To all stakeholders

Email: retailpriceregulation@ofgem.gov.uk

Date: 25 November 2020

Consultation on updating the allowance for the Shetland Cross Subsidy in the default tariff cap

Dear stakeholders,

In this letter, we consult on amendments to our default tariff cap ("cap") methodology that are required for the next charge restriction period April 2021 – September 2021. This letter sets out the background to the issues and the detail of the approach we propose to take.

The cap includes a policy cost allowance to enable suppliers to recover costs associated with specific government schemes. One of the schemes it covers is the Assistance for Areas with High Electricity Distribution Costs (AAHEDC) scheme. As part of its recent Hydro Benefit Replacement Scheme and the Common Tariff Obligation review,[1] BEIS consulted on the government's plans to amend this scheme to spread the costs of the Shetland cross-subsidy across GB consumers.

This government policy change will increase the cost of the AAHEDC scheme from 1 April 2021. The existing cap methodology will accommodate this government policy change from the seventh cap period and beyond, however the existing methodology would not reflect this change for the sixth cap period, April 2021 – September 2021. We propose to amend 'Annex 4 – policy cost allowance methodology' of standard licence conditions (SLC) 28AD to reflect the change in data availability, as per Section 28AD.15 of the SLC.[2] This letter is consulting on how we propose to address this issue.

We want to ensure transparency with stakeholders and provide this opportunity to comment ahead of setting the default tariff cap for the next charge restriction period, in February 2021.

[1] BEIS, 2019: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/815822/HBRS-CTO-consultation.pdf

[2] Ofgem electricity Standard Licence Conditions, 2020: https://epr.ofgem.gov.uk/Content/Documents/Electricity%20Supply%20Standard%20Licence%20Conditions%20Consolidated%20-%20Current%20Version.pdf

Background

Energy suppliers are subject to a number of environmental and social obligations. In most cases, these obligations result in additional costs to suppliers, which we include in the policy cost allowance within the cap. We estimate these policy costs using administrative data and wherever possible rely on publicly available information to do so.

One such scheme is the AAHEDC, which is also known as the Hydro Benefit Scheme. This scheme aims to reduce the electricity prices in areas of high distribution costs (currently Northern Scotland). Historically it spread the higher costs that are driven by the isolated nature of Shetland's energy infrastructure across all the North of Scotland customers through electricity distribution charges. This meant that Shetland consumers avoided facing higher electricity prices than consumers in the rest of the North of Scotland.

We calculate the allowance for this scheme by using the final charges as published by National Grid Electricity System Operator (NGESO). For summer cap periods, the final charge is not available, so we use the previous year's charge increased using RPI. This charge is also uplifted using our estimate of distribution losses.

Government Approach

In July 2019, the government published its three yearly review of the Hydro Benefit Replacement Scheme and Common Tariff Obligation. This included a consultation on their intended approach to the Shetland cross-subsidy. Following consideration of this consultation, the government has decided that the cross-subsidy will be applied following the current arrangements of the Hydro Benefit Replacement Scheme as far as possible.[3] This means that NGESO will collect the cross-subsidy amount from all licenced suppliers across GB and pass it onto the distribution network operator for the North of Scotland, in line with the current scheme.

The government estimates the cross-subsidy amount for the first year of its operation in 2021/22 will be £27m. NGESO will calculate the price per kWh and publish the draft AAHEDC tariff, including the Shetland cross-subsidy, in March 2021. It will publish the final AAHEDC tariff in its July 2021 publication.

Impact on price cap

The government's decision will not change how the AAHEDC is operated, but rather extend the current arrangements to include this additional charge. This means that, for price cap periods after NGESO next publishes the final AAHEDC tariff (ie from the seventh cap period), this additional cost will be allowed for under the existing price cap methodology. However, for the summer cap period, April 2021 – September 2021, where we normally calculate the allowance using the previous published final changes, we need to make a one-off amendment to allow for this additional cost.

The AAHEDC tariff for the fifth price cap period is 0.030 p/kWh.[4] Using the £27m figure that BEIS stated in its recent decision, we estimate that allowing for the additional Shetland cross-subsidy would see the cap AAHEDC tariff for the sixth price cap period rise to approximately 0.043 p/kWh (refer to section below for details of calculation). After applying inflation and allowing for losses, this would mean approximately a 43p rise in the AAHEDC cost allowance within the cap (all else being equal).[5] The exact amount will be determined at the time of our Febuary cap level announcement and we will take into account the most

[3] BEIS, 2020: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/865280/hbrs-cto-consultation-government-response.pdf
[4] NGESO, 2020: https://www.nationalgrideso.com/document/173046/download
[5] Based on a consumer's typical consumption

recent OBR publication of RPI and the updated loss multipliers, which are published in January.

Proposed approach for the sixth cap period

The allowance for the AAHEDC scheme is calculated in 'Annex 4 – policy cost allowance methodology v1.7' of SLC 28AD.[6] To update the allowance for the AAHEDC scheme for a summer period, the current methodology uses the NGESO charging statement published on its website in July from the previous year. This is then combined with RPI to calculate the cost allowance for the February update.

However, the July 2020 charging statement does not include the additional amount of the Shetland cross-subsidy.

The current source notes in cell C13 of tab '3g AAHEDC' of the annex model state –

"Previous year's charge combined with RPI for Feb update, which is made prior to the final (or draft) charge being published by National Grid. RPI is most recent OBR forecast for the previous charging year"

We propose to update this text to –

"Previous year's charge combined with RPI for Feb update, which is made prior to the final (or draft) charge being pubilshed by National Grid. RPI is most recent OBR forecast for the previous charging year. For 28AD charge restriction period April 2021 – September 2021, an additional p/kWh figure is included to allow for the Shetland Cross Subsidy. For all subsequent charge restriction periods the Final AAHEDC tariff will incorporate the Shetland Cross Subsidy."

We propose to update cell V13 of tab '3g AAHEDC' with an additional uplift amount to reflect the Shetland Cross Subsidy. To estimate the additional uplift we must divide the yearly subsidy amount (£27m) by the latest estimate of demand. We take this estimate of demand from the latest AAHEDC tariff publication,[4] 216.30TWh. Converting this to kWh, we estimate the uplift amount to be 0.012483 p/kWh. Further details of this can be found in 'Annex 4 – policy cost allowance methodology v1.71' that accompanies this consultation.

The demand figure used is the forecast NGESO used to set the AAHEDC tariff for the 2020/21 scheme year. This forecast was partly affected by COVID-19, which has reduced demand. We are setting an AAHEDC tariff for the 2021/22 scheme year – by this point, it is possible that the impact of COVID-19 on demand may be less significant. However, there is also a general downward trend in demand. These effects work in opposite directions, meaning that it is unclear whether demand in 2021/22 will be higher or lower than this estimate. Given the small materiality of this additional charge, the fact that our estimate will only apply for one cap period and the absence of an equally straightforward alternative demand figure, we consider that it is appropriate to use the 2020/21 demand figure.

Proposed approach for the seventh cap period and beyond

The current methodology is sufficient to allow for the additional Shetland cross-subsidy allowance from charge restriction period October 2021 – March 2022. So, this additional allowance will be included in subsequent cap periods as per the existing methodology

[6] Ofgem, 2020: https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-level-1-october-2020-31-march-2021

Next steps and consultation responses

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 4 January 2021**.

Yours faithfully,

Anna Rossington,
Deputy Director, Retail Price Protection