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Dear Rob,

Capacity market allowance in the default tariff cap

Thank you for your open letter of 15 January inviting comments on your proposed approach to the capacity market (CM) calculations in the default tariff cap for the next price cap periods in light of recent developments.

We welcome the fact that Ofgem is working closely with BEIS in the lead up to the second period price cap decision. Given the very short timescales involved in this process it is important that Ofgem is able to accommodate any last minute developments in its decision. We understand that BEIS plans to publish a decision on its recent consultation ahead of 7 February, whilst the P378 final modification report from the BSC Panel is due to be issued to Ofgem on 5 February (having been presented to the BSC Panel the day before). Accordingly, Ofgem needs to be fully prepared to respond in a timely and effective way by 7 February.

1. Confidence threshold

We are concerned that Ofgem has set too high a threshold for retaining the CM charge allowance in the second period of the price cap. Ofgem says it will do so if *'there is sufficient confidence that suppliers will have to pay the CM Supplier Charge during (or prior to) the second cap period'*. We think Ofgem should retain the allowance *unless* it has sufficient confidence that suppliers won't have to pay the CM charge during the second cap period.

The nature of the test will be material in a situation where, for example, BEIS expresses a continued intent to resume CM payments but where there are uncertainties still to be resolved. In deciding whether to include an allowance for CM charges in the cap, Ofgem must balance the consumer interest in providing maximum price protection against the consumer interest in a well-functioning market with adequate security of supply.

With regard to price protection, as Ofgem acknowledges, there is scope to make adjustments in future price cap periods should the allowance in the second period turn out not to have been required. However, a decision *not* to include an allowance in period two is likely to have an immediate adverse impact on market confidence, potentially leading to loss of generation capacity that cannot easily be reversed if and when CM charges are subsequently resumed (as part of a State Aid re-approval decision). On that basis, we think a prudent approach, consistent with its statutory objective, would be for

Ofgem to retain the allowance *unless* it has sufficient confidence that suppliers won't have to pay the CM charge during the second cap period.

2. Retrospective adjustments

Ofgem's letter considers how Ofgem might deal with a situation where no allowance is made for CM charges in a price cap period, but payment of CM charges is resumed during the period. Although the immediate risk relates to the second price cap period, a similar risk could arise in the third price cap period if Ofgem still has insufficient confidence by the relevant date that payments will resume. It is hoped that the European Commission will be in a position to confirm State Aid approval ahead of the CM Delivery Year due to start on 1 October 2019, but such approval may well come through after Ofgem's cut-off date for its decision relating to the third period (i.e. 7 August).

In such a situation, Ofgem's starting position should be that any shortfall in supplier revenue is made good in a subsequent price cap period, notwithstanding Ofgem's policy preference to avoid retrospective payments. The alternative of expecting suppliers to absorb such costs within the headroom allowance is not sustainable, even for relatively immaterial amounts, given the many other areas of cost deviation (not least mutualisation costs relating to recent supplier failures or non-payment of obligated costs) that will need to be absorbed in the headroom.

3. Proposed methodological changes

Ofgem sets out how it would propose to modify the calculations in 'Annex 2' under the two scenarios. If the CM charge allowance is retained, it will estimate the next T-1 auction clearing price based on the clearing price at last year's T-1 auction. If the CM charge allowance is removed (other than for administrative costs) it will modify the formula in one of the spreadsheet cells to exclude the relevant costs. We have no comment at this stage on these detailed proposals.

4. Legal basis for modification

We assume that Ofgem intends to make the modifications to 'Annex 2' pursuant to SLC 28AD.15, which states that Ofgem must consult, but does not specify a minimum consultation period. However, it appears to us that the provisions in Sections 1 and 4(3) of the Domestic Gas and Electricity (Tariff Cap) Act relating to modifications are absolute and cannot obviously be overridden by provisions within the licence conditions. On that basis we would encourage Ofgem to satisfy itself that it has the *vires* to make the modifications with a consultation period of 7 days rather than the 28 days specified in Section 4(3).

If you have any comments or queries on any aspect of this response please don't hesitate to contact me.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy