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All stakeholders

Email: RetailPriceRegulation@ofgem.gov.uk

Date: 05 August 2020

Dear Stakeholders,

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

On 17 June 2020, we issued an open letter[1] 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. Due to the FIT allowance also forming part of the prepayment meter ('PPM') cap, our decision to determine the FIT allowance also applies to the eighth PPM cap charge restriction period.[2]

In our open letter in June, we noted that a data source previously used by Ofgem as part of the determination of the FIT allowance is no longer being updated or published. We set out potential options to replace the previous data source to use in the determination of the FIT allowance for the default tariff cap from the fifth charge restriction period onwards and for the eighth PPM cap charge restriction period.

For the remainder of this letter, for simplicity, we refer to the the default tariff cap in the fifth charge restriction period. This should be read to also apply to the PPM cap in the eighth charge restriction period.

This letter sets out our decision on which data source to use to determine FIT costs for the upcoming charge restriction period. As explained in detail below, we have decided to proceed with our proposal for the fifth charge restriction period and make no change to our current methodology in using the most recent OBR forecast of FIT scheme costs to determine the FIT scheme allowance. This letter also provides information on our decision

[1] https://www.ofgem.gov.uk/publications-and-updates/consultation-letter-changes-feed-tariffs-allowance-default-tariff-cap

[2] The PPM cap started before the default tariff cap, and hence the cap period October 2020 - March 2021 is cap period eight for the PPM cap, and cap period five for the default tariff cap. The PPM cap ends on 31 December 2020. On 5 August 2020 we published our decision to set a PPM level in the default tariff cap. Therefore this letter refers to the eighth, and final, cap period for the PPM cap, and fifth cap period onward for the default tariff cap.

to consult on the methodology for the FIT scheme allowance for the sixth charge restriction period and subsequent periods.

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

Background

The 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 Standard Licence Condition (SLC) 28AD of the electricity and gas standard supply licence conditions.[3] 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.

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[4] we made a decision to base the FIT allowance on the latest Office for Budget Responsibility (OBR) estimates of total scheme costs.[5]

In December 2019, the OBR published a 'Restated March 2019 forecast' of their Economic and Fiscal outlook publication[6] 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.

In June 2020, we issued an open letter to consider 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 and asked for representation from stakeholder on these options.

[3] Licence Conditions on Ofgem website:
https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions
[4] https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview
[5] In January 2019, the CMA published their final decision to adopt an adjusted version of the methodology used for Ofgem's default tariff cap to calculate its PPM cap. This included the adoption of the methodology set out in Annex 4 for the Policy cost allowance methodology.
[6] https://obr.uk/efo/economic-fiscal-outlook-march-2019/

Decision

We have decided to proceed with our proposed approach for the fifth[7] charge restriction period (October 2020 - March 2021). We will make no change to our current methodology for calculating the FIT scheme allowance. This means we will use the March 2019 OBR forecast as our source for FIT scheme costs and will continue to use forecasted demand data from BEIS[8] for the fifth charge restriction period.

We have also decided that we will consult on new options for how to calculate the FIT scheme allowance methodology for the sixth charge restriction period onward. This consultation will take into consideration the recent comments raised by respondants and will discuss the various options for determining the FIT scheme allowance within the default tariff cap from the sixth charge restriction period onward. We expect to consult later this year.

In reaching this decision, we have carefully considered feedback from stakeholders. We consider using the OBR forecast for the fifth charge restriction period is the most reflective estimate of fixed scheme costs, given that we have only recently completed a full year of the scheme with closed registrations. Consulting again prior to the sixth charge restriction period will allow further consideration of the wider FIT scheme cost allowance. Annex 1 provides a high-level summary of stakeholders' views, and gives our response.

Annex 4 of SLC 28AD of the electricity and gas supply licences has been published alongside this decision document. The FIT scheme cost allowance in this annex is unrevised from previous cap updates given that our methodology for the fifth charge restriction period remains unchanged.

We have also made the decision to update the source weblinks in the CfD tab of Annex 4 of SLC 28AD, as per the approach set out in Annex 2 of our June open letter.

In respect to PPM cap, the policy cost allowance, which includes the FIT allowance, is determined on the basis of SLC 28A.7 and is calculated in accordance with paragraph SLC 28AD.10.[9] This means that the changes made to Annex 4 of SLC28AD.10 is also relevant for the policy cost allowance in the PPM cap methodology.

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[7] Eighth for the PPM cap

[8] https://www.gov.uk/government/collections/annual-renewables-obligation-level-calculations

[9] Electricity supplier licence: Standard Conditions – Consolidated to 11 June 2020: https://epr.ofgem.gov.uk//Content/Documents/Electricity%20Supply%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf?utm_source=ofgem&utm_medium=&utm_term=&utm_content=licencecondition&utm_campaign=epr

Yours faithfully,

Anna Rossington
Deputy Director – Retail Price protection

Annex 1: Summary of relevant stakeholders views

We received six responses to the open letter. We have uploaded non-confidential responses to our website.[10] We thank stakeholders for engaging with the open letter and providing detailed responses.

We have carefully considered these responses. We have provided a high-level summary of the main themes highlighted by respondants, and we set out our response to these themes below.

Using actual FIT costs instead of forecasts

Respondents generally welcomed the proposal to using actual FIT scheme costs from the sixth charge restriction period onwards, instead of the OBR forecast.

However, stakeholders were concerned that we were using an unnecessarily long lag between actual FIT costs and the pass-through to the price cap allowance. Stakeholders recommended that instead of sourcing these costs from annual FIT reports, we should source these costs from quarterly FIT invoices to reduce the lag.

We have considered the comments made. We agree in principle that if a suitable data source is available that allows us to reduce the lag between actual FIT costs and their pass-through to the price cap allowance, then we should consider this as part of our review of the FIT scheme cost allowance within the default tariff cap.

We will therefore consult on the FIT allowance methodology in time for the sixth charge restriction period and will incorporate stakeholder responses into the options provided for the FIT scheme cost input and the overall methodology. We expect to consult on this issue later this year.

Include actual demand instead of forecast demand

Our current methodology spreads costs over a forecast of demand (MWh) sourced from BEIS annual Renewables Obligation calculations.[11] We did not consult explicitly on changing the demand input. Respondents noted that one of the impacts of the COVID-19 pandemic and subsequent lockdown was a significant reduction in overall demand (MWh) and believe this has created uncertainty in future levels of demand. Some stakeholders highlighted that

[10] https://www.ofgem.gov.uk/publications-and-updates/consultation-letter-changes-feed-tariffs-allowance-default-tariff-cap
[11] https://www.gov.uk/government/collections/annual-renewables-obligation-level-calculations

this demand reduction has resulted in energy suppliers experiencing higher FIT costs (£/MWh) than our current methodology or proposed options would allow for.

Stakeholders suggest that our proposal to using actual costs should be accompanied by using actual demand from the same period, highlighting that this would be similar to the method used to determine BSUOS (Balancing Services) costs in the cap. Stakeholders also indicated that this would be ideally implemented in time for the fifth charge restriction period. However, in understanding that this may not be feasible, these stakeholders expressed a view that Ofgem should adopt this general approach from the sixth charge restriction period onward.

We agree in principle that any reduction in demand due to unforeseen circumstances, such as the COVID-19 lockdown, could reduce the FIT scheme cost component in the default tariff cap. While it is difficult to plan for such events that may cause significant swings in demand, there is a risk that our current methodology may not accurately reflect the change in costs associated with such an event. Therefore, we agree it is appropriate to consider this issue further.

We will therefore consult on the FIT allowance methodology in time for it be effective for the sixth charge restriction period. In this consultation we will take into consideration the views recently expressed by respondents on both of the issues set out in this annex, but will also seek additional views that stakeholders may raise.

Rationale for not amending methodology for the fifth charge restriction period

We do not believe it is appropriate to make changes to the methodology for the fifth charge restriction period. We discuss costs and demand in turn.

We view the OBR’s forecast of FIT scheme costs as the most reflective estimate of FIT scheme costs for the fifth charge restriction period. 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 yet publically available.

In terms of demand, we did not consult explicitly on this input which currently sits outwith the scope of this consultation. Due to the unforeseen circumstances resulting from the impact of COVID-19, respondants have requested we ensure both the FIT cost allowance and the wider price cap reflects various additional COVID-19 related costs. As discussed in our open letter on managing the impact of COVID -19 “In the longer term, if there is a material change in suppliers’ costs as a result of COVID-19 impacts, including bad debt costs, we will consider how to reflect these in the default tariff cap methodology while protecting existing and future domestic default tariff customers".[12] At the moment data is too uncertain and the scale of impact of COVID-19 on industry costs is unclear. Any allowance for COVID-19 related costs within the FIT component should be viewed in the round with any future assessment on the impact of COVID-19 on industry costs.

[12] Managing the impact of COVID-19 on the energy market – relaxing network charge payment terms: https://www.ofgem.gov.uk/publications-and-updates/managing-impact-covid-19-energy-market-relaxing-network-charge-payment-terms