

All stakeholders

Email: RetailPriceRegulation@ofgem.gov.uk

Date: 17 June 2020

Dear Stakeholders,

Feed-in Tariffs (FIT) allowance in the default tariff cap

This purpose of this letter is to consult stakeholders on the options available to determine the Feed in Tariff ("FIT") allowance within the default tariff cap ("cap") from the fifth charge restriction period (October 2020 - March 2021) onward. A data source previously used by Ofgem as part of the determination of the FIT allowance is no longer being regularly updated and published. This requires us to identify the most suitable successor or alternative data source.

This letter considers the options available for a suitable data source to use in the determination of the FIT allowance within the cap. The cap has been designed to reflect the underlying costs of supplying energy to the consumer. Using the most reliable and publicly available data to determine the FIT allowance within the cap will allow us to account for changes in underlying costs experienced by suppliers, while ensuring default tariff customers are not overcharged.

This letter presents these options to stakeholders and seeks their views. We have also indicated our proposed approach, which we believe represents the best option for determining the FIT cost allowance in the remaining price cap periods. We will take into consideration any reponses to this consultation in our decision making on the future of the FIT cost allowance within the cap.

<u>Background</u>

The default tariff cap ("cap") includes a policy cost allowance to ensure that suppliers are able to recover the additional costs related to their obligations under different Government environmental and social programmes. The policy cost allowance is set out in 'Annex 4 – Policy cost allowance methodology' of SLC 28AD.¹ There are currently six policy schemes in operation which are accounted for in this allowance.

The FIT scheme is a government programme designed to promote the uptake of renewable and low-carbon electricity generation technologies. The additional costs that suppliers incur due to their obligations relating to this scheme are estimated in the policy costs allowance.

¹ Licence Conditions on Ofgem website:

https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions

We calculate policy costs for each six-monthly cap level update, using administration data (i.e. official forecasts or data from scheme administrators, rather than information collected from the suppliers themselves). In our 2018 decision we made a decision to base the FIT allowance on the latest OBR estimates of total scheme costs.²

In December 2019, the OBR published a 'Restated March 2019 forecast' of their Economic and Fiscal outlook publication³ that provided their decision to exclude the warm home discount and FIT schemes from their forecast, and to stop anticipating their future classification in the public finances.

We are now considering the options available to source FIT scheme costs for the policy cost allowance, due to the OBR publication no longer including a forecast of FIT costs. This letter invites comments on our proposal and options considered on the source of FIT scheme costs.

We are also taking the opportunity to make a minor change to update the source link of inputs 'Interim Levy rate' and 'Total reconciled supply volumes – most recent full year' in tab '3c CFD'. This is due to an update of the Low Carbon Contract Company (LCCC) transparency tool website. The LCCC have carried out a superficial redesign of their website which has resulted in a change to the source web address links. We are not proposing to change the source data used to determine Contracts for Difference (CfD) costs. Details of this are set out in Annex 2 below.

<u>Proposal</u>

We considered three alternative options for our future source of forecasting FIT scheme costs for future cap periods. These options are outlined in Annex 1 of this letter.

We propose to proceed with option 3 from Annex 1. This option involves using the March 2019 OBR forecast for FIT costs in cap period 5 October 2020 - March 2021. To estimate FIT scheme costs in cap period 6 and all subsequent cap periods, we propose to use actual FIT scheme costs taken from the latest available Ofgem FIT annual report available when updating the cap.

We view the OBR's forecast of FIT scheme costs as the best estimate for cap period 5. This is due to the fact that we have only recently completed our first full scheme year since the FIT scheme closed its registration, and data on the actual costs incurred are not published until December 2020.

Going forward, beyond cap period 5, we do not propose to use the OBR estimates for all cap periods as the OBR forecast will no longer be updated to reflect the changes in the actual costs reported.

We believe that using a previous scheme years costs from the FIT annual report is the best method to estimate FIT costs from cap period 6 onwards. The December 2020 annual FIT report, and all future reports, will account for scheme years with a closed registration. We expect that the actual scheme costs, reported in future FIT annual reports, are likely to stabilise due to the number of installations registered reaching a steady state. There may still be some smaller scale registrations up until March 2020, however we consider that using the FIT annual reported costs will be more reflective of the development of FIT costs in the future.

We will monitor the development of FIT costs over the upcoming periods and may consider alternative forecasts of FIT scheme costs as our source if they become publically available.

² Default tariff cap Decision – appendix 5, page 9:

https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix 5 - policy and network costs.pdf ³ Restated March 2019 forecast, page 12-13:

https://obr.uk/docs/dlm_uploads/Restated_March_2019_forecast.pdf

We also invite stakeholders views on alternative options outside of those considered in Annex 1.

Our proposed changes would be made in 'Annex 4 – Policy cost allowance methodology' of SLC 28AD.

We propose to make changes to sheet '3d FiT' to change the title in Cell B12 from "Latest OBR forecast of environmental levies for scheme year - Feed-in-tariffs" to "FIT cost for scheme year". We also propose to change the source text and link in cell D12 from "OBR, Economic and fiscal outlook. Fiscal supplementary tables: receipts and others Environmental Levies, Table 2.7" to "Ofgem Annual FIT report". We propose to add the following text to cell C12: "For the Aug 2020 update we will use the value previously used in the Feb 2020 update, taken from the Mar 2019 OBR forecast. For the remaining updates we will use the figures taken from the FIT annual reports."

This means that beyond cap period 5, in each six-monthly update of the cap level, we propose to use the latest available Ofgem annual FIT report to populate the relevant cells in row 12. In addition, we propose to insert a row below row 12 for inflation figures. The FIT cost estimate calculation (row 19) will also be amended to incorporate this new calculation from cap period 6 onward.

We would not propose to change the historical values in cells H12:T12.

We have published a draft revised Annex 4 that would come into effect for cap period 5 alongside this letter for your consideration.

<u>Next steps</u>

We welcome views on the proposed changes set out in this letter. We ask stakeholders to send any comments to <u>RetailPriceRegulation@ofgem.gov.uk</u> by **close of business on 15 July 2020.**

Yours faithfully,

Anthony Pygram Director, Conduct and Enforcement

Annex 1: Options for FIT source

We considered three options for our source used to estimate FIT scheme costs for future cap periods. We have provided further details below on each option, and our consideration of using each as the source.

Option 1

Use actual FIT scheme costs from the latest Ofgem annual FIT report⁴ that is available when we update the cap, and inflate these costs for the relevant period.

In December each year we publish the FIT costs for the most recently completed scheme year, with the scheme year running from April to March (e.g. scheme year 2018/19 was published in December 2019). This implies that each December publication would be used to update the two cap periods in the following year.

The December publication is a report on the actual costs incurred during the most recently completed scheme year. There is therefore a lag of two regulatory years between the costs detailed in the annual report and the cap period that they would be used in (e.g. December 20 publication of 2019/20 costs would be used for cap periods 6 and 7 that are both in regulatory year 2021/22).

Option 1 would require us to inflate these costs to the appropriate scheme year that they will apply to, using RPI inflation figures from the most recent OBR economic and fiscal outlook publication available when we set the cap.⁵

Option 2

Use the OBR's latest forecast of environmental levies costs for the FIT scheme from the March 2019 publication⁶ for cap period 5 and all remaining cap periods.

The OBR's 2019 economic and fiscal outlook publication originally contained forecasts of FIT scheme environmental levies up until 2023-2024.⁷ The OBR have since excluded FIT scheme costs from their forecast of environmental levies as they are no longer required in its publication. This option would relay on the forecast made in the OBR March 2019 publication for future periods of the cap.

<u>Option 3</u>

Use OBR's March 2019 FIT scheme cost forecast for cap period 5 only. For period 6 onward use the actual FIT scheme costs from the latest available Ofgem FIT annual report and adjust for inflation.

This option implies that we would adopt option 2 for cap period 5 and then option 1 from cap period 6 onwards.

Table 1 summaries the above data source options for each charge restriction period.

⁴ <u>https://www.ofgem.gov.uk/environmental-programmes/fit/contacts-guidance-and-resources/public-reports-and-data-fit/annual-reports</u>

⁵ <u>https://obr.uk/efo/economic-and-fiscal-outlook-march-2020/</u>

⁶ https://cdn.obr.uk/March-2019 EFO Web-Accessible.pdf

⁷ https://obr.uk/download/march-2019-economic-and-fiscal-outlook-supplementary-fiscal-tables-receipts-andother/

	Cap Period 5	Cap Period 6 onward
Option 1	Ofgem FIT annual report (inflation adjusted)	Ofgem FIT annual report (inflation adjusted)
Option 2	OBR March 2019 Forecast	OBR March 2019 Forecast
Option 3	OBR March 2019 Forecast	Ofgem FIT annual report (inflation adjusted)

Table 1: Summary of data source options

Our assessment of the options

Option 1 uses actual FIT costs from previous scheme years to forecast future scheme year costs using inflation.

In December 2018, the government announced their decision to close the FIT scheme to new applicants from 1 April 2019.⁸ This implies that no new applications made to the FIT scheme from 1 April 2019 would be accredited, subject to some limited exceptions.

Although there is a lag between the scheme year cost being published and the cap period it applies to, we expect that the number of installations registered to the scheme will start to reach a steady state across periods as the scheme closes registration. Microgeneration Certifications Scheme (MSC) scale installations had up to 31 March 2020 to apply to the scheme. Also, recent ammendments to legislation in light of Coronavirus may extend the validity period for some. However, the likely impact of the above is likely to be small compared to the wider context of the scheme.

We note that actual costs incurred by suppliers in each scheme year depends largely on the amount of generation, which relies on external environmental factors. Using the actuals from the FIT annual report (option 1) would allow the ability to account for any underlying changes in FIT costs over time, albiet in a lagged manner. Using the OBR 2019 forecast (option 2) would not allow for unforeseen changes that may impact underlying costs.

Figure 1 compares option 1 and option 2 against the actual costs incurred in that cap period. Historically, it highlights that using previous scheme reports of actual costs and inflating them to set an allowance for a given period (option 1), would always be lower than the best available estimate of costs in that period (option 2). This is because the FIT scheme was growing year on year. However, as the scheme reaches some form of steady state, then it shows this differential diminishing as costs converge.

Proposed approach

We propose to proceed with option 3. This means that we will use the March 2019 OBR forecast for cap period 5, and then use actual FIT scheme costs from the latest available Ofgem FIT annual report, adjusted for inflation, to estimate FIT scheme costs for cap period 6 onwards.

The OBR's forecast of FIT scheme costs is the best estimate for cap period 5 given that one full scheme year has only been completed since the scheme closed its registration, and data on the costs incurred is not published until December 2020.

We do **not** propose to use the OBR estimates for all future cap periods as the OBR forecast will no longer be updated to reflect the changes in the actual costs. From cap period 6 onward, we believe that using the previous scheme costs from the FIT annual report, adjusted for inflation, is the best approach to adopt. The December 2020 annual FIT report and all future reports will account for scheme years with a closed registration. While we expect that the number of installations registered to reach a steady state and therefore

⁸ <u>https://www.ofgem.gov.uk/publications-and-updates/feed-tariffs-essential-guide-closure-scheme</u>

future costs will start to stabalise, this option will allow for any unforeseen changes to underlying costs.



Figure 1: Comparison of options against actual costs incurred

Annex 2 – Updated links for CfD

levy-rates

Tab '3c CfD' of 'Annex 4 – Policy cost allowance methodology' uses data taken from the LCCC transparency tool on their website. In the latest version of Annex 4 (v1.5) published on our website in Febuary 2020, we included a comment in column E, explaining this link would be decommissioned in March 2020 and that we would update as appropriate for the next cap announcement.

This link was decommissioned due to the LCCC redesigning their website. The source links for the following inputs in tab '3c CfD' for 'Annex 4 – Policy cost allowance methodology' will be updated to the following:

Cell E13 for the 'Iterim levy rate' input will be updated to: <u>https://www.lowcarboncontracts.uk/index.php/dashboards/cfd/levy-dashboards/interim-levy-rate-and-total-reserve-amount</u>

Cell E25 for the 'Total reconciled supply volumes – most recent full year' input will be updated to: <u>https://www.lowcarboncontracts.uk/dashboards/cfd/actuals-dashboards/reconciled-daily-</u>

It is important to note, the source data we are using remains unchanged. Only the links on the LCCC website have changed due to their website redesign. We will still continue to base both of these model inputs on the same source data taken from the LCCC.