All stakeholders

Email: RetailPriceRegulation@ofgem.gov.uk

Date: 15 January 2019

Dear stakeholders,

Capacity market allowance in the default tariff cap

On 1 January 2019, we introduced a price cap for domestic customers on standard variable and default tariffs (the 'default tariff cap'). The first price cap period (1 January until 31 March) includes an allowance for Capacity Market (CM) payments. This letter outlines our approach to the CM calculations in the default tariff cap for the next price cap periods in light of recent developments.

The 15 November 2018 judgment of the General Court of the Court of Justice of the European Union[1] had the effect of removing the European Commission's State Aid approval for the GB CM scheme. The government introduced a standstill period[2] until the scheme can be approved again. On 19 December 2018 the government set out that it is minded to restart the collection of CM payments from suppliers during the standstill period (depending on the outcome of its consultation) to facilitate the expected deferred payments to capacity providers (if and when the State Aid case is approved).[3]

We recognise there is a risk that the default tariff cap does not include an allowance for capacity payments which suppliers are later required to pay, or equally includes an allowance which subsequently suppliers may not be required to pay.

On 7 February we will set the level of the default tariff cap for 1 April until 30 September (the second cap period). <u>If – by the time we update the cap for the second cap period - there is sufficient confidence that suppliers will have to pay the CM Supplier Charge during (or prior to) the second cap period, then we will include a CM allowance for that period reflecting the costs associated with the CM Supplier Charge</u>.

However, <u>if we cannot be confident about the likelihood of suppliers having to pay these charges, we will set the allowance to account for only the ongoing administrative costs of the CM scheme and not the CM Supplier Charge</u>. In such a situation, we expect to consult at a later date (once there is more clarity on whether the CM Supplier Charge will be collected)

[1] http://curia.europa.eu/juris/document/document.jsf?text=&docid=207792&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=1430154

[2] The 'standstill period' refers to the period beginning on 15 November 2018 (the date of the General Court judgment) and ending when the Secretary of State determines that it has ended, following the European Commission granting State Aid approval again to the main GB CM scheme. During the standstill period, the scheme does not have State Aid approval and aid cannot be granted under the scheme.

[3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767015/proposals-for-technical-amendments-to-the-capacity-market.pdf

on an approach to any CM allowance for future cap periods. We will propose any necessary amendments to the default tariff cap calculations at that time, in line with our standard update timetable for the cap in April and October. This will ensure the cap reflects up to date information on the costs suppliers are incurring and limits error from inadvertently being included in the calculations.

In the development of the default tariff cap, we consulted on the option of using an 'error correction' mechanism to retrospectively correct for forecast error when the cap level is updated. We decided not to include an error correction mechanism in the design.

As we stated in our previous consultation process, with any error correction mechanism there are risks of creating market distortions, and in ensuring the correction accurately reflects over- or under-recovery in the previous period. We have also already accounted for cost uncertainty in the design, including through a headroom allowance, which will reduce the adverse impact on suppliers of any forecast error.

If necessary, we would consider the implications of suppliers being required to pay the CM Supplier Charge during the second cap period without there being an allowance in the cap. We would consider whether this was sufficiently material, and of a one-off, unusual nature, such that there was an argument to include an allowance in the third cap period to take account of payments made by suppliers in relation to the second cap period. We will consider this further following responses to this consultation, and if necessary also as part of a future consultation on the approach to the third cap period and beyond.

Annex 1 to this letter provides more detail on our approach to the CM allowances for the second and subsequent cap periods. Annex 2 provides information on our proposed changes to the CM allowance calculations for the second cap period.

We are also taking the opportunity to fix a minor calculation error in relation to CM administrative costs – we also cover this in Annex 2.

We welcome views on the approach set out in this letter. Please provide any responses to RetailPriceRegulation@ofgem.gov.uk by **close on 23 January 2019.**

We appreciate this is a relatively short period in which to provide views. However, we consider this is an urgent matter and we were not in a position to consult until there was greater clarity about the likely position on CM payments. We want to ensure we are transparent with stakeholders, and provide an opportunity to comment ahead of setting the default tariff cap on 7 February.

Yours faithfully,

Rob Salter-Church
Director – Retail Systems Transformation

The Office of Gas and Electricity Markets
10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000 **Fax** 020 7901 7066

Annex 1: Our approach to the Capacity Market Cost Component

Background

The default tariff cap sets the maximum price per unit of energy that a supplier can charge its customers on standard variable and default tariffs. In order to set this maximum charge we estimate the efficient cost of each component of a customer's bill (eg network costs, wholesale costs, operating costs etc.). We then update this level every six months to reflect changes in underlying costs.

One element within the cap is the Capacity Market Cost Component. This reflects the costs of the CM scheme. At a high level, we calculate the cost using information on: the amount of capacity procured, the capacity payments to generators determined through the auctions and the peak demand base. We determine these costs on a fiscal year basis (eg April 2018 to March 2019), using a weighted average of the costs for the two CM delivery years which overlap the fiscal year. The allowance also includes the administrative costs of the CM scheme. Appendix 4 of our decision on the default tariff cap explains the methodology in more detail.[4]

Following the General Court's judgement, the government published a consultation on 19 December 2018.[5] This set out that it is minded to restart the collection of CM payments from suppliers. The government said that it was considering two options for collecting these payments, and sought views on these options. The consultation closed on 10 January. The government is considering the responses to its consultation.

On 7 February we will set the level of the default tariff cap for 1 April until 30 September (the second cap period). This timetable is required by the licence – we must publish the cap level by the fifth working day in February. In order to calculate and finalise the cap in a robust way, we need to know the inputs and methodology ahead of the point that we set the cap.

Proposed approach for the second cap period

Scenario a) confidence in supplier payments restarting before or during the second cap period

This is the scenario where we consider that, by the time we set the level for the second cap period, it is likely that supplier CM payments will restart. In this scenario, we propose to maintain an allowance, calculated in the same way as at present. This would therefore include the costs of CM payments (ie the CM Supplier Charge), as well as administrative costs.

The government postponed the T-1 2018 auction following the General Court's judgement. This auction relates to the 2019-20 CM delivery year, which forms part of our calculation for the second cap period. Annex 2 sets out how we propose to estimate the expected costs of this T-1 2018 auction.

There is a possibility that CM payments collected could be returned to suppliers in future (in the event that State Aid approval is not granted). Suppliers would then need to pass these payments back to consumers. However, determining how to pass these payments back to consumers would be a market-wide issue, which would not just affect customers protected by the default tariff cap.

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[4] Ofgem (2018) Default tariff cap: decision. Appendix 4, paragraphs 2.35 to 2.37.
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_4_-_wholesale_costs.pdf

[5] BEIS (2018) Proposals for technical amendments to the Capacity Market.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767015/proposals-for-technical-amendments-to-the-capacity-market.pdf

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10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000 **Fax** 020 7901 7066

Scenario b) insufficient confidence in supplier payments restarting before or during the second cap period

If there is insufficient confidence by the time we update the cap that CM supplier payments are likely to restart, we propose to include a minimal Capacity Market Cost Component in the second cap period.

This would solely be to allow suppliers to recover the administrative costs of the CM scheme. Suppliers are still responsible for paying these costs through the settlement costs levy, even while payments to generators are suspended.

We would not include any allowance for the costs of CM payments (ie the CM Supplier Charge). This would avoid the level of the cap being set too high, including costs which suppliers were unlikely to incur.

In Annex 2, we explain how we would implement this approach within the wholesale cost allowance model (Annex 2 of standard licence condition 28AD).

Proposed approach for the third cap period and beyond

The third cap period will run from 1 October 2019 to 31 March 2020. We will set this cap by 7 August 2019.

If, by the end of July 2019, it is likely that suppliers will be required to make CM payments for the third cap period (or indeed have started making such payments during the second cap period), we will include a CM allowance that reflects expected CM supplier payments for the third cap period.

If we had not included an allowance in the second cap period, and noting our general stance not to include retrospective correction elements in the cap, we would then need to consider whether there was a justifiable rationale – reflecting relevant legislation – for allowing recovery of any costs associated with CM payments in relation to the second cap period in subsequent cap periods. We would consult nearer the time if we were to do this.

However, we would need to take into account the following considerations.

- **Error correction:** In our decision on the default tariff cap, we explained why we had not included a mechanism to retrospectively correct for forecast error.[6] We still consider that this is the correct general position, given the distortions and lack of accuracy of any correction mechanism and the inclusion of a headroom allowance. We therefore see a retrospective correction mechanism as a last resort, for exceptional circumstances only. It may still be appropriate in this specific case, but this would be without prejudice to the general position set out in our default tariff cap decision.

- **Materiality:** As above, the default tariff cap includes a headroom allowance and other allowances to recognise the net cost of uncertainty.[7] We would need to consider the materiality of any payments suppliers had made. Furthermore, suppliers have already received a CM allowance within the cap for the first cap period, but are not currently making such payments. We therefore need to consider not only the CM payments made in the second cap period, but also any offsetting impacts from other cap periods. This would be relevant when considering the materiality of the issue, and the size of any adjustment.

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[6] Ofgem (2018) Default tariff cap: decision. Appendix 3, paragraphs 3.7 and 3.8.
https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_3_-_updating_the_cap_methodology.pdf
[7] Ofgem (2018) Default tariff cap: decision, paragraph 2.4.
https://www.ofgem.gov.uk/system/files/docs/2018/11/decision_-_default_tariff_cap_-_overview_document_0.pdf

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10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000 **Fax** 020 7901 7066

Next steps and consultation responses

We welcome views on this letter by **close on 23 January 2019.**

We recognise that this is a short period for comment. However, this is unavoidable in light of the fixed deadline for setting the level of the cap. As we said above, we want to ensure we are transparent with stakeholders and provide them with an opportunity to comment on our approach. Following the government's consultation on the Capacity Market, we now have further clarity to enable us to set out the interactions with the cap. We cannot set the level of the cap without determining how to adjust the CM allowance and therefore, a longer consultation period is not possible within the timeframe set out in the licence. Given our general view that retrospective adjustments are difficult and undesirable, we want to make sure that the level for the second cap period is as accurate as possible, and that stakeholders have an opportunity to comment on our proposed approach.

We will publish our decision when we set the cap level on 7 February.

We appreciate that the situation is evolving, and that further clarity may emerge after we have set the cap level for the second cap period. As discussed above, if necessary, we intend to issue a consultation on any changes required for the third cap period and beyond.

The Office of Gas and Electricity Markets
10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000 **Fax** 020 7901 7066

Annex 2: Implementation within the model

This annex explains in more detail how we propose to change the Capacity Market Cost Component. We cover both scenarios a) and b) above.

The Capacity Market Cost Component is part of the wholesale cost allowance methodology. This model is Annex 2 to standard licence condition 28AD. Where we refer to specific sheets or cells below, we are referring to this model.

Scenario a) confidence in supplier payments restarting before or during the second cap period

In this case, we would calculate the CM Cost Component in the usual way, reflecting the costs associated with capacity contracts.

This would reflect that a supplier was making CM payments. Although these payments would not be passed onto generators immediately, this does not affect a supplier's outgoings. From a supplier's perspective, there is little difference compared to when the CM scheme was in full operation.

It is possible that suppliers may be required to make CM payments during the second cap period in relation to previous months. We would not take these months into account when setting the level of the cap for the second cap period:

- CM payments for October to December 2018 cover the period before the cap came into effect, and are therefore irrelevant from a cap perspective. Suppliers already had the opportunity to take the CM scheme into account when setting their pre-cap tariffs.

- For January to March 2019, the first cap period already included an allowance for the CM.

We do however need to consider the T-1 2018 auction.[8] The government postponed this auction following the General Court's judgement.

The cap methodology calculates the Capacity Market Cost Component based on the two CM delivery years which overlap the relevant fiscal year. For the second cap period, the two CM delivery years are 2018-19 and 2019-20. The T-1 2018 auction relates to the 2019-20 CM delivery year, and is therefore relevant to the second cap period.

We do not know what the outcome of the T-1 2018 auction will be, either in terms of the obligated capacity or the auction clearing price. However, there is information that would allow us to estimate these values.

We recognise that any estimate of the costs of the T-1 2018 auction would be an approximation. However, any positive estimate is still likely to be more accurate than assuming that this auction will have no cost at all. We therefore propose to include an estimate of the costs of the T-1 2018 auction within the calculation for the second cap period.

Obligated capacity

We propose to estimate the obligated capacity using the target capacity for the T-1 2018 auction, as specified by the government in July 2018. This was 4.6GW.[9]

[8] This is the auction which will deliver in winter 2019-20.
[9] Capacity Market Auction Parameters 2018, letter from BEIS to National Grid, July 2018. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/723175/Parameters_Letter_to_Fintan_Slye_-_National_Grid.pdf

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For the second cap period, the obligated capacity for the T-1 2018 auction (in MW) is set in cell R48 of sheet '6b Obligated capacity'. We therefore propose to enter a value of 4,600 in this cell.

This cell is only used to calculate the Capacity Market Cost Component for the second cap period – it does not affect other cap periods. Depending on the timing of any auction, we may be able to use the actual capacity for subsequent cap periods.

Auction clearing price

The auction clearing price for the T-1 2018 auction is set on line 23 of sheet '6c Clearing prices and CPI'.

Cell C23 is the auction clearing price (in £/kW/year). We propose to use the value of the T-1 2017 auction clearing price as an estimate. This was £6/kW/year. We consider that this is appropriate because it is the most recent T-1 auction.

However, given we are using this auction clearing price as an estimate for the value in a later year, we propose to adjust this for inflation. The T-1 2017 auction clearing price was not subject to indexation, given that the auction was held in the same year as delivery. To estimate the cost for the T-1 2018 auction, we would be applying the auction clearing price to the following winter. We therefore propose to use October 2017 – April 2018 as the base period in cell D23.[10] The applicable base CPI value is 104.8 – we would apply this in cell E23. The model will then index the auction clearing price using the CPI values set out in the CPI section of '6c Clearing prices and CPI'.

Cell F23 is the CM delivery year. This is 2019/2020 for the T-1 2018 auction.

As currently set up, the model uses the same price for a given auction in all applicable cap periods. For the T-1 2018 auction, this means the second, third, fourth and fifth cap periods.

Once the actual auction clearing price is available, we would consider whether to update the T-1 2018 clearing price for subsequent cap periods. This could require changes to the model and a further consultation.

Estimated impact

We provisionally estimate that the Capacity Market Cost Component would be around £14.59 in the second cap period. This estimate is a GB average, for a single rate electricity customer with a typical level of consumption. It is a provisional figure because it does not use the final input values for other parameters (losses and demand).

If we did not include the T-1 2018 auction, we estimate the Capacity Market Cost Component would be only £0.24 lower (£14.35). The decisions about the T-1 2018 auction therefore only have a small impact. However, we still think it is best to be as accurate as possible.

The Capacity Market Cost Component is an annualised figure used to set the level of the cap – it does not represent the amount a typical customer would pay during the second cap period. The wholesale cost allowance model assumes profile class 1 (ie single rate) customers have 43.2% of their demand in the summer season. Under this approach, we estimate that a typical customer would pay around £6.31 towards the CM scheme during the second cap period. This assumes their supplier priced at the cap.

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[10] The October-April base period reflects the base period used for T-4 auctions, which are subject to indexation (unlike the T-1 auctions).

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Scenario b) insufficient confidence in supplier payments restarting before or during the second cap period

In this case, we would set a minimal Capacity Market Cost Component in the second cap period. This would include the CM administrative costs, but exclude all other costs. This would reflect that suppliers are continuing to pay the administrative costs of the CM scheme, through the settlement costs levy.

In this case, we would propose editing the cells where we calculate the total scheme costs for the second cap period. These are cells Q17 and Q22 in sheet '5b Supplier charge'. There is one cell for each CM delivery year that relates to the second cap period.

We would delete the element of the formula that calculates the CM payments. This would leave only the element that relates to administrative costs. For example, the formula below is from cell Q17. The strikethrough in red shows the section we would delete.

> =IF('6d Winter peak demand'!R13="","-",0.5*'6e Admin costs'!Q11~~+SUMPRODUCT('6b Obligated capacity'!R14:R28,'5c Uplift clearing prices'!Q14:Q28)*'6d Winter peak demand'!R17~~)

This is a straightforward approach for implementing our policy intent in this scenario. As we would only edit the values for the second cap period, this option would avoid any impacts on the values calculated in Annex 2 for other cap periods. We therefore propose to use this approach if we are in this scenario.

Estimated impact

We provisionally estimate that a minimal Capacity Market Cost Component would be around £0.11 in the second cap period.[11] This estimate is a GB average, for a single rate electricity customer with a typical level of consumption. It is a provisional figure because it does not use the final input values for other parameters (losses and demand).

The Capacity Market Cost Component is the value that feeds into the level of the cap. However, the cap is an annualised figure. The Capacity Market Cost Component is therefore not the amount that a typical customer would pay in relation to the CM scheme during the second cap period. In this scenario, we estimate that a typical single rate customer would pay around £0.05 towards the CM scheme in the second cap period. This assumes a supplier is pricing at the cap.

Methodology correction

We have noticed a small calculation error in relation to CM administrative costs. We are proposing to amend this for the second and subsequent cap periods.

There are two CM delivery years feeding into the calculation for each cap period. Our approach to allocating administrative costs is to allocate half of the administrative costs to each delivery year, so that the cap level in each cap period reflects the total CM administrative cost. This calculation is on sheet '5b Supplier charge'.

However, there is currently a formula error for the second CM delivery year. The model currently includes the full administrative cost for the second CM delivery year,[12] meaning that we are very slightly over-recovering this cost and setting the cap marginally higher than it needs to be. The materiality is very small – we estimate this would account for around £0.06

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[11] The estimated impacts figures take into account the methodology correction for administrative costs – see section 'methodology correction' below.

[12] In all cases except the historical example for April – September 2015 (column G).

within the Capacity Market Cost Component for a typical single rate customer in the second cap period.

We propose to correct this. We will therefore multiply the administrative cost by 0.5, in the same way as the current formula for the first CM delivery year. This correction will affect cells Q22:Z22.

We do not propose to make retrospective adjustments to the formulas for the first cap period or the historical examples. This will ensure that the model still reflects the actual value for the first cap period and the historical figures cited in the decision document.

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10 South Colonnade, Canary Wharf, London, E14 4PU **Tel** 020 7901 7000 **Fax** 020 7901 7066