



Making a positive difference
for energy consumers

All stakeholders

Email: RetailPriceRegulation@ofgem.gov.uk

Date: 25 November 2020

Dear stakeholder,

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

The purpose of this letter is to consult stakeholders on the options for how to determine the Feed in Tariff ("FIT") scheme allowance methodology within the default tariff cap ("cap") from cap period six (April 2021 - September 2021) onward.

We welcome views on the proposed changes set out in this letter. We ask stakeholders to send any comments to RetailPriceRegulation@ofgem.gov.uk by **close of business on 04 January 2020**.

We will publish the non-confidential responses we receive alongside a decision on next steps on our website at www.Ofgem.gov.uk/consultations.

In our consultation in June 2020,¹ we noted that a data source previously used by Ofgem as part of the determination of the FIT allowance is no longer being updated or published.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 consulted on potential options to replace this source. We made a decision in August 2020² to make no change to our current methodology in determining the FIT allowance for cap period five. We also decided to consult on the overall methodology for the FIT scheme allowance for cap period six and subsequent periods.

¹ Ofgem (2020), Consultation letter on changes to Feed-in Tariffs allowance in the default tariff cap <https://www.ofgem.gov.uk/publications-and-updates/consultation-letter-changes-feed-tariffs-allowance-default-tariff-cap>

² Ofgem (2020), Decision on changes to the Feed-in Tariffs allowance in the default tariff cap <https://www.ofgem.gov.uk/publications-and-updates/decision-changes-feed-tariffs-allowance-default-tariff-cap>

In our policy consultation in September 2020 on the impact of COVID-19 on the cap,³ we noted that a reduction in overall demand could increase the FIT scheme costs currently being incurred by suppliers beyond those included in the cap allowance, on a per MWh supplied basis. We also noted that we intend to account for any additional FIT costs resulting from COVID-19 through changes to our FIT scheme methodology.

This letter considers the options available to determine a methodology for the FIT scheme allowance within the cap, sets out our preferred option, and seeks stakeholder views. In setting out these options we have considered stakeholder responses to our open letter in June, our policy consultation in September 2020 on the impact of COVID-19 on the cap, as well as our own judgement and other sources of information.

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.⁴ There are currently six policy schemes in operation which are accounted for in this allowance, one of which is the FIT scheme.

When we designed the cap we decided⁵ to base the FIT allowance on the latest Office for Budget Responsibility (OBR) estimates of total scheme costs, divided by a forecast of total supply volumes for the given scheme year from the Department for Business, Energy & Industrial strategy (BEIS). Total supply volumes excludes the capped amount of exempt electricity – and also excludes the forecast Energy Intensive Industry (EII) volumes.

In December 2019, the OBR published a 'Restated March 2019 forecast' of its 'Economic and fiscal outlook' publication⁶ that provided its decision to exclude FIT schemes from their forecast, and to stop anticipating their future classification in the public finances.

The June 2020 open letter on FIT scheme costs

In June 2020, we issued an open letter⁷ to consider the options available to source FIT scheme costs for the policy cost allowance, due to the OBR's new publications no longer including a forecast of FIT scheme costs. We asked for representations from stakeholders

³ Ofgem (2020), Reviewing the potential impact of COVID-19 on the default tariff cap
<https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation>

⁴ Licence Conditions on Ofgem website:
<https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions>

⁵ <https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-decision-overview>

⁶ <https://obr.uk/efo/economic-fiscal-outlook-march-2019/>

⁷ Ofgem (2020), Consultation on changes to the Feed-in Tariffs allowance in the default tariff cap.
<https://www.ofgem.gov.uk/publications-and-updates/consultation-letter-changes-feed-tariffs-allowance-default-tariff-cap>

on three options: using actual FIT costs from the previous year, retaining the current source, or using a combination of the two.

We proposed to use the third, hybrid, option. Our view was that future costs reported after the FIT scheme had closed for new registrations would begin to stabilise. We considered that the OBR's forecast of FIT scheme costs was the best estimate for cap period five given that one full scheme year had only been completed since the scheme closed its registration, and data on the costs incurred, published in 2020, would not be available in time for cap period five. We noted that using annual FIT reports from cap period six onwards was appropriate as the reports available would relate to scheme years with a closed registration and with costs that had begun to stabilise.

Stakeholders' comments to the June 2020 open letter on FIT scheme costs

Stakeholders raised three main points in response to the consultation:

- They welcomed the move towards using actual FIT costs (on a lagged basis) instead of the OBR forecasts. However, all stakeholders who responded were concerned that we were proposing to use an unnecessarily long lag between actual FIT costs and the pass through to the cap allowance. All 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. Three stakeholders also noted that inflation should still be considered in the calculation when we move to a pass through methodology.
- All respondents also noted that one of the impacts of the COVID-19 pandemic and subsequent lockdown was a significant reduction in overall demand (MWh). Some stakeholders highlighted that this demand reduction has resulted in energy suppliers experiencing higher FIT costs (£/MWh) than our current methodology or proposed options would allow for.
- All stakeholders suggested that our proposal to use 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. Three stakeholders also indicated that this would be ideally implemented in time for the fifth cap 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 cap period onward.

Our decision on the open letter on FIT scheme costs

In August 2020, we made a decision⁸ to make no change to our current methodology for cap period five in determining the FIT allowance and decided to consult on the methodology for the FIT scheme allowance for cap period six and subsequent periods.

September 2020 policy consultation on the impact of COVID-19 on the cap

In our September 2020 policy consultation,⁹ we discussed the impact COVID-19 had on suppliers' FIT scheme costs. We noted that a reduction in overall demand (MWh) increases the FIT scheme costs currently being incurred by suppliers beyond those that have been forecasted and so included in the cap allowance, on a per MWh supplied basis.

We highlighted our intention to account for any additional FIT costs resulting from COVID-19 through a separate consultation on changes to our FIT scheme methodology. We considered that allowing suppliers to recover the actual costs of FITs on a lagged basis would fully account for the impacts of COVID-19 on FIT costs.¹⁰

Stakeholders' comments to the September 2020 consultation

Three stakeholders welcomed our proposal to consult separately on changes to the FIT scheme methodology. They agreed that we should ensure that the actual costs that suppliers have incurred should be recovered on a lagged basis.

Proposal for this consultation

In this letter we consider two options for determining the methodology for the FIT scheme allowance for cap period six onwards. We discuss these options in Annex 1.

We propose to use option A, pass through costs and demand on an 18 month lagged basis, to determine the FIT allowance.

The proposed option differs from what we had previously proposed in our June 2020 open letter.

- We now propose to use lagged demand along with lagged costs to determine the FIT allowance.
- We have reduced the lag in data from 24 months to 18 months by changing our proposed source of FIT scheme costs from the Ofgem annual FIT report to the quarterly FIT invoices issued by Ofgem.

⁸ Ofgem (2020), Decision on changes to the Feed-in Tariffs allowance in the default tariff cap <https://www.ofgem.gov.uk/publications-and-updates/decision-changes-feed-tariffs-allowance-default-tariff-cap>

⁹ Reviewing the potential impact of COVID-19 on the default tariff cap: September 2020 policy consultation <https://www.ofgem.gov.uk/publications-and-updates/reviewing-potential-impact-covid-19-default-tariff-cap-september-2020-policy-consultation>

¹⁰ Subject to any fluctuations in demand.

- We have also proposed to **not** inflate actual costs that are being recovered on a lagged basis.

Our new proposal is largely aligned with the recommended approach from stakeholders when they responded to our June 2020 open letter. The proposal addresses stakeholders' concerns about recovering the increased FIT costs that resulted from COVID-19 and also addresses stakeholders' concerns about the length of lag between when costs are incurred and when they are recovered.

Our proposal to not inflate costs that are being recovered on a lagged basis is a change from our June proposal. We have considered this in the context of our new proposal in moving to the pass through of costs on a lagged basis. Although we are now proposing to base the calculation of the allowance in cap period six on costs in a previous period, suppliers received an allowance for FIT costs in each previous cap period. Suppliers are therefore not recovering the totality of their FIT costs on a lagged basis – the lag only applies to the increment between the previous allowance and actual costs. We consider that accounting for inflation in relation to this increment would be immaterial, and would not justify increasing the complexity of the methodology.

We note that our June proposal used RPI, whereas we now consider that CPIH would be the appropriate inflation metric to use if we were to apply inflation, given it is consistent with the inflation index used in other areas of the cap (i.e. operating costs). Also, as outlined in our cap consultations, CPIH is the Office for National Statistics(ONS) leading inflation index, whilst the ONS has discouraged the use of RPI as a measure of inflation since 2013.¹¹

We have included option B in Annex 1, continuing to use forecast costs and forecast demand to determine the FIT allowance, purely as a reference to our existing methodology. We do not think this option can be used in future cap periods due to the potential systematic risk involved with using an outdated source. No stakeholder advocated for this option to be used for cap period six onwards.

We provide further assessment and considerations of these options in Annex 1.

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

¹¹ Default Tariff Cap: Statutory Consultation Appendix 6 – Operating costs, https://www.ofgem.gov.uk/system/files/docs/2018/09/appendix_6_-_operating_costs.pdf

We propose to make changes to Annex 4 by adding a new sheet called '3i New FIT methodology' which includes inputs and calculations. This tab calculates the FIT scheme costs for cap period 6 onwards. We have also amended tab '2a Aggregate costs', cells W16:AA16 and W22:AA22 so that they link to this new sheet for cap period 6 onwards. In sheet '3d FIT', which has the existing methodology, we have removed cells V12:AA18 to reflect that the existing methodology is only used to calculate the FIT scheme allowance up to cap period 5. We have published a draft revised Annex 4 alongside this letter.

Next steps

We welcome views on the proposed changes set out in this letter. We ask stakeholders to send any comments to RetailPriceRegulation@ofgem.gov.uk by **close of business on 04 January 2020**.

Subject to consultation, we intend to publish a decision **at the start of February 2021**, so that any changes will have effect from 1 April 2021 (the sixth cap period).

Yours faithfully,

Anna Rossington
Deputy Director, Retail Price protection

Annex 1: Options for determining the FIT scheme allowance methodology

We consider two options for determining the FIT scheme methodology from cap period six onwards. Option A is based on stakeholders' feedback on how they consider the FIT allowance should be determined – recovering actual costs, on a £/MWh basis, on a lagged basis. Option B maintains our current methodology. We provide a summary of the options in Table 1 (showing, by option, the data used for each cap period), followed by more detailed descriptions, and our assessment of the options.

Table 1: Options under consideration for FIT scheme allowance methodology¹²

#	A	B
Option	Lagged pass through of costs and demand sourced from FIT quarterly reports (18 month lag)	OBR cost forecast divided by BEIS forecast of demand. This is the same as the current methodology.
Period 6 (Apr 21- Sep 21)	Actual cost divided by actual demand in period Oct 19 - Sep 20	OBR cost forecast from March 2019 publication divided by BEIS latest forecast of electricity supplied.
Period 7 (Oct 21 –Mar 22)	Actual cost divided by actual demand in period Apr 20 - Mar 21	OBR cost forecast from March 2019 publication divided by BEIS latest forecast of electricity supplied.
Period 8 (Apr 22 – Sep 22)	Actual cost divided by actual demand in period Oct 20 - Sep 21	OBR cost forecast from March 2019 publication divided by BEIS latest forecast of electricity supplied.
Period 9 (Oct 22 – Mar 23)	Actual cost divided by actual demand in period Apr 21 - Mar 22	OBR cost forecast from March 2019 publication divided by BEIS latest forecast of electricity supplied.
Period 10 (Apr 23 –Sep 23)	Actual cost divided by actual demand in period Oct 21 - Sep 22	OBR cost forecast from March 2019 publication divided by BEIS latest forecast of electricity supplied.
Period 11 (Oct 23 – Dec 23)	Actual cost divided by actual demand in period Apr 21 - Mar 22	OBR cost forecast from March 2019 publication divided by BEIS latest forecast of electricity supplied.

Option A

The methodology used in options A means that there would be an 18 month lagged pass through of costs and exempt electricity supplied (MWh) from the quarterly FIT invoices sent to suppliers. These figures are published on a lagged basis by Ofgem.¹³

¹² The table displays the inputs that would be used for cap periods up to the end of 2023. This is for illustrative purposes and assumes that the default tariff cap is extended by the secretary of state to the end of 2023.

¹³ Ofgem, Feed-in Tariffs quarterly report <https://www.ofgem.gov.uk/environmental-programmes/fit/contacts-guidance-and-resources/public-reports-and-data-fit/feed-tariffs-quarterly-report>

This method uses the levelisation fund reported in the FIT quarterly invoice as the input for FIT scheme costs (£). We calculate the total exempt electricity supplied (MWh) as the total electricity supplied (MWh) minus the total exempt supply¹⁴ (MWh). We would use these figures to calculate the FIT scheme allowance (£/MWh).

This method does not assume that the cap on exempt electricity sourced from outside of the UK is reached every quarter. We instead propose to take the minimum of the total exempt electricity sourced from outside the UK and the respective exempt supply cap. This is a change from the assumption we make in our existing methodology, but is linked to our proposal to pass through actual demand. We discuss this further in the assessment section below.

Option B

This option maintains the current methodology.

FIT scheme costs would be sourced from the OBR's forecast of environmental levies costs in the March 2019 publication.¹⁵ The estimate of electricity supplied would be sourced from the latest BEIS annual report on renewable obligation levels.¹⁶ We would divide the forecast FIT scheme costs by the estimate of electricity supplied to calculate the FIT scheme allowance.

Our assessment of the options

Considerations on adopting a pass through methodology

In general our view is that where possible policy costs should be recovered in the period in which they are incurred. This means we would continue to use forecasts for the FIT allowance if an appropriate source was available.

This consultation and our assessment does not impact on our approach in other policy areas. The assessment below is focused on the FIT scheme methodology.

Using forecasts generates uncertainty. We don't expect actuals to match forecasts for a specific policy exactly in any given year. But overall, we expect the variation to balance out over time. This is what we refer to as non-systematic error.

¹⁴ The total exempt supply takes the minimum of the total renewable electricity sourced from outside the UK and the exempt supply cap, and then adds this figure to the exempt supply to Energy Intensive Industries.

¹⁵ https://cdn.obr.uk/March-2019_EFO_Web-Accessible.pdf

¹⁶ Department for Business, Energy & Industrial Strategy (2019), Annual renewables obligation level calculations <https://www.gov.uk/government/collections/annual-renewables-obligation-level-calculations>

However, option B faces a significant risk of systematic error in the forecasts we use for costs (£) and demand (MWh) to determine the FIT allowance. For forecasts of FIT scheme costs, the problem is that the OBR's forecast of future FIT scheme costs, published in March 2019, will not be updated. Since the forecast is not updated, it will not incorporate any developments in underlying factors that will influence future costs, such as any increase in the number of FIT generators relative to those included in the OBR's forecast. For forecasts of demand, the unforeseen circumstances of COVID-19 have resulted in a reduction in overall demand below the level which is forecasted in cap period four. This increases the FIT scheme costs being incurred by suppliers on a per MWh supplied basis beyond those that have been forecasted and so included in the cap allowance. Uncertainty about restrictions as a result of COVID-19 could also increase the risk that demand is different to forecasts in future scheme years.

Adopting a pass through methodology, as in option A, allows actual costs incurred by suppliers in previous periods, on a £/MWh basis, to be recovered on a lagged basis. The benefit of this is that it reduces the risk of suppliers being over or under funded in the event that costs, on a £/MWh basis, vary significantly from the original forecast due to exogenous shocks. The proposed approach ensures that any additional costs, on a £/MWh basis, incurred due to the impacts of COVID-19 are fully recovered in future cap periods. As shown in Table 1, option A ensures these costs would be recovered over cap periods six and seven. This aligns with the approach that suppliers preferred in response to our June 2020 open letter.

There are downsides to option A. One is the time between costs being realised, published, and then included in the FIT allowance. A second downside is the increased risk of impacting suppliers' cash flows if there are large variations in costs between periods. Option B would more closely recover policy costs in the period they are incurred. Using forecasts is often more appropriate when there is more variation in costs over time, for example where a scheme is growing or where there is price uncertainty.

With option A there is also a risk that suppliers will not fully recover their actual costs (in £) from a previous period. Suppliers would only recover the full costs if demand is stable between the period the costs were incurred and the period they were recovered in. However, given the small changes in demand between periods, we consider this risk to be small.

Exempt electricity sourced from outside of the UK

Option B uses forecast electricity data from BEIS. This includes a forecast of total electricity supplied and a forecast of the level of electricity supplied to EII that is exempt. We also need to subtract for the exempt level of renewable electricity which is sourced from outside

the UK which is not forecasted by BEIS. In option B, we make a simplification by assuming that the exempt supply cap on renewable electricity sourced from outside the UK is breached for each scheme year. This means we subtract the total electricity supplied sourced from BEIS by the exempt supply cap for renewable electricity sourced from outside the UK.

Option A uses the actual level of exempt electricity supplied and does not make any assumptions on the exempt cap being breached each quarter. Our source of the FIT quarterly invoices include the actual level of exempt electricity supplied, this is a sum of the level exempt due to being renewable electricity sourced from outside the UK and the exempt level supply to the EII. This means that we no longer need to assume that the exempt cap on renewable electricity supplied from outside the UK is breached and can use the actual figures, if they are below the capped level.

Length of lag

Our general view when adopting a pass-through methodology is that the lag should be kept to a minimum, taking into account when data is available to calculate a robust allowance.

Due to the timing of when FIT quarterly invoices are sent to suppliers and the timing of our announcement of each cap period, the shortest feasible lag that could be achieved is 18 months. This is what we have used in option A. This aligns with the suggestion from three stakeholders in response to our June 2020 consultation. Some stakeholders also suggested that we could recover costs, on a £/MWh basis, on a 21 month lag using the quarterly FIT invoices. We don't see any reason for having a longer lag than is necessary if we are using the quarterly invoices as our source.

All stakeholders advocated for a similar pass through approach to BSUoS, but most did recognise that the same lag may not be able to be achieved. The lag for passing through BSUoS costs is 15 months due to the availability of data, National Grid Energy System Operator publishes settlement runs daily on the BSUoS costs. As we state above, the minimum lag we can feasibly achieve for FIT data is 18 months due to the timing of when data is available.

In our June 2020 open letter¹⁷ we proposed to source FIT scheme costs from the FIT annual report on a 24 month lag, since the annual report is reconciled. We recognise that by shortening the time lag, and using quarterly data from invoices, the data will not be reconciled. This could mean that both the levelisation fund and total relevant electricity

¹⁷ Ofgem (2020), Consultation on changes to the Feed-in Tariffs allowance in the default tariff cap. <https://www.ofgem.gov.uk/publications-and-updates/consultation-letter-changes-feed-tariffs-allowance-default-tariff-cap>

supplied are subject to change. However, we consider it unlikely that these figures will change significantly. We also consider that any potential small inaccuracy in the quarterly figures is outweighed by the benefits of passing through costs with less of a lag.

Inflation

As explained above, option A uses input data on an 18 month lag – the shortest period achievable. However, we do not consider that this lagged amount should be inflated. Suppliers have received an allowance for FIT costs in each previous cap period. They are therefore not recovering the totality of their FIT costs on a lagged basis – the lag only applies to the increment between the previous allowance and actual costs (which could be positive or negative). We consider that accounting for inflation in relation to this increment would be immaterial, and would not justify increasing the complexity of the methodology.