deadband[11], recovered over a six-month period[12].

4.5 Given the length of time since the February 2023 call for input, as part of our December 2023 consultation we sought updated feedback from stakeholders on the scope of any future wholesale review. In that consultation, we highlighted the following three areas as potential priorities for any future wholesale review:

i. Additional wholesale allowance methodologies
ii. Review of the policy to move to quarterly cap updates
iii. Wholesale methodology under market-wide half hourly settlement (‘MHHS’)

4.6 In this chapter, we summarise stakeholder responses to questions asked about topics for future review in chapter five of the December 2023 consultation. We hope to provide further details on our proposed approach to future wholesale reviews in a spring 2024 update to the Price Cap Programme of Work.

Summary of responses

Additional wholesale allowance methodologies

Prioritisation

4.7 Most of the suppliers who responded to the consultation were supportive of a review of the additional wholesale allowances. However, only a few told us to prioritise this over other areas. The allowances for transaction costs and Unidentified Gas (‘UIG’) were each mentioned by at least one supplier as needing review as they no longer accurately reflect costs.

4.8 Some suppliers urged Ofgem to prioritise the review of other cap components, such as the Contract for Difference (‘CfD’) allowance. More detailed information can be found in the ‘CfD’ and ‘Other topics’ sections below.

[11] The backwardation allowance is a two-sided allowance, it can be a cost to customers (backwardation) or a benefit (contango).
[12] In the 18 July letter we said that, in addition to reviewing potential additional wholesale costs, we intended to also review the recovery period for the backwardation costs in the cap. However, in the consultation we did not cover this point, which will instead form part of a future review of the enduring wholesale allowances and methodologies.

Methodology

4.9 A supplier said that wholesale allowances should be set based on a forward-looking assessment of potential outcomes for the relevant price cap period, instead of rolling forward historical costs. In their view, the past is not always a good predictor of the future. They also told us that suppliers need more clarity on which risks suppliers are expected to manage, and consequently which allowances are subject to retrospective review and which ones are not. To that extent, they consider two categories of allowances:

- For the costs that Ofgem expects suppliers to risk manage, an allowance should be set recognising the potential range of cost outturns and the cost of sourcing risk management products. Such allowances should not be subject to ex-post review.
- For costs that Ofgem does not expect suppliers to risk manage, an allowance should be set and always be subject to ex-post reconciliation.

4.10 The same supplier urged Ofgem to reassess the removal of the Market Stabilisation Charge ('MSC') as part of any wholesale allowances review. When the MSC is removed, they want to see an increase in wholesale allowances to enable suppliers to manage increased risk.[13]

4.11 Another supplier told us that when reviewing the wholesale allowances, Ofgem should consult on the underlying models and ensure an adequate level of transparency.

4.12 Another supplier told us that the review of the wholesale allowance methodologies should include addressing issues such as the Group Correction Factor ('GCF') that are used during the settlement process and the assumption that 30% of electricity consumption happens in peak hours. Ofgem should also keep seasonal normal demand assumptions under review, as well as peak power products liquidity.

[13] The open letter we published on the 12 October 2023 sets out our intention to allow the MSC to expire at the end of its current extension period in March 2024: https://www.ofgem.gov.uk/publications/future-market-stabilisation-charge-after-march-2024

Quarterly cap updates and backwardation

Quarterly cap updates

4.13 A few suppliers were supportive of a review of the policy to move to quarterly cap updates. In general, this reflected the view that the balance of costs versus benefits of quarterly updates may have changed as wholesale market conditions have stabilised.

4.14 Some suppliers said that quarterly updates had caused market liquidity issues. One explained that illiquidity led to increased costs from holding larger basis risks.[14] The same supplier also said that moving to quarterly updates increased operational burden and costs, due to a rise in customer contact and workload associated with more frequent price cap updates.

4.15 On the other hand, a different supplier told us that the move to quarterly had brought clear benefits in terms of suppliers' exposure to wholesale volatility. It had also worked well in an environment of declining prices and volatility.

4.16 Only one supplier said that the quarterly review should be prioritised, alongside the wholesale allowances review. One asked Ofgem to demonstrate that the move to quarterly updates is having significant impacts on customers before considering whether to review the wholesale methodology, as any significant changes will by definition only be in place for less than two years before MHHS commences.

4.17 One supplier told us that they see material benefits in moving back to seasonal cap updates. However, they also added that other changes would be needed. The move to quarterly updates and the shorter notice period have reduced the delay between when commodity hedges are bought and delivered, ultimately reducing suppliers' risks. They flagged that moving back to seasonal cap updates would then increase suppliers' risks. This would not be problematic if the MSC was to remain post-March 2024. However, if that was not the case, they expect the wholesale allowances to reflect increased risks.

Backwardation

4.18 One supplier said that quarterly cap updates make it more difficult to procure suitable backwardation hedging products to manage the deadband exposure. This

[14] Basis risk means that a supplier would see differences between the costs it incurred and the indexed allowance provided – for example, if the supplier bought different wholesale products with greater availability.

was not the case before the August 2022 decision to move away from seasonal cap updates, as seasonal products tend to be more liquid.

4.19 One supplier told us that we should review the backwardation allowance methodology. They said that adopting a longer-term hedging strategy would lead to greater price stability for customers as prices volatility would be smoothly incorporated into prices.

Market-wide half hourly settlement

Prioritisation

4.20 Most of the suppliers who responded to the consultation told us that reviewing the wholesale allowances in light of the move to MHHS should be low priority compared to other areas. One supplier said that MHHS will only be introduced in 2027 and there was therefore time to address any implications for the price cap.

Methodology

4.21 Two suppliers told us that changes to the wholesale allowances should include regulatory and methodological changes needed to support the move towards flexibility products, such as Time of Use (‘ToU’) tariffs. One said that Ofgem should begin this review by assessing who the price cap is intended to protect, and what tariffs they will likely be on (eg single rate, static or dynamic multi rate).

4.22 One supplier commented on the potential impact of retaining the current shaping allowance methodology post-MHHS. They suggest that customers who use their energy in cheaper off-peak periods should be offered lower priced tariffs compared to customers who use their energy in high-priced peak periods, as their shaping costs are lower. The current shaping allowance is based on the average demand shape of domestic customers. They recommend introducing a shaping profile for a customer with high usage in peak periods.

4.23 A supplier told us that, even though the future impacts of MHHS are uncertain, Ofgem should already consider adjusting the wholesale methodology so that, for example, it adapts automatically to changes in the consumption profile for non-ToU tariffs, eg the mix of peak versus baseload. They also pointed out that MHHS changes will result in significant costs for suppliers that should be accounted for in the cap allowances.

Contract for Difference (CfD)

4.24 Most of the suppliers who responded to the consultation urged Ofgem to review the CfD allowance as they said that suppliers tend to under-recover CfD costs.

4.25 Two suppliers recommended Ofgem consider a reconciliation mechanism to reconcile CfD outturn costs with forecasts. They said that this would make the GB energy sector more resilient to market shocks.

Other topics

4.26 A few suppliers asked Ofgem to carry out a broader review of retail price regulation. One of them told us that a complete bottom-up review of the cap components would improve cost reflectivity and allow Ofgem to review the price cap under the lenses of future-proofing and affordability.

4.27 One supplier told us that several areas within the price cap, such as gas transportation costs and ECO, need urgent attention as suppliers are under-recovering and have no or limited ability to control these costs.

4.28 One supplier urged Ofgem to significantly simplify and streamline the price cap. Ofgem should consider what could be done to ensure that the cap only applies to default and not evergreen tariffs. They also recommended a simplified approach, where wholesale allowance is set quarterly and other costs are passthrough and set less frequently (eg annually).

Next steps

4.29 We thank stakeholders for the time they have taken to engage with the scoping of the potential next phase of the wholesale review and recognise the value of their views on the areas that we should prioritise.

4.30 We will consider this feedback ahead of communicating further our intended approach to reviewing wholesale allowances in the future via an update to the Price Cap Programme of Work in spring 2024.

5. Technical Changes to 'Annex 2 - Wholesale Cost Allowance Methodology' Model

Section summary

This section summarises stakeholder responses to proposed technical changes to the Annex 2 Wholesale Costs Allowance Methodology model. We confirm our decision to make changes to the model to improve the historical transparency of demand share values and to incorporate into our Capacity Market Methodology the new measure called 'peak relevant demand'.

Context

5.1 In appendix 4 of the December 2023 consultation, we proposed two minor technical changes to the Annex 2 – Wholesale Cost Allowance Methodology model. We proposed changes to Annex 2 demand share values to improve transparency. We also proposed to have regard to a new input 'peak relevant demand' within the Capacity Market Allowance, which we expect will replace a previous input known as 'peak gross demand'.

Decision

5.2 We have decided to proceed with the proposed changes to tab '3b Demand'. This will make all relevant demand share values for each fuel and meter type available for all historic and future periods.

5.3 We have also decided to proceed with our proposal to incorporate into our Capacity Market Methodology the new measure called 'peak relevant demand', which we expect the Low Carbon Contract Company (LCCC) to publish going forward. We will use the new 'peak relevant demand' input for the calculation of the April – June 2024 cap level, should this input be publicly available to allow us to do so. We are making this decision in anticipation of the relevant legislation being in place to facilitate the change to Energy intensive Industry (EII) exemption.

5.4 Both changes will take effect from April 2024 (ie from Charge Restriction Period 12a) onwards.

Summary of responses

5.5 We received responses from three suppliers supporting the changes to the communication of demand shares. No respondents opposed the changes.

5.6 We received one response to our question on our proposal for a change in Capacity Market Cost Allowance Methodology, which was from an energy supplier. The supplier noted they would have welcomed more advance notice of how the prospective new Capacity Market input changes will be structured.

Considerations

5.7 We note the point raised over greater advanced notice and recognise the benefits of increased notice in allowing suppliers to accommodate such a change within their systems and models. We will endeavour to do this where possible but note that Ofgem does not have responsibility over the Capacity Market inputs, as responsibility is held by another organisation.

5.8 For the avoidance of doubt, we are making this change on the basis that the relevant legislation is in place by 1 April 2024 as expected, to give effect for the change to EII exemption for which this input relates to. We will work with LCCC and industry, as appropriate, should the relevant legislation not be in place as expected. In February 2024, we have also set out more detailed proposals[15] for our intended approach to amending the price cap methodology, should the relevant legislation not be in place by 1 April as expected.

[15] Ofgem (2024), Changes to the timing and availability of price cap inputs, https://www.ofgem.gov.uk/publications/changes-timing-and-availability-price-cap-inputs

Appendices

Appendix 1 – Methodology to compare the wholesale allowances and costs

Variable indices

i= supplier

j = cap period

p = {Electricity, Gas}

q = {non-PPM, PPM}

r = {Other SVT, Unexpected SVT}

s = region

Costs per SVT customer

A1.1 We calculate the cost per SVT customer simply as the total wholesale costs divided by the total number of SVT customers for each supplier (**i**), cap period (**j**) and fuel (**p**).

$$Cost\_per\_customer_{i,j,p} = \frac{\sum_{qr} Total\_Wholesale\_costs_{i,j,p,q,r}}{\sum_{qr} Customers_{i,j,p,q,r}}$$

Where;

$$Total\_Wholesale\_costs_{i,j,p,q,r} = Bulk\_wholesale_{i,j,p,q,r} + Shaping_{i,j,p,q,r} + Imbalance_{i,j,p,q,r}$$

Allowance per SVT customer

A1.2 We calculate the wholesale allowances per SVT customer for each supplier (**i**), cap period (**j**), fuel (**p**) and payment type (**q**) by multiplying the allowance per unit (£/MWh) by the average consumption per customer.

$$Allowance\_per\_customer_{i,j,p,q} = Allowance\_per\_MWh_{j,p,q}\ Average\_consumption_{i,j,p,q}$$

A1.3 As allowances differ by payment type (**q**) we calculate the allowance per customer for each payment type and then take a customer weighted average.

$$Allowance\_per\_customer_{i,j,p} = \frac{\sum_q Allowance\_per\_customer_{i,j,p,q} Customers_{i,j,p,q}}{\sum_q Customers_{i,j,p,q}}$$

A1.4 Where average consumption is a weighted average across SVT customer segments (**r**) (unexpected and other);

$$Average\_consumption_{i,j,p,q} = \frac{\sum_r Average\_consumption_{i,j,p,q,r} Customers_{i,j,p,q,r}}{\sum_r Customers_{i,j,p,q,r}}$$

A1.5 And where the allowance per unit is calculated as below;

$$Allowance\_per\_MWh_{j,p,q} = direct\_fuel\_index_{j,p,q}(1 + Uplifts_{j,p})$$

Where;

$$Uplifts_{j,p} = \sum\big(shaping\_allowances_{j,p} + imbalance\_allowance_{j,p} + transaction\_costs_{j,p} + losses_{j,p}\big)$$

And;

$$losses_{j,p} = I_p\, UIG_j + \left(1 - I_p\right)\left[1 - \frac{\sum_s power\_losses_{j,s}}{14}\right];\; I_p = \begin{cases} 1 \; if \; p = Gas \\ 0 \; otherwise \end{cases}$$

A1.6 The allowance variables are taken from the sources below for each cap period (**j**) and fuel (**p**) and payment type (**q**).

Variable	Source(s)
$direct\_fuel\_index_{j,p,q}$	For cap period 9a (October 2022-December 2022) and 9b (January 2023 – March 2023) we use the Annex 2 model v1.15[16] as published on the 27 February; sheet "8a(iii) Backwardation calc"; reference AB16:AC19 For cap periods 10a (April 2023 – June 2023) and 10b (July 2023 – September 2023) we use the Annex 2 model v1.171[17] as published on the 25 May 2023; sheet "8a(iii) Backwardation calc"; reference H136:I139
$shaping\_allowances_{j,p}$	Annex 2 model v1.171[22]; sheet "3a allowances" Electricity Single-Rate Metering Arrangement: Seasonal to monthly shaping + Monthly peak/baseload to hourly shaping + Rehedging day ahead Gas non-PPM & PPM: Quarterly to monthly shaping + Rehedging day ahead
$imbalance\_allowance_{j,p}$	Annex 2 model v1.171[22]; sheet "3a allowances"; Imbalance
$transaction\_costs_{j,p}$	Annex 2 model v1.171[22]; sheet "3a allowances"; Transaction costs
UIG_j	Annex 2 model v1.171[22]; sheet "3a allowances"; Unidentified gas
$power\_losses_{j,s}$	Annex 2 model v1.171[22]; sheet "3a allowances"; Tab 3c Electricity Losses; Single-Rate Metering Arrangement

Comparison between costs and allowances

A1.7 We calculate the difference between costs incurred and the allowances simply by subtracting the former from the latter for each supplier (**i**), cap period (**j**) and fuel (**p**).

$$Delta_{i,j,p} = Allowance\_per\_customer_{i,j,p} - Cost\_per\_customer_{i,j,p}$$

[16] Ofgem (2023), "Default tariff cap level: 1 April 2023 to 30 June 2023" , https://www.ofgem.gov.uk/publications/default-tariff-cap-level-1-april-2023-30-june-2023
[17] 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