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Dear Rob,

Capacity market allowance in the default tariff cap

I refer to your open letter dated 15th January regarding Capacity Market (CM) payments in the next price cap period.

In its technical consultation¹, the Government stated that it is minded to restart collection of the CM Supplier Charge during the standstill period and that the Commission have no objection. Further, that a positive State Aid decision would allow deferred payments to be made to capacity providers who have met their obligations during the standstill period. The Government had received a range of representations across industry that it would be beneficial for confidence and for efficient operations to resume monthly collection now in anticipation of deferred payments. We note that Government has also stated in its consultation that “pending the outcome of this consultation, suppliers may therefore feel it sensible to continue to collect money from their customers to fund this charge”.

The Government has been clear that the judgment ruled on procedural grounds and did not challenge the fundamental nature of the Capacity Market or find it incompatible with State aid. The Government has stated that it continues to believe that the Capacity Market is the right mechanism to deliver secure electricity supply at least cost, and are therefore working closely with the Commission to reinstate the full functioning of the Capacity Market as soon as possible.

We expect BEIS and Ofgem to work closely together and that Government will endeavour to provide a response to the technical consultation confirming its minded to position, ahead of 7th February when Ofgem will set the cap level. Notwithstanding, we believe that the Government’s statements of policy intent should already provide sufficient confidence for Ofgem to continue to include the full CM allowance in the price cap.

In the appendix to this letter, we expand on issues of process, cost recovery and financeability.

Yours sincerely,

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¹ Proposals for Technical Amendments to the Capacity Market, BEIS, 19th December 2018

APPENDIX TO NPOWER'S RESPONSE (capacity market and default tariff cap)

Process

We understand that Ofgem would be relying on SLC28AD.15(a) if it were to amend the methodology in the model, without the need for a full statutory consultation if using licence modification powers. This is questionable given that the methodology is set out in an Annex to the SLC. The upward trajectory of costs and likely significant increase to the cap level must not compromise due process and the legitimate recovery of efficient costs.

Headroom and materiality

Ofgem points to the headroom allowance in the cap for mitigating the impact of not including a specific CM allowance or when considering whether to make a retrospective correction. Ofgem estimates a CM cost of £14.59 (annualised second cap period) which exceeds the current headroom allowance of c£12. This is before the impact of other cost uncertainties and the increasing costs of mutualisation due to supplier insolvencies. It is difficult to see how this would not pass a materiality test and is extremely concerning. We do not see how such an approach would be compatible with the financing of licence activities.

We do not understand why Ofgem would need to consider the CM allowance and payments in the first cap period to offset impacts from other periods, given BEIS statements that (subject to State Aid approval) generators would be fully recompensed for the standstill period. Suppliers not being required to make payments prior to reinstatement would be irrelevant if and when we are required to pay the CM Supplier Charge in full.

Given the strong likelihood that suppliers will incur CM Supplier Charges to facilitate deferred payments to capacity providers (for which accruals would be prudent and form part of an efficient cost base), the sensible approach would be to maintain a CM allowance in the cap. In the unlikely event that charges are not collected, Ofgem could make a one-off adjustment to ensure no windfall for suppliers.

We are also concerned that removing the CM allowance would send the wrong signal to the market, with the risk that fixed price contracts fall leaving suppliers unable to recover backdated charges.

Charging Mechanism

At npower, we understand the need for certainty from the perspective of capacity agreement holders (and their investors / financiers) that funding to pay deferred payments will be available once State Aid approval has been re-granted. On that basis and to minimise bill shock, we support the reintroduction of the supplier charge via the existing Electricity Settlements Company (ESC) processes. We understand from working group discussions that whilst BEIS have identified some changes that are required to the associated regulations, BEIS could reinstate ESC collection of the CM Supplier Charge before those changes are made.

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“error correction”

Throughout the price cap consultations, npower consistently stated that Ofgem should have a Recovery mechanism, in which adjustments to forecasts are trued up in subsequent periods. The mechanism is completely standard in price controls, including network charging in Great Britain. The recovery mechanism fulfils Ofgem’s primary duty in relation to the interests of present and future consumers, because the “deadweight” cost of risk is greatly reduced.

We recognise that Recovery mechanisms do have a distorting effect, since the cost adjustments fall in to the “wrong” supply period and cause the controlled price to deviate from the “competitive price”, currently in the Fixed Term Contract (FTC) market. However, a degree of distortion is both inevitable and tolerable. For example;

- i) The “6-2-12” wholesale indexation is distorted because the hedge delivery period does not coincide fully with the supply delivery period;
- ii) In Standard Variable Tariff (SVT) pricing, it has been the practice of suppliers (in energy and in other markets) to “smooth” cost variations by spreading across supply periods. Amongst other things, this reduces bill shock.

The use of recovery and other mechanisms that places costs in the “wrong” period is a matter of balance in relation to market distortions. In the case of the tariff cap, the existing indexation method and the addition of a recovery mechanism, there is the additional consideration of the variation of the misalignment between costs and prices. To a certain extent the ebb and flow of this has the effect of increasing the maximum differential between SVT and FTC increases, thereby stimulating engagement, albeit at the expense of potential bona fide overstatement of savings (the next reset cap price not being known in advance). The effect of the “distortion” is therefore mitigated.

Our view was, and is, that the balance weighs in favour of a Recovery mechanism, since the overall saving of the deadweight costs of risk outweighs the issues of “distortion”.

Having already experienced the negative effects of not having a Recovery mechanism, Ofgem now has the opportunity to redress this by introducing one.

Component costs

In the first paragraph of the background, Ofgem correctly asserts that the cap should be built bottom up at component level. It *necessarily* follows that changes in components should flow straight through to changes in the cap.

In setting the cap, the choices are therefore;

- i) Include 100% of the CM on the basis that it is more likely than not to be charged to the supply period and associated consumers ostensibly benefitting from the capacity, whether this be sooner or later;
- ii) Include 0% of the CM on the basis that it is less likely than 50% of being charged;
- iii) Include X% of the CM on the basis of X% likelihood of it being charged;
- iv) Use a Recovery mechanism in the cap.

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Since the CM will either be charged or not charged, then the X% mechanism has a 100% chance of being the wrong amount. This would be inordinately messy to unravel.

BEIS has signalled a clear intention of charging the CM. It behoves Ofgem to align to the BEIS view. In the absence of Recovery then Ofgem has no choice other than i) to include CM in the cap.

Gas and Electricity Act compliance

We believe that Ofgem should recognise that;

- i) The cap is built bottom up at component level;
- ii) According to the Domestic Gas and Electricity (Tariff Cap) Act 2018 (TCA18) s1(6)(b) the headroom must allow some room for competition if even it improperly includes an element for misforecasting by Ofgem;
- iii) The headroom is limited and is already used up, for example in the costs of smart and Unidentified Gas;
- iv) TCA18 did not repeal or make relevant amendments to the Gas Act 1986 and the Electricity Act 1989. It is therefore a requirement on Ofgem to enable suppliers to finance their activities;
- v) If Ofgem removes the CM from the cap and it is subsequently charged, this would place Ofgem in breach of GA86/EA89. Proceeding with a cap reduction with this knowledge arguably would place Ofgem in breach at the point of setting the cap.

Accordingly, to comply with primary legislation, Ofgem cannot remove the CM from the cap without putting in place a recovery mechanism.