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Dear Anna,

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

Thank you for the opportunity to respond to this open letter. We set out our key points below and have provided more detail on these points in Annex 1.

We note that Ofgem is considering two options (A and B) for determining the FIT scheme allowance for cap period six onwards. Option A, where actual costs and actual demand are passed through on an 18 month lagged basis, is Ofgem's preferred option. Option B would continue to use forecast costs¹ and forecast demand to set the allowance. Option B has no lag but is exposed to potential systematic risk involved with using an outdated source².

As we stated in our response to the June 2020 consultation³, we would welcome a move toward using actual FIT costs instead of OBR forecasts and actual demand data. To that end, we support most of methodology proposed under Option A.

We have two main concerns regarding Ofgem's proposed methodology:

- Ofgem decided to exclude the value of deemed exports from the original FIT allowances despite representations from suppliers to the contrary. We believe this decision was unjustified since there was no matching adjustment to the wholesale cost allowance, and therefore Ofgem has double counted the benefit of deemed exports on a supplier's cost base. Ofgem should take this opportunity to reinstate deemed export costs in FIT allowances going forward. We estimate this would increase the FIT allowance in the electricity cap by circa £0.67 at TDCV.
- We also do not agree with Ofgem's proposal not to inflate costs that are being recovered on a lagged basis and we urge Ofgem to revert to its June 2020 proposal

¹ Based on the latest Office for Budget Responsibility (OBR) estimate of total scheme costs, divided by a forecast of total supply volume for the given scheme year from the Department for Business, Energy and Industrial Strategy (BEIS)

² The OBR's new publications on public finances after December 2019 will no longer include a forecast of FIT scheme costs.

³ Consultation letter on changes to Feed-in Tariffs allowance in the default tariff cap (June 2020)
<https://www.ofgem.gov.uk/publications-and-updates/consultation-letter-changes-feed-tariffs-allowance-default-tariff-cap>

of inflating lagged costs. Based on forecast RPI inflation in the period 2021-2023 (which is the basis on which FIT tariffs are indexed) we estimate this would increase the FIT allowance in the electricity cap by circa £0.70 at TDCV.

Finally, we have identified a few possible errors in the input data for Ofgem's 'Annex 4' spreadsheet which we would encourage Ofgem to double check.

Please do not hesitate to contact me or James Soundraraju (tel: 07548707639; email: jsoundraraju@scottishpower.com) if you have any questions arising from this response.

Yours sincerely,



Richard Sweet
Head of Regulatory Policy

FEED-IN TARIFFS (FIT) SCHEME ALLOWANCE METHODOLOGY IN THE DEFAULT TARIFF CAP – SCOTTISHPOWER RESPONSE

1. Introduction

We welcome Ofgem’s decision to move to a lagged pass-through approach to setting the FIT allowance and to take account of actual demand in calculating the costs.

We comment below on two main areas of concern with regard to Ofgem’s proposals:

- Ofgem’s decision to exclude the value of deemed exports from the FIT allowance, which we believe double counts the benefit to suppliers and results in a shortfall in the of circa £0.67 at TDCV (section 2);
- Ofgem’s decision not to adjust for inflation, which based on forecast inflation over the period 2021-2023 results in a shortfall in the of circa £0.70 at TDCV (section 3).

We also draw attention to some possible incorrect data values in Annex 4 (section 4).

2. Deemed export costs

Ofgem is proposing to base the FIT allowance on the value of the Levelisation Fund, as used by the OBR, which is calculated as follows:

$$LF = GP + DE + ME + QC - (D + M)*SSP$$

where GP = Total generation payments
DE = Total deemed export payments
ME = Total metered export payments
QC = Total qualifying costs
D = Total deemed export electricity (MWh)
M = Total metered export electricity (MWh)
SSP = System Sell Price (£/MWh)

This definition excludes the value of deemed and metered export payments ((D+M)*SSP), which is correct from an overall economic (and Levy Control Framework) perspective, since these exports do indeed have a value. However, as explained below, it is not correct, for the purpose of the price cap, to exclude the value of deemed exports, since this results in double counting of the benefit of deemed exports to suppliers. We believe the most straightforward way of remedying this error would be to reinstate the value of deemed exports in the FIT allowance.

Ofgem’s November 2018 decision document (Appendix 5)⁴ justified the use of the OBR Levelisation Fund value (which excludes the value of deemed exports) as follows:

“2.12. One stakeholder argued that because the OBR forecasts of FIT costs were net of the expected value of deemed exports, they would understate the cost of the

⁴ Default tariff cap decision – Appendix 5 – Policy and network costs (paragraph 2.12 and 2.13)
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_5_-_policy_and_network_costs.pdf

scheme. It argued that this was the case because suppliers are billed assuming that there are no deemed exports, and while in theory there may be industry benefit from exports, this is entirely theoretical and difficult to track. It said that inflating the forecast cost of the scheme to exclude the assumed benefit of deemed exports would increase the allowance by £0.28/MWh.”

“2.13. While the benefit to any supplier associated with deemed exports is uncertain (depending on the volume of exports that took place, and when they occurred), and would be different for different suppliers, we do not agree that this benefit is “entirely theoretical”. A supplier will benefit from being allocated lower volumes in settlement where its customers have exported electricity in a given period.”

Ofgem is correct in saying that suppliers will benefit *on average* from the deemed exports, assuming that energy is exported in the quantities assumed (50% of generation). The exports from FIT installations should reduce the required import from each grid supply point (GSP) needed to meet metered demand. This will in turn impact the group correction factor⁵ and result in a lower wholesale cost to all suppliers being served by that GSP (regardless of how many FIT installations they have). Where exactly the saving will manifest itself in an individual supplier’s costs will depend on the circumstances but, for example, if a supplier purchased volumes based on expected demand without adjusting for deemed export, it would incur a negative imbalance charge in respect of the surplus energy.

Ofgem’s decision to exclude the value of deemed exports from the FIT allowance would have been justified if this value was included in the wholesale cost stack instead. But there is no suggestion anywhere in Ofgem’s 2018 decision on the wholesale cost allowance (Appendix 4) that this was the case. If the costs were to have been included, they would have appeared in one of the allowances shown in Ofgem’s table A4.5 reproduced below, most likely the ‘shaping, forecast error and imbalance costs’ line.

Table A4.5: Summary of additional direct fuel cost allowances for gas and electricity

Allowance	Electricity (single rate and multi-register)	Gas
Shaping, forecast error and imbalance costs	6.0%	4.3%
Transaction costs	0.4%	0.3%
Additional risk and uncertainty	1.0%	1.0%
Total	7.4%	5.6%

Source: Ofgem

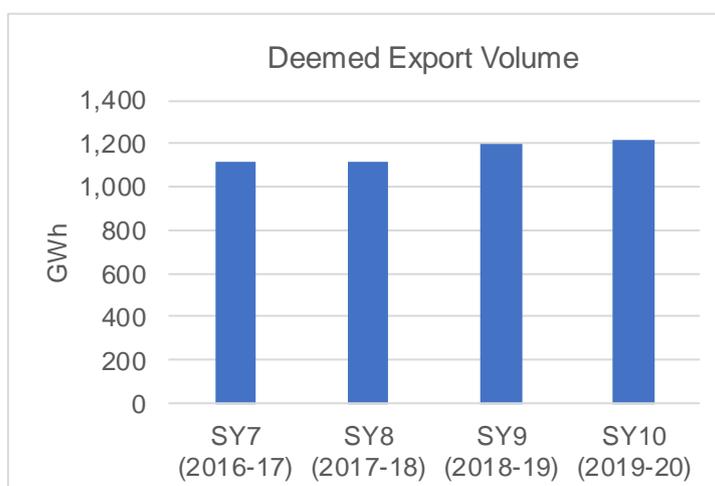
Ofgem explains its approach to calculating the ‘shaping, forecast error and imbalance costs’ in paragraphs 2.18 to 2.23. There is no reference to the treatment of deemed exports, but in the case of imbalance costs (where deemed exports might have an impact, as noted above) Ofgem says these are based on historical imbalance volumes and the average absolute price difference between system buy and day-ahead prices.

We strongly suspect that Ofgem’s approach to estimating wholesale costs was based on the costs actually incurred by suppliers at the time (which were the subject of a number of RFIs to suppliers) and relied heavily on historical data for aspects like imbalance costs. Given that suppliers were already benefiting from similar volumes of deemed exports in 2017 (see Figure

⁵ GSP Group Correction Factors (GGCFs) are used to ensure that the total energy allocated to Suppliers in each Settlement Period in each GSP Group matches the energy entering the GSP Groups from the transmission system, adjoining GSP Groups and through embedded generation (Source : Elexon - <https://www.elexon.co.uk/operations-settlement/trading-settlement/gsp-group-correction-factors/>)

1), Ofgem would have needed to make an explicit correction to add back in the value of deemed exports. Ofgem makes no mention of making such a correction.

Figure 1 – Trend in volume of deemed exports



Source: FIT Annual Reports

In corroboration of the above, we would note that the ‘shaping, forecast error and imbalance costs’ allowed for in the cap are broadly consistent with our experience of actual costs. Had Ofgem made an appropriate adjustment for deemed export, we would have expected the allowance to exceed our view of costs by the value of deemed export (since in our internal accounting we allocated those costs against the FIT scheme rather than wholesale electricity).

If Ofgem considers that it *has* made appropriate allowance for the value of deemed exports in the wholesale allowance, it should explain how it has done so. If it has not, it should reinstate this amount in the FIT allowance.

The materiality of this adjustment is illustrated in the tables below. Table 1 shows the breakdown of the Levelisation Fund including the contribution of the value of deemed exports.

Table 1 – Breakdown of Levelisation Fund

FIT Scheme year/ quarter	Total generation payments	Total deemed export payments	Total metered export payments	Total qualifying costs	Value of deemed exports	Value of metered exports	Levelisation Fund (= cost of scheme)
10 Q1	£393,241,870	£17,940,547	£4,820,690	£17,021,140	£15,555,579	£6,403,284	£411,065,384
10 Q2	£445,326,474	£20,835,175	£9,441,203	£256,410	£32,979,696	£6,510,495	£436,369,071
10 Q3	£348,098,641	£12,080,519	£7,597,779	£287,150	£10,121,456	£5,730,539	£352,212,095
10 Q4	£305,604,213	£8,324,086	£6,497,667	£522,640	£5,643,948	£4,012,110	£311,292,548
11 Q1	£450,690,439	£19,808,271	£23,694,343	£17,412,540	£9,914,719	£10,733,434	£490,957,439
11 Q2	£452,325,556	£20,892,720	£30,968,642	£59,060	£15,037,168	£20,059,407	£469,149,403

Table 2 shows the impact on the FIT allowance of including the value of deemed exports. For Periods 5 and 6 including deemed export costs increases the cap at TDCV by an average of £0.67. (The ‘Total Exempt Electricity supplied (MWh)’ in the table is derived from the values in Ofgem’s Annex 4 spreadsheet. As explained in section 4 below, we believe some of these values may be incorrect, but this does not materially affect the estimate of materiality.)

Table 2 – Materiality of deemed export costs

	Period 5 (Oct '20-Mar '21)	Period 6 (Apr-Sep '21)
Levelisation Fund (£)	1,510,939,098	1,623,611,485
Value of deemed export (£)	64,300,679	40,717,290
Total Electricity supplied (MWh)	275,266,021	261,785,742
Total Exempt Electricity supplied (MWh)	17,002,873	17,537,518
FIT cost estimate (£/MWh)	5.85	6.65
FIT cost estimate inc value of deemed export (£/MWh)	6.10	6.81
Difference in FIT estimate (£/MWh)	0.25	0.17
Average difference in FIT cost estimate (£/MWh)	0.21	
TDCV (MWh pa)	3.1	
EBIT & headroom uplift multiplier	1.034	
Impact on cap at TDCV inc EBIT and headroom (£)	0.67	

3. Inflation

Contrary to its June 2020 proposals, Ofgem is now proposing not to include an adjustment for inflation. As explained below, we believe this is incorrect and results in a material shortfall in the allowance. Ofgem justifies its decision not to adjust for inflation as follows:

“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.”

This justification appears to confuse adjustments for ‘time value of money’ with adjustments to reflect the underlying indexation of FIT tariffs. Although the allowance is calculated based on costs incurred in a prior period (referred to as a lagged basis), it is not correct to regard the amount received via the price cap as being a lagged payment for the actual costs incurred in the prior period (in which case ‘time value of money’ would be relevant). This can easily be understood if one considers the final period of the price cap. The costs incurred in that period cannot be recovered in future periods (since the price cap will have ended and prices will then reflect actual contemporaneous costs). The correct interpretation is that the allowance in each period is intended as a proxy for the actual costs incurred in that period. There are two main sources of variation in £/MWh FIT costs between periods:

- a) natural and seasonal variability in demand and solar irradiation
- b) annual indexation of FIT tariffs to RPI.

Differences due to natural and seasonal variability may be positive or negative and may be expected to average out to zero over time (ignoring long term trends in demand and climate). The proposed approach of using £/MWh costs from prior periods as the proxy will mean that the allowance in some periods is greater than the actual cost in that period and in other periods is less, but on average it should ensure that costs are fully recovered, before taking into account the effect of RPI indexation.

However, the fact that FIT tariffs are indexed to RPI means that the allowance will on average undershoot actual costs by RPI. **This undershoot can be avoided if the allowance in each period is uplifted to reflect RPI and we strongly encourage Ofgem to do so.** As explained below, the magnitude of the adjustment would not be immaterial.

Ofgem also suggests that if it were to adjust for inflation it would use CPIH, since this index is used in other areas of the cap (eg operating costs) and CPIH has been the ONS’s preferred measure of inflation since 2013. This misses the point. The reason for including an inflation adjustment is that FIT tariffs are indexed to inflation and the FIT scheme (which was introduced before 2013) uses RPI. There is no reason why the same index should be used for operating costs and FITs, given the different contexts, and it would be straightforward for Ofgem to include the necessary time series of RPI data (which it could lift directly from the RPI values used to index the FIT tariffs).

The materiality of this adjustment is illustrated in Table 3 where the baseline FIT allowance is assumed to be £6/MWh and the inflationary uplift is calculated as 1.25⁶ times the prevailing rate of RPI inflation. Over the three years 2021 to 2023 the impact on the price cap of this adjustment averages £0.70 at TDCV, similar in magnitude to the value of the deemed export adjustment.

Table 3 – Materiality of inflation increment

	2021	2022	2023
Forecast RPI ⁷	2.6%	3.1%	3.0%
Assumed baseline FIT allowance (£/MWh)	£6.00	£6.00	£6.00
Inflation increment (1.25*RPI) (£/MWh)	£0.20	£0.23	£0.23
Price cap increment at TDCV (inc EBIT & headroom)	£0.63	£0.75	£0.72

⁶ As an approximation we multiply by 1.25 to reflect the 15 month lag between the midpoint of the observation period and the midpoint of the corresponding price cap period. This could be done more precisely by taking into account the actual RPI indexation factor applying in the FIT scheme in the respective observation and price cap periods.

⁷ Forecasts of RPI taken from <https://www.statista.com/statistics/374890/rpi-rate-forecast-uk/>

4. Incorrect data values in Annex 4

We have checked the input data in Ofgem’s spreadsheet ‘Annex 4 – Policy cost allowance methodology v1.71’ against our own values and identified a few discrepancies in Ofgem’s worksheet ‘3i New FIT methodology’ as summarised in Table 4 below.

Table 4 – Possible errors in Ofgem spreadsheet input data

Quarter	Ofgem FIT Annex 4			SP estimate	Difference (MWh)
	Total Electricity supplied (MWh)	Total Exempt Electricity supplied (MWh)	Total supplied minus exempt (MWh)	Volume applicable from Invoice (MWh)	
Jan – Mar 2019	74,227,469	3,504,708	70,722,761	72,657,101	1,934,340
Apr – Jun 2019	64,431,133	4,735,437	59,695,696	60,926,426	1,230,730
Jul – Sep 2019	63,176,820	2,559,203	60,617,617	58,441,383	-2,176,234
Oct – Dec 2019	74,631,055	4,777,949	69,853,106	69,853,106	0
Jan – Mar 2020	73,027,013	4,930,284	68,096,729	68,096,729	0
Apr – Jun 2020	55,167,169	4,494,248	50,672,921	50,672,921	0
Jul – Sep 2020	58,960,505	3,335,037	55,625,468	53,808,771	-1,816,697

We would encourage Ofgem to double check that its calculations are correct for each of the quarters where we have identified a discrepancy.

In the case of the final quarter (July to September 2020), it appears that Ofgem may have incorrectly calculated the Total Exempt Electricity. Ofgem says (footnote 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.”

As shown in Table 5, based on the definition above, we believe the Total Exempt Electricity supplied for the period July-September 2020 should be 5,151,734 MWh instead of 3,335,037 MWh.

Table 5 – Calculation of Total Exempt Electricity supplied

	Jul-Sep 2020 (MWh)
(A) Renewable electricity sourced from outside the UK	3,335,037
(B) Exempt supply cap	2,971,118
(C) Exempt supply to Energy Intensive Industries	2,180,617
Min(A,B)+C	5,151,734
Total Exempt Electricity supplied (Ofgem Annex 4)	3,335,037