

Centrica plc
Regulatory Affairs
Ground Floor, Lakeside West
30 The Causeway
Staines
Middlesex
TW18 3BY
www.centrica.com

Anna Rossington
Deputy Director, Retail Price Protection
Ofgem
10 South Colonnade
Canary Wharf
London E14 4PU.

4 January 2021.

Sent by email to: RetailPriceRegulation@ofgem.gov.uk

Dear Anna,

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

Thank you for the opportunity to respond to the above consultation. This is a non-confidential response on behalf of the Centrica Group.

We support the FIT allowance in the default tariff cap being reviewed. We agree with the need to ensure that suppliers can recover the additional costs related to their obligations under different Government environmental and social programmes.

In our response to the June consultation we recommended that from price cap 6 onwards the FIT allowance should be based on **outturn costs and demand** with an 18-month lag, with costs **adjusted for inflation as appropriate**.

The new proposal (Option A), however, does not correctly define outturn costs or include an appropriate treatment of inflation. If these are not addressed, the new proposal (Option A) would systematically and materially prevent suppliers from recovering the costs of the FIT scheme. The proposal requires adjusting in the following way:

- A methodology based on outturn costs must use the **Amount levelised across licensees**, not the **Levelisation Fund**
- Outturn costs must be inflated in the way appropriate to the FIT scheme, RPI inflation, to ensure the price cap allowance reflects expected supplier costs in the relevant cap period

The Cost of FIT scheme:

The **amount levelised across licensees** must be used to reflect the cost of the scheme for price cap methodology purposes. The value of deemed export, included in the **Levelisation fund**, is already reflected in the loss factors used for the price cap. This means using the Levelisation fund

to set the FIT scheme allowance will double count the benefit of deemed export in the overall price cap allowance and so systematically underfund suppliers.

The overall cost to consumers of the FIT scheme is reasonably approximated by the amount of the **Levelisation Fund**. However, to provide the correct allowance in the supplier price cap it is necessary to understand the different elements of the Levelisation Fund are how these interact with other areas of the price cap.

The table below is based on table 2.1 from the recently published [Feed-in Tariff Annual Report](#) for 2019-2020¹.

Cost	Total (£)	Description
FIT generation payments (A)	£1,501,082,684	The total value of payments made to accredited generators, for on-site generation
Total deemed export payments (B)	£58,010,402	The total value of payments made to accredited generators for electricity that is deemed to have been exported to the grid
Qualifying FIT costs (C)	£18,002,550	The total administration costs allocated to FIT licensees. The administration costs are determined annually by the Secretary of State
Value of deemed export (D)	£45,558,770	The total value of deemed export to the licensees is defined as the amount of electricity deemed to have been exported by all accredited installations multiplied by the System Sell Price (SSP) for the annual period. This is the equivalent wholesale market price
Total metered export payments (E)	£28,623,646	The total value of payments made to accredited generators for electricity that is metered to have been exported to the grid
Value of metered export (F)	£20,478,214	The total value of metered export to the licensees is defined as the amount of electricity deemed to have been exported by all accredited installations multiplied by the System Sell Price (SSP) for the annual period. This is the equivalent wholesale market price.
Levelisation fund (=A+B+C-D+E-F)	£1,539,682,298	This figure represents the cost of the scheme in Year 10
Amount levelised across licensees (=A+B+C+E-F)	£1,585,241,068	The amount that is levelised across licensees is the sum of generation payments, deemed export payments, the difference between metered export payments and the value of those exports , and qualifying FIT costs

Suppliers are invoiced for their market share of the “**Amount levelised across licensees**” i.e. £1,585,241,068 for 2019/20. Therefore, the **Amount levelised across licensees** represents the **direct cost to suppliers** of the FIT scheme.

We acknowledge that this value will overstate the cost of the scheme *to consumers* since it does not recognise the **indirect benefit to suppliers** of deemed exports spilling onto the system (labelled D in table 2.1 above, £45,558,770). These deemed exports will reduce the level of **Non-Technical Losses**² on the electricity system and as such will be reflected in the industry loss factors published by Distribution Network Operators (DNOs). The Balancing and Settlement Code ([BSCP 128](#)) sets out obligations on DNOs to submit loss factors using an approved methodology, which must comply with the principles set out in the BSCP – including the principles that generic

¹ We have corrected (in red text) the final row, as the Ofgem publication erroneously overstates the amount levelised across licensees by not treating the value of metered export correctly (labelled F).

² As defined in: [BSCP128: Production, Submission, Audit & Approval of Line Loss Factors \(elxon.co.uk\)](#)

loss factors shall account for all losses (Technical and Non-Technical) and shall be re-calculated at least every 2 years. The resulting loss factors are also audited to ensure they comply with the approved methodology.

For the purpose of the price cap methodology, it is important to recognise that these published loss factors are also used to uplift the typical consumption values to derive the purchase volumes on which the wholesale allowance is based. Therefore, by using the latest approved industry loss factors the price cap methodology already reduces the volumes suppliers need to purchase, and so the level of the price cap, in a way which captures the benefit of the deemed FIT exports in table 2.1 above.

As a result, it is only the **amount levelised across licensees** that can be used to reflect the cost of the scheme for price cap methodology purposes. To use the **Levelisation fund** will double count the benefit of deemed export in the overall price cap allowance and so systematically underfund suppliers.

Outturn costs must be appropriately inflated, by RPI inflation:

In our response to the June consultation, we supported the use of outturn costs and demand in the absence of an updated OBR forecast, but we were clear that these outturn costs would need to be appropriately adjusted for inflation. The adjustment for inflation is necessary to convert the outturn costs into an appropriate forecast of costs in the relevant price cap period.

We did not recommend a pure lagged pass through of FIT costs. Our recommendation to use outturn demand was provided in the context of Ofgem's clearly stated position³ that the use of outturn costs would require the application of RPI inflation to the appropriate scheme year. Instead our recommendation was to use outturn demand alongside inflated outturn costs. The use of outturn demand served two purposes:

- It would enable suppliers to recover the additional FIT costs incurred as a result of the demand suppression caused by COVID lockdown restrictions (which Ofgem has stated it intends to do);
- It would offer protection to consumers and suppliers against the significant uncertainty surrounding future demand levels (reducing future forecast uncertainty in the cap)

With the FIT scheme closed to new registrations, the levels of capacity, generation and export under the scheme has stabilised and therefore prior periods will provide a robust view of the underlying levels of capacity, generation and export that will apply in future price cap periods.

However, in order to provide a robust view of the expected costs in future price cap periods, these outturn costs must take account of the known increases in tariff rates that will be in effect in the relevant cap period. Outturn costs on their own, as proposed by Ofgem's lagged pass through approach, will systematically and materially understate the expected costs for each applicable price cap period.

³ Ofgem stated in its June consultation: "*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*" [emphasis added]

For example, in order to provide a robust forecast of FIT costs for the sixth price cap period (in FIT year 12), it seems self-evident to us that the outturn data from Q3 and Q4 of FIT year 10 and Q1 and Q2 of FIT year 11 must be adjusted for the known tariff changes that will be in effect in FIT year 12. This requires Q3 and Q4 costs from FIT year 10 to be uplifted by an estimated 3.2% (2.2% for the FIT year 11 tariff increase⁴ and a latest estimate of 1.0% for FIT year 12 increase⁵), and Q1 and Q2 costs from FIT year 11 to be uplifted by an estimated 1.0%. It is not credible to base FIT allowances in the price cap on outturn scheme costs which will be systematically lower than the costs faced by suppliers during the cap period.

With respect to the appropriate measure of inflation, tariff rates are published by 1st February annually by Ofgem, and as set out in supply licence condition 33, these tariff rates are increased each year by RPI. Therefore, the only appropriate measure of inflation to use to uplift outturn costs from prior periods is RPI. Since these are published by 1st February, they will always be available for the price cap.

We do not accept the rationale put forward in the consultation for the use of CPIH. Different measures of inflation are used throughout the price cap methodology, with the clear intent being that in each instance the appropriate measure of inflation is used for each element. For instance, the capacity market allowance uses CPI because the capacity market regulations stipulate that clearing prices are uplifted by CPI. The Renewables Obligation allowance and the AAHEDC allowance both use RPI, again because RPI is stipulated in the respective methodologies as the relevant inflation measure. For the FIT scheme, in line with supply licence condition 33, tariffs are increased each year by RPI and therefore RPI is the appropriate inflation measure to convert historic outturn costs into an appropriate forecast of costs in the relevant price cap period.

Regardless of the official status of the RPI measure of inflation, it's purpose in the price cap for the FIT allowance is not to reflect the level of general price change in the wider economy, but it is instead to reflect the level of tariff change that will be applied in each FIT year. Therefore, for this purpose, it is the only correct measure of inflation.

In combination, the systematic defects we have identified above result in a material under funding of suppliers FIT costs in the price cap. The table below demonstrates the scale of this:

	2017/18	2018/19	2019/20	2020/21
Amount Levelised Across Licensees	£1,428,599,531	£1,481,729,589	£1,585,241,068	£1,620,116,371*
Option A scheme cost assumption	£1,241,270,193	£1,361,907,302	£1,449,421,904	£1,498,099,253
Difference to actual costs	-£187,329,338	-£119,822,288	-£135,819,164	-£122,017,118
Option B scheme cost assumption	£1,330,000,000	£1,455,000,000	£1,502,500,000	£1,545,000,000
Difference to actual costs	-£98,599,531	-£26,729,589	-£82,741,068	-£75,116,371

* 2020/21 estimated by uplifting 2019/20 outturn for 2020/21 published tariff rate increase of 2.2%

The Option A methodology as proposed would have resulted annual shortfalls averaging £140m if it had been in place historically. The OBR forecast has also under forecast total costs and our expectation is that it will continue to do so (albeit to a lesser extent than Option A) since the

⁴ April 2020 (2.2%): [Feed-in Tariff \(FIT\): Tariff Table 1 April 2020 | Ofgem](#)

⁵ Latest 2020 Q4 [OBR forecast](#) (actual rate will be known by 1st February 2021). Whilst we use an estimate here for FIT year 11, we note that the actual uplift is required to be published by Ofgem by 1st February and so will be known at the time of setting the price cap, removing any uncertainty.

underlying increase in FIT generation capacity driving the OBR forecast error will continue to cause shortfalls in future price cap periods.

Therefore, it is clear the FIT methodology needs to be amended. However, as demonstrated above, the methodology proposed by Ofgem (Option A) results in a greater systematic error and supplier shortfall than the current methodology.

It has long been part of the statutory framework that Ofgem must have regard to the ability of suppliers to finance their licensed activities and meet their regulatory obligations. This longstanding requirement is further reinforced by the Domestic Gas and Electricity (Tariff Cap) Act 2018 (the Act) which specifically identifies “...*the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence...*”⁶ The defects we have identified need to be corrected so the price cap can allow suppliers to recover the additional costs related to their obligations under the FIT scheme.

We hope you find these comments helpful. Please contact me if you have any questions.

Yours sincerely,

Andy Manning
Head of Industry Transformation, Governance & Forecasting
Centrica Legal & Regulatory Affairs (UK & Ireland)
Centrica Regulatory Affairs, UK & Ireland

⁶ See: <https://www.legislation.gov.uk/ukpga/2018/21/section/1/enacted>.
Page 5 of 5