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All stakeholders

Email: RetailPriceRegulation@ofgem.gov.uk

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Dear Stakeholders,

Decision on changes to 'Annex 3 – Methodology for determining the Network Cost Allowance' and the allowance for the Shetland Cross Subsidy in the default tariff cap

On 25 November 2020, we issued two open letters to consult stakeholders on changes to the Network Cost Allowance and the allowance for the Shetland Cross Subsidy within the default tariff cap (cap) from the sixth charge restriction period (April 2021 – September 2021) onward. We proposed to amend the spreadsheet models (models) forming Annex 3 and Annex 4 of SLC 28AD[1,2] to accurately reflect recent changes in data inputs. As part of the amendments, we also proposed to update the 'Supplementary workbook to Annexes 2, 3 and 4 – Demand and losses' (supplementary workbook).

This letter sets out our decision to proceed with our proposals. These are:

Annex 3 – Network Cost Allowance

- Determine Distribution Use of System (DUoS) costs at the Benchmark Annual Consumption Levels using an average unit charge weighted by the half-hourly share of demand. The share of demand will be calculated in the supplementary workbook.
- Use the Baseline Obligation values as a new data source to weight Exit Capacity National Transmission System (ECN) charges at Local Distribution Zone (LDZ) level.
- Remove the 'TO exit charge' and 'SO exit charge' and add the 'General Non-Transmission Services Exit Charge' as a new input.

Annex 4 – Policy Cost Allowance

- Include an additional uplift amount to reflect the Shetland Cross Subsidy in the allowance for the Assistance for Areas with High Electricity Distribution Costs (AAHEDC) scheme.

[1] Licence Conditions on Ofgem website:
https://www.ofgem.gov.uk/licences-industry-codes-and-standards/licences/licence-conditions

[2] Annex 3 includes the 'Network cost allowance methodology - elec' and the 'Network cost allowance methodology - gas'. Annex 4 includes the 'Policy cost allowance methodology'.

In reaching this decision, we have carefully considered the feedback received. Annex 1 to this decision letter provides a high-level summary of these views, and gives our response. We have published Annexes 3 and 4 of Standard Licence Condition (SLC) 28AD and the supplementary workbook alongside this document.[3]

Changes to 'Annex 3 – Methodology for determining the Network Cost Allowance' and the supplementary workbook

Background

The cap includes a Network Cost Allowance to ensure that suppliers are able to recover costs that are incurred through gas and electricity network charges. Data inputs previously used to determine the Network Cost Allowance have changed in structure or availability. In our November 2020 Annex 3 consultation,[4] we proposed alternative data sources and amendments to the structure and format of the models forming Annex 3 and the supplementary workbook to reflect these changes from the sixth cap period onward.

A summary of the changes in data inputs and our proposals can be found below.

- Following the change to the Distribution Connection and Use of System Agreement (DCUSA) under Distribution Change Proposal (DCP) 268,[5] the electricity DUoS charges set for April 2021 are based on a three unit rate Red/Amber/Green (RAG) tariff. As part of determining the DUoS costs at the Benchmark Annual Consumption Level,[6] we proposed to calculate an average unit charge. To weight the RAG unit charges, we proposed to use the half-hourly share of demand as determined in the supplementary workbook.

- The existing gas target volumes of National Transmission System (NTS) capacity used to weight exit zones in Annex 3 are published up to March 2021. From April 2021 onward, we proposed to use the Baseline Obligation values published in National Grid Gas's long term summary reports[7] as a new data source for the weightings.

- Following the introduction of Uniform Network Code (UNC) modification 678A, the existing terminology and references to the 'SO exit charge' and 'TO exit charge' in Annex 3 no longer accurately reflect the gas transmission charging regime that is in place. We proposed to remove both inputs and add the ''General Non-Transmission Services Exit Charge' as a new input to better align with the current gas transmission commodity charges.

[3] Annex 4 of SLC 28AD is also updated in line with our decision on changes to methodology used to determine the Feed-in Tariffs allowance in the default tariff cap: https://www.ofgem.gov.uk/publications-and-updates/decision-feed-tariffs-fit-scheme-allowance-methodology-default-tariff-cap
[4] Consultation on changes to 'Annex 3 – Methodology for determining the Network Cost Allowance' of the Default Tariff Cap: https://www.ofgem.gov.uk/publications-and-updates/consultation-changes-annex-3-methodology-determining-network-cost-allowance-default-tariff-cap
[5] DCP268 - DUoS Charging Using HH Settlement Data - https://www.ofgem.gov.uk/publications-andupdates/dcp268-duos-charging-using-hh-settlement-data
[6] The 'Benchmark Annual Consumption Levels' are the levels of annual consumption at which the Network Cost Allowance is calculated. For electricity, these are nil kWh, 3,100 kWh for single-register metering arrangements and 4,200 kWh for multi-register metering arrangements.
[7] National Grid Gas's Exit Capacity Publications, Allocation & Release Obligation LT Summary Report and Baseline Capacity Statement: http://mip-prd-web.azurewebsites.net/ExitCapacityPublication/Index

For more information on the background to the changes and our proposals, please refer to the November 2020 consultation.

Decision

We have decided to proceed with our proposed approach from the sixth cap period onward, as set out in our November consultation. Following the consultation period, we received feedback from three stakeholders. Only one respondent raised a direct issue with our proposals. We have summarised their comments and our considerations in Annex 1 of this letter.

This decision means that the updated Annex 3 models and supplementary workbook that are published alongside this document will be used when updating the cap level for the sixth charge restriction period.

Changes to 'Annex 4 – Methodology for determining the Policy Cost Allowance' to reflect the Shetland Cross Subsidy

Background

The cap includes an allowance for a government scheme called the AAHEDC scheme. The government amended this scheme to spread the costs of the Shetland Cross Subsidy across GB consumers.

In our November 2020 consultation,[8] we proposed adding an uplift amount to the AAHEDC allowance in the cap to reflect the addition of the Shetland Cross Subsidy to the scheme.

Decision

We have decided to proceed with our proposed approach. This will mean an uplift will be applied to the AAHEDC allowance in the cap from the sixth charge restriction period, as set out in our November 2020 consultation. Following the consultation we received feedback from one stakeholder. The respondent did not raise any issues with our approach. We have summarised its comments and our considerations in Annex 1 of this letter.

This decision means that the updated Annex 4 model published alongside this document will be used when updating the cap level for the sixth charge restriction period.

Yours faithfully,

Anna Rossington
Interim Director, Retail

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[8] Consultation on updating the Shetland Cross Subsidy Allowance in the default tariff cap: https://www.ofgem.gov.uk/publications-and-updates/consultation-updating-allowance-shetland-cross-subsidy-default-tariff-cap

Annex 1: Summary of relevant stakeholder views and considerations

Changes to 'Annex 3 – Methodology for determining the Network Cost Allowance' and the supplementary workbook

We received three responses to our November 2020 consultation on changes to Annex 3 and the supplementary workbook in the price cap. We have uploaded the non-confidential responses to our website and provided a high level summary of the points raised and our response to specific points below.

We received a response from one stakeholder who supported all our proposals. It agreed that using Elexon data to calculate the share of demand for each cap period is the most effective method of reflecting DUoS costs from 1 April 2021. It also agreed that the Baseline Obligation volumes are a suitable source of weightings for ECN charges, and that the 'General Non-transmission Services Exit Charge' should replace the 'SO exit charge' and 'TO exit charge'.

<u>Including DUoS in the calculation of headroom allowances</u>

Stakeholder's view

One stakeholder raised concerns around the level of precision of our approach in terms of estimating DUoS costs. While it acknowledged our approach was practical in implementing changes to the cap following DCP 268, they highlighted that using a weighted unit charge will result in an estimate of DUoS costs that is less likely to reflect actual DUoS costs when compared to the previous approach.

As a result of this, the stakeholder considers that suppliers will be exposed to greater uncertainty and that the DUoS allowance should be included in the costs components used to scale the headroom allowance.

Considerations

The changes introduced by DCP 268 mean that DUoS charges will vary depending on when customers consume electricity. Differences between the demand profile of a supplier's customer base and the demand profile we use to set the DUoS allowance could therefore create differences between the DUoS costs a supplier incurs and the allowance it is able to recover. We accept that our approach may therefore increase the uncertainty around DUoS costs.

However, our current view is that DUoS charges should still be known to a reasonable degree of precision. In general, we would not expect the profile of domestic customers' demand (in aggregate) to vary significantly between years.

The headroom allowance is set to cover a level of risk and uncertainty not included in other elements of the cap. We do not consider that there is material cost uncertainty arising from DUoS charges, and that any uncertainty would be covered by the existing level of headroom.

Regional consumption profiles to calculate average DUoS costs

Stakeholder's view

On stakeholder did not support our proposal to determine the half-hourly share of demand using Elexon's national consumption profile in the supplementary workbook. It considers that it is not fair to recover costs based on a national average as consumption profiles differ between regions.

As an example, the stakeholder mentions that in the Northern Scotland region there is higher load for charging heating equipment over the Red charging period. As a result, suppliers are exposed to higher costs than the 2020-21 DUoS unit rate in applicable Load Managed Areas.

Considerations

Our proposal used the national average demand profile to allocate consumption in the RAG time bands in each charge restriction region. For single-rate and multi-register metering arrangements, we use the average demand profile for Profile Class 1 and Profile Class 2 respectively. If a regional demand profile allocates more consumption to the Red charging period than the national average, then other regional demand profiles must allocate less consumption to the Red charging period. Suppliers will therefore incur net costs in some regions and net benefits in other regions. Suppliers will generally have a spread of customers across different regions – we consider that this means our approach will provide a sufficient approximation of suppliers' costs. Any alternative approach would be significantly more complex.

In regard to the example of increased load during peak times due to charging heating equipment, we consider that customers with electric-only heating are likely to have above typical consumption. As we noted in our price cap decision,[9] the benchmark at nil consumption is lower than the cost reflective level, while the unit rate is higher. This means that suppliers can recover revenues above costs from consumers who have above typical consumption. Considering both points (DUoS costs and above typical consumption) in the round, we have not seen evidence that there is an overall concern for suppliers with a high proportion of electric heating customers in the Northern Scotland region.

Distribution Network Operator derogations

Stakeholder's view

One stakeholder stated that Distribution Network Operators (DNOs) are likely to apply for derogations from their charging methodologies and the requirement to provide 15 months' notice. It stated that this could be for a number of reasons including the recovery of bad debt and Supplier of Last Resort (SoLR) payments. If these requests were to be approved, it would likely result in an increase in DUoS costs from April 2021.

It requested that we include any approved additional network costs resulting from derogation requests that we are aware of (or consider likely to be approved) by 5 February 2021 in the allowance.

[9] November 2018, paragraph 1.5: https://www.ofgem.gov.uk/system/files/docs/2018/11/appendix_1_-_benchmark_methodology.pdf

Considerations

In May 2019, we published a decision which addressed the issues DNOs face relating to costs associated with a SoLR event.[10] This sets out the changes to the SLCs that allow the pass through of these costs as part of the DNOs' allowed revenue. The stakeholder raised the example of the costs associated with a DNO derogation included in the second charge restriction period. However, as set out in the May 2019 decision, costs associated with a SoLR event are now passed through the allowed revenue mechanism which will subsequently be passed onto suppliers through network charges. So these costs will be allowed for in the network costs component of the price cap. This means a derogation is not needed unless the costs breach a materiality threshold.

Under SLC 28AD, we are required to publish the price cap level for charge restriction periods starting on 1 April no later than the fifth working day of February. We perform the cap level calculations with the information available at the time. If we publish an approved derogation request regarding the breaching of the materiality threshold before the February cap announcement, we will include an allowance in the sixth charge restriction period. However, if the derogation has not been approved by that time, it will not be included.

Updating the allowance for the Shetland Cross Subsidy

We received one response from one stakeholder regarding the allowance of the Shetland Cross Subsidy. It was in broad agreement with our approach and stated they felt the changes we made to 'Annex 4 – policy costs allowance methodology' adequately reflected the proposals.

[10] Ofgem, May 2019: https://www.ofgem.gov.uk/publications-and-updates/decision-modifications-electricity-distribution-licence-recover-costs-associated-appointing-supplier-last-resort