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Dear Leonardo,

Consultation on amending the methodology for setting the Contracts for Difference (CfD) allowance

We are pleased to respond to your consultation on options to amend the CfD allowance in the price cap to make it more reflective of the CfD-related costs and benefits to suppliers; in particular, whether to **enable the allowance to be negative** when forecast CfD payments from suppliers are negative (ie suppliers are paid) and whether to **reconcile** the expected levy payment with actual CfD payments.

We set out our views on Ofgem's proposals in Annex 1. In summary:

1. We agree with Ofgem's proposal to amend the CfD allowance to **allow negative payments** (Options 2 and 3). We agree that this should be reflected in the CfD allowance in the price cap and, as such, we do not support option 1 (status quo).
2. We prefer option 3 which **reconciles** actual costs to the forecast costs over Ofgem's minded-to position (option 2) not to reconcile the forecast allowance to actuals:
 - It is more accurate since it passes exact costs through and therefore customers pay an accurate price
 - Suppliers avoid the risk of hedging CfD allowances for price cap customers - a benefit that is not considered in Ofgem's assessment
 - We do not consider the reconciliation in option 2 would be too complex (as Ofgem suggests) and we would be happy to work with Ofgem to address any issues (as we have in the implementation of other requirements related to the Default Tariff Cap). We propose a high-level approach in Annex 1 attachment.
3. Ofgem was silent in this consultation on how frequently the CfD allowance would be updated when there is a quarterly cap to be introduced. Ofgem has now confirmed that it would be updated quarterly, and we consider that it is likely that updating the CfD allowance quarterly rather than six monthly could reduce the volatility and

uncertainty of the different options. We would encourage Ofgem consider the impact of doing so in more detail.

If you would like to discuss any aspect of our response, please do not hesitate to contact me.

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The signature is written in a cursive style with a large initial 'R'.

Richard Sweet
Head of Regulatory Policy

**CONSULTATION ON AMENDING THE METHODOLOGY FOR SETTING
THE CONTRACTS FOR DIFFERENCE (CFD) ALLOWANCE
– SCOTTISHPOWER RESPONSE**

1. Introduction

The consultation sets out options to amend the CfD allowance in the price cap to make it more reflective of the CfD-related costs and benefits to suppliers. The current CfD allowance is based on the Interim Levy Rate (ILR). The ILR is used to fund the day-to-day CfD payments to generators and is chargeable as a £/MWh rate on eligible demand daily. Although day-to-day CfD payments to generators may be negative, ie generators pay the Low Carbon Contracts Company (LCCC), the ILR has a floor of zero. As a result, the CfD allowance in the cap currently has a floor of zero. This is not reflective of the costs of CfDs to suppliers when wholesale prices are materially higher than the CfD strike price for an extended duration. In this case suppliers receive a payment from generators via the LCCC.

There are two elements to this consultation:

- 1 Ofgem is proposing to change the CfD allowance in the price cap, replacing the ILR with an expected levy payment. This would **enable the allowance to be negative** when forecast CfD payments from suppliers are negative (ie suppliers are paid). Ofgem's options 2 and 3 contain this element but option 1 (status quo) does not.
- 2 Ofgem is also considering whether to **reconcile** the expected levy payment with actual CfD payments. (Option 3).

2. Allowing negative payments

We agree with Ofgem's proposal to amend the CfD allowance to allow negative payments. The ILR floor was set to zero so that the LCCC did not have to pay suppliers on a £/MWh rate daily. Its inclusion in the calculation of the CfD allowance in the price cap has not been an issue up until now. Since wholesale prices have been and are forecast to continue to be higher than CfD payments, the ILR floor has been triggered. Without this floor, the ILR would have been negative. We agree that this should be reflected in the CfD allowance in the price cap and as such we do not support option 1, status quo.

3. Reconciliation

We support option 3 which reconciles actual costs to the forecast costs for two reasons:

- 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.

We do not agree with Ofgem's minded-to position (option 2) not to reconcile the forecast allowance to actuals. The risks that CfD hedging poses for suppliers are not

considered in the assessment. Ofgem says it does not prefer option 3 for feasibility and customer impact issues and we address these in turn below.

Feasibility

Ofgem cites a complex reconciliation method as one disadvantage of option 3. Ofgem also suggests that the time lag associated with reconciliation may create further risks to suppliers, in particular:

- **cashflow** issues; and
- increased risk of gains and losses due to **customer number movement**.

Reconciliation process

Whilst a reconciliation process would be more complex than having no reconciliation, we do not believe that the reconciliation method would need to be very complex and are happy to work with Ofgem and suppliers to deliver this. Ofgem does not discuss the design of a mechanism or specify where the particular issues arise, and it is therefore difficult to go into specifics in response. However, we do not think a lag of 6 months would make this a particularly complex process.

Table 1 provides an illustrative example of how the reconciliation adjustment could be calculated, on the assumption of a quarterly cap with a quarterly updated to the CfD allowance (as Ofgem has recently proposed). The detailed calculations are contained in a spreadsheet accompanying this response.

Table 1: Illustrative example of reconciliation calculation

		Price Cap period 1a	Price Cap period 1b	Price Cap period 2a	Price Cap period 2b	Price Cap period 3a	Price Cap period 3b	Price Cap period 4a	Price Cap period 4b
		CfD allowance year				CfD allowance year			
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
CfD year 1	Apr to Jun of CfD year	7.09	7.20	7.60	7.60				
	Jul to Sep of CfD year	6.37	6.40	6.60	6.80	6.80			
	Oct to Dec of CfD year	6.49	6.80	7.00	7.20		6.86		
	Jan to Mar of CfD year	6.26	6.30	6.50	6.70			7.00	
CfD year 2	Apr to Jun of CfD year					8.09	8.20	8.60	8.60
	Jul to Sep of CfD year					7.37	7.40	7.60	7.80
	Oct to Dec of CfD year					7.49	7.80	8.00	8.20
	Jan to Mar of CfD year					7.26	7.30	7.50	7.70
Demand weight, profile class 1	Apr to Jun	21.9%	21.9%	21.9%	21.9%	21.9%	21.9%	21.9%	21.9%
	Jul to Sep	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%	21.0%
	Oct to Dec	28.8%	28.8%	28.8%	28.8%	28.8%	28.8%	28.8%	28.8%
	Jan to Mar	28.3%	28.3%	28.3%	28.3%	28.3%	28.3%	28.3%	28.3%
Total reconciled supply volumes - most recent full year		255,959,956				258,123,456			
Green Excluded Electricity cap		13,072,916				13,600,600			
GEE uplift		5.4%	5.4%	5.4%	5.4%	5.6%	5.6%	5.6%	5.6%
Op cost levy (£/MWh)	Not used for purposes of this eg	0.08	0.08	0.08	0.08	0.08	0.08	0.08	0.08
ELP weighted by demand (£/MWh)		6.88	7.02	7.28	7.44	7.95	8.09	8.35	8.51
Reconciliation Adjustment (£/MWh)					0.043	0.05	-0.01	0.15	
Allowance incl REC (£/MWh)					7.48	8.00	8.08	8.50	

This approach assumes that:

- The reconciled rates are daily rates so would need to be defined as a weighted average (LCCC shows the demand too to allow this).
- Further updates to the reconciled rates as per the settlement process are excluded for simplicity
- The same forecast weightings for reconciliation as is used in calculation of the CfD allowance are used for simplicity
- GEE is not reconciled for simplicity but there could be further consideration on whether to amend GEE in light of actuals

This approach works with the timeline of when the CfD forecast and reconciled rates are published by LCCC as well as fitting well with a quarterly cap.

Cashflow

With regards to cashflow, we do not see this as a significant issue. There is the potential for slightly more volatility in this relatively small element of the cap and we are actually already dealing with cashflow issues in relation to the actual CfD reconciliation. The cashflow impacts would be reduced with a quarterly cap.

Impact of customer movement

There is a risk that if there is customer movement between cap periods then the actual cost will not be reflected. [X]

We cannot hedge for changes in the generation output so will likely be disadvantaged by this.

We consider that for suppliers the risks associated with hedging, which include changes to customer numbers, outweigh the risk of gains and losses due to customer movement.

Customer impact

Ofgem states that “the reconciliation process in option 3 ensures customers pay a more accurate price but potentially exposes them to more volatility and uncertainty”

We consider that customers *actually* paying an accurate price outweighs any *potential* for volatility and uncertainty. Although there is the potential for slightly more volatility in this relatively small element of the cap (less than 1% by value) we do not believe this will be significant in the scale of volatility that is seen with regards to wholesale prices, network costs and other more significant costs between cap periods. In addition, we consider there would be less volatility and uncertainty if there was a quarterly cap.

ScottishPower
May 2022