

All stakeholders

Email: RetailPriceRegulation@ofgem.gov.uk

Date: 7 February 2019

Dear stakeholders,

Decision: Capacity Market allowance in the default tariff cap

On 15 January 2019, we issued an open letter about the Capacity Market (CM) allowance in the default tariff cap.¹ We set out potential options for the CM allowance in the second cap period, which will run from 1 April to 30 September 2019. This reflected the uncertainty about whether and when suppliers would be required to make CM payments in relation to this cap period.

This letter sets out our decision. This affects the level of the cap for the second cap period, which we have published today.²

Summary of decision

We have decided to include a full CM allowance in the second cap period. This allowance covers the costs associated with the CM Supplier Charge, as well as the administrative costs of the CM scheme.

In reaching this decision, we have carefully considered feedback from stakeholders. Annex 1 provides a high-level summary of stakeholders' views, and gives our response where relevant.

Our decision also reflects a letter from government to Ofgem dated 1 February 2019, following its December 2018 consultation on 'Proposals for technical amendments to the Capacity Market'.³ The government indicated that, subject to European Commission approval of the CM that would permit this, it intends "to ensure that suspended payments are made to holders of Capacity Market agreements for 2018/19". It said that it "would expect suppliers' contributions to the scheme to be determined according to the current charging methodology based on peak-time demand over 2018/19". Given this, we consider it would be reasonable for suppliers to collect these costs from their customers, including those on default tariffs.

¹ Ofgem (2019), Capacity market allowance in the default tariff cap.

https://www.ofgem.gov.uk/system/files/docs/2019/01/capacity_market_default_tariff_cap_letter_final_0.pdf

² Ofgem (2019), Default tariff cap level: 1 April 2019 – 30 September 2019.

<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-level-1-april-2019-30-september-2019>

³ BEIS (2018) Proposals for technical amendments to the Capacity Market.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767015/proposals-for-technical-amendments-to-the-capacity-market.pdf

In the event that the European Commission does not provide State Aid approval for deferred payments, we expect suppliers to reimburse customers. In this circumstance, we would consult on the best way to ensure that consumers recover any unnecessary charges relating to the CM scheme.

To set the CM allowance in the cap, our methodology uses data from the CM auctions for the relevant delivery years. Data is not yet available from the T-1 auction for the 2019-20 CM delivery year, as the auction has been delayed. To apply the methodology to the second cap period, we have estimated the costs of the T-1 auction. We have also fixed a minor error in relation to CM administrative costs. Annex 2 provides detail of how we have calculated the CM allowance.

Background

The default tariff cap came into effect on 1 January 2019. It sets the maximum price per unit of energy⁴ that a supplier can charge its customers on standard variable and default tariffs. In order to set this maximum charge we estimate the efficient cost of each component of a customer's bill (eg wholesale costs, network costs and operating costs).

One element within the cap is the CM Cost Component. This reflects the costs of the CM scheme. At a high level, we calculate the CM Cost Component using information on: the amount of obligated capacity procured, the capacity payments to generators (and other capacity providers) determined through the auctions, and the peak demand base. We determine these costs on a fiscal year basis (eg April 2018 to March 2019), using a weighted average of the costs for the two CM delivery years which overlap the fiscal year. The allowance also includes the administrative costs of the CM scheme. Appendix 4 of our decision on the default tariff cap explains the methodology in more detail.⁵

The 15 November 2018 judgement of the General Court of the Court of Justice of the European Union⁶ had the effect of removing the European Commission's State Aid approval for the GB CM scheme. This introduced a standstill period⁷ until the scheme can be approved again.

Implication of the standstill period for the second cap period

The first cap period runs from 1 January to 31 March 2019. We set the level of this cap period on 6 November 2018. This level includes a full CM allowance.

The Court's subsequent judgement, and the standstill period, created uncertainty about what should happen to the CM allowance for future cap periods. The second cap period runs from 1 April to 30 September 2019. We must publish the cap level for the second cap period by the fifth working day in February. At this point, we do not know whether the European Commission will provide State Aid approval for the CM scheme. The European Commission's decision will determine whether there are any CM payments to capacity providers, and therefore ultimately any costs to suppliers. At the point we update and publish the cap level, we therefore do not know definitively whether there are costs to include in the cap or not.

At this point, we also do not know when the European Commission will make its State Aid decision. However, the government has previously referred to "the unlikely event that the

⁴ The cap also sets an implied maximum standing charge.

⁵ Ofgem (2018) Default tariff cap: decision. Appendix 4, paragraphs 2.35 to 2.37.

https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf

⁶ <http://curia.europa.eu/juris/document/document.jsf?text=&docid=207792&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=1430154>

⁷ The 'standstill period' refers to the period beginning on 15 November 2018 (the date of the General Court judgment) and ending when the Secretary of State determines that it has ended, following the European Commission granting State Aid approval again to the main GB CM scheme. During the standstill period, the scheme does not have State Aid approval and aid cannot be granted under the scheme.

timescale for State aid approval slips beyond 1 October 2019".⁸ The European Commission may therefore issue its State Aid decision during the second cap period.

We cannot prejudge the European Commission's decision on the State Aid case. However, given the fixed schedule for updating the cap, we need to decide how to approach the CM allowance for the second cap period.

On 19 December 2018, the government issued a consultation on its proposals following the Court's decision.⁹ We highlight two aspects of its proposals, and the implications for the cap.

- The government said that it was "minded to continue to collect payments from suppliers during the standstill period". If suppliers were required to make payments, then we would consider that the cap should facilitate this by providing a CM allowance. As set out in our January open letter, even if these payments would not be passed onto capacity providers immediately, this would not affect a supplier's outgoings.
- The government also said that its intention was to "make provision for deferred payments to capacity providers, following the end of the standstill period, to replace capacity payments missed as a result of the standstill period". This would mean that, if State Aid approval was granted, suppliers would need to make CM payments to fund these deferred payments. In this case, the total costs to suppliers of the CM scheme would not be affected by the payment schedule.

Suppliers would aim to collect money to cover these costs. In principle, the cap could allow suppliers to recover these total costs over time by including a usual CM allowance, or alternatively on a one-off basis through a larger CM allowance. The first approach would allow the price cap to reflect the costs in the intended cap periods, rather than grouping costs in a later cap period. This could be more appropriate, as the level of the cap would more accurately reflect our CM methodology.

There is therefore a rationale for including an allowance within the cap, either if suppliers are making payments immediately, or if they are saving up the money received through the allowance to make a payment at the end of the standstill period (should the European Commission approve deferred payments).

On 1 February 2019, the government sent us a letter confirming its intentions in light of its consultation. The government indicated that, subject to European Commission approval of the CM that would permit this, it intends "to ensure that suspended payments are made to holders of Capacity Market agreements for 2018/19". It said that it "would expect suppliers' contributions to the scheme to be determined according to the current charging methodology based on peak-time demand over 2018/19".

Given this, following its consultation, we consider that we should set the cap to enable suppliers to collect CM costs from their customers. This will enable suppliers to ultimately pay for deferred payments to capacity providers, should the European Commission grant State Aid approval for this.

If the European Commission does not grant State Aid approval for deferred payments we would expect suppliers to reimburse customers for the CM costs collected (see the section below).

⁸ BEIS (2018) Proposals for technical amendments to the Capacity Market, page 13.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767015/proposals-for-technical-amendments-to-the-capacity-market.pdf

⁹ BEIS (2018) Proposals for technical amendments to the Capacity Market.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767015/proposals-for-technical-amendments-to-the-capacity-market.pdf

As a general stance, we consider that retrospective corrections to the cap are undesirable. In our decision on the default tariff cap, we explained why we had not included a mechanism to retrospectively correct for forecast error.¹⁰ We still consider that this is the correct general position, given the distortions and lack of accuracy of any correction mechanism. Given the clearly expressed intent of the government, including a CM allowance in the cap now would avoid retrospective payments in future, in the event that the European Commission grants State Aid approval for deferred payments to capacity providers.

We have therefore included an allowance, calculated in broadly the same way as at present. Annex 2 provides more information on the calculations.

Approach in subsequent cap periods if no approval for deferred payments

There is a possibility that the European Commission does not grant State Aid approval for deferred payments. In this event, we expect suppliers to reimburse customers. Under the Domestic Gas and Electricity (Tariff Cap) Act 2018, our objective when setting the cap is to protect existing and future domestic customers who pay standard variable and default rates. This ensures their bills better reflect the underlying costs of supplying the energy they consume. We would consult with stakeholders on the best way to ensure customers recover any unnecessary charges relating to the CM scheme.

One possibility would be to adjust the cap level in future cap periods. This does not affect our general stance not to include retrospective corrections in the cap. Our current view – and the basis for including a full CM allowance in the second cap period – is that this is an exceptional situation which warrants us making an exception to our general stance, in line with the objective set out in the Act.

Third cap period

The third cap period will run from 1 October 2019 to 31 March 2020. We will set this cap by 7 August 2019. We will keep the CM allowance for the third cap period under review, in the event that new information emerges. This includes the European Commission's opening decision in its formal investigation, which is expected in early 2019. We will engage with stakeholders as required.

Yours faithfully,

Anna Rossington

Deputy Director – Retail Price Protection

¹⁰ Ofgem (2018) Default tariff cap: decision. Appendix 3, paragraphs 3.7 and 3.8.
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_3_-_updating_the_cap_methodology.pdf

Annex 1: Summary of relevant stakeholder views

We received 16 responses to the open letter. We have uploaded non-confidential responses to our website. We thank stakeholders for engaging with the open letter, particularly given the unavoidably short period for comment.

We have carefully considered these responses. However, after we published our open letter, the government provided us with an update on its position, following its December consultation. We took our decision to include a full CM allowance in light of this update.

We therefore provide a high-level summary of the main themes in responses, and only respond to certain specific points as necessary. For the avoidance of doubt, our decision to include an allowance does not mean that we agree with any one particular argument made by stakeholders in favour of including an allowance. Rather we have taken account of the general views, among other relevant considerations, in reaching our decision.

Overall position

Overall, respondents supported including a full CM allowance in the second cap period.

One stakeholder said that our proposed approach of attempting to reflect our best understanding appeared to be a reasonable and proportionate response.

Rationale for including a CM allowance

Many stakeholders told us that the government had provided sufficient confidence that CM payments would be made, eg through its consultation.

Several stakeholders said that we should include a CM allowance unless there was sufficient evidence that suppliers would not be required to make CM payments during the second cap period. One stakeholder said that “only if, and when, it becomes clear that State Aid will not be approved should the allowance be removed from the default tariff cap”.

A couple of stakeholders said that, as there was a possibility that suppliers would need to make CM payments, they would need to accrue in their accounts the amount that would be due for CM payments. They said that suppliers should therefore collect these payments from customers.

Several stakeholders referred to the potential impact on investor confidence of our decision on whether to include a CM allowance. A couple of stakeholders said that a lack of confidence could create risks for security of supply, or raise the costs of ensuring security of supply.

Several stakeholders suggested potential impacts in the event that we did not include an allowance in the second cap period. Several stakeholders said that if suppliers had to make deferred payments, this could create financial stress for suppliers. Some stakeholders told us that any later increase to the level of a future cap period could have impacts on consumers – these included price spikes and confusion.

We have considered the comments made. However, our decision to include a full CM allowance for the second cap period is driven by the update we received from the government.

Approach to calculation when including CM allowance

Annex 2 of our January open letter set out how we proposed to change the CM Cost Component in the model.

We received very few comments on the detail of how we would include a CM allowance. One stakeholder said that “we support Ofgem’s approach to estimating the expected costs

of the T-1 2018 auction". Another stakeholder said it had "no comment at this stage on these detailed proposals".

We did not receive any specific comments about our proposal to correct a small calculation error in relation to CM administrative costs.

Given this response, we have maintained our proposals in relation to the T-1 auction and correcting the calculation error, as described in Annex 2.

Legal comments

Several stakeholders said that the Act requires a 28 day consultation for licence modifications. One stakeholder also referred to "compliance with the requirements of general public law". We consider that our consultation process was appropriate and in compliance with relevant obligations.

Several stakeholders said that removing a CM allowance would have insufficient regard to financeability. We are aware that the Act requires us to have regard to the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence. We do not consider that our decision raises any issues from this perspective.

Approach in the event that State Aid is not granted

Several stakeholders said that we could adjust the cap in a later period in the event the CM was not reinstated. For example, one stakeholder said "Ofgem could set future caps at a lower rate". Another stakeholder said that it "would like to see Ofgem take the same steps to consider the correction of over-recovery as it would do in relation to under-recovery".

Notwithstanding our general position on correcting errors from one cap period to the next, we agree that we would be able to adjust the cap in a later cap period in exceptional circumstances such as this. We consider that it is important to avoid a situation where suppliers make significant windfall gains as a result of collecting money from consumers which they do not ultimately require to make CM payments.

Other comments

Several stakeholders said that headroom was not intended to cover costs where we had previously provided an explicit allowance. Several stakeholders also said that headroom has already been used up, or exceeded by other costs. Given that we have included a full CM allowance following the government's letter, we have not needed to reach a view on these points.

One stakeholder repeated comments from previous consultations that the cap should include a recovery mechanism. We do not agree, for the reasons set out in our previous documents.

Annex 2: Implementation within the model

This annex explains in more detail our approach to calculating the CM Cost Component.

The CM Cost Component is part of the wholesale cost allowance methodology. This model is Annex 2 to standard licence condition 28AD. Where we refer to specific sheets or cells below, we are referring to this model.

General approach

In general, we will calculate the CM Cost Component in the usual way. This reflects the government's position that it would expect suppliers' contributions to the CM scheme to be determined according to the current charging methodology based on peak-time demand.

T-1 2018 auction

We do however need to consider the T-1 2018 auction. The government postponed the T-1 2018 auction following the General Court's judgement. This auction relates to the 2019-20 CM delivery year, which forms part of our calculation for the second cap period.

The cap methodology calculates the CM Cost Component based on the two CM delivery years which overlap the relevant fiscal year. For the second cap period, the two CM delivery years are 2018-19 and 2019-20. The T-1 2018 auction relates to the 2019-20 CM delivery year, and is therefore relevant to the second cap period.

We do not know what the outcome of the T-1 2018 auction will be, either in terms of the obligated capacity or the auction clearing price. However, there is information that allows us to estimate these values.

We recognise that any estimate of the costs of the T-1 2018 auction is an approximation. However, any positive estimate is still likely to be more accurate than assuming that this auction will have no cost at all. We have therefore included an estimate of the costs of the T-1 2018 auction within the calculation for the second cap period.

Obligated capacity

We have estimated the obligated capacity using the target capacity for the T-1 2018 auction, as specified by the government in July 2018. This was 4.6GW.¹¹

For the second cap period, the obligated capacity for the T-1 2018 auction (in MW) is set in cell R48 of sheet '6b Obligated capacity'. We have therefore entered a value of 4,600 in this cell.

This cell is only used to calculate the CM Cost Component for the second cap period – it does not affect other cap periods. Depending on the timing of any auction, we may be able to use the actual capacity for subsequent cap periods.

Auction clearing price

The auction clearing price for the T-1 2018 auction is set on line 23 of sheet '6c Clearing prices and CPI'.

Cell C23 is the auction clearing price (in £/kW/year). We have used the value of the T-1 2017 auction clearing price as an estimate. This was £6/kW/year. We consider that this is appropriate because it is the most recent T-1 auction.

¹¹ Capacity Market Auction Parameters 2018, letter from BEIS to National Grid, July 2018. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/723175/Parameters_Letter_to_Fintan_Slye_-_National_Grid.pdf

However, given we are using this auction clearing price as an estimate for the value in a later year, we have adjusted this for inflation. The T-1 2017 auction clearing price was not subject to indexation, given that the auction was held in the same year as delivery. To estimate the cost for the T-1 2018 auction, we have applied the auction clearing price to the following winter. We have therefore used October 2017 – April 2018 as the base period in cell D23.¹² The applicable base CPI value is 104.8 – we have included this in cell E23. The model then indexes the auction clearing price using the CPI values set out in the CPI section of '6c Clearing prices and CPI'.

Cell F23 is the CM delivery year. This is "2019/2020" for the T-1 2018 auction.

As currently set up, the model uses the same price for a given auction in all applicable cap periods. For the T-1 2018 auction, this means the second, third, fourth and fifth cap periods.

Once the actual auction clearing price is available, we would consider whether to update the T-1 2018 clearing price for subsequent cap periods. This could require changes to the model and a further consultation.

Methodology correction

We noticed a small calculation error in relation to CM administrative costs. We have amended this for the second and subsequent cap periods, after consulting on this change through the January open letter.

There are two CM delivery years feeding into the calculation for each cap period. Our approach to allocating administrative costs is to allocate half of the administrative costs to each delivery year, so that the cap level in each cap period reflects the total CM administrative cost. This calculation is on sheet '5b Supplier charge'.

The formula was correct for the first CM delivery year. However, there was a formula error for the second CM delivery year. The model included the full administrative cost for the second CM delivery year, in all cases except the historical example for April – September 2015 (column G). This meant that we were very slightly over-recovering this cost and setting the cap marginally higher than it needed to be. The materiality was very small – in the January open letter, we estimated this would account for around £0.06 within the CM Cost Component for a typical single rate customer in the second cap period.

We have corrected this typographical error. We multiply the administrative cost by 0.5, in the same way as the current formula for the first CM delivery year. This correction affects cells Q22:Z22.

We have not made retrospective adjustments to the formulas for the first cap period or the historical examples. This ensures that the model still reflects the actual value for the first cap period and the historical figures cited in the decision document.

¹² The October-April base period reflects the base period used for T-4 auctions, which are subject to indexation (unlike the T-1 auctions).