Rupert Steele OBE
Director of Regulation

Chris Smith
Retail Markets
Ofgem
9 Millbank
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4 May 2012

Dear Chris,

THE STANDARDISED ELEMENT OF STANDARD TARIFFS UNDER THE RETAIL MARKET REVIEW

I am writing with ScottishPower's response to Ofgem's consultation on the Standardised Element of Standard Tariffs under the Retail Market Review (RMR).

We responded on 16 March 2012 to Ofgem's main Domestic RMR proposals (the 'December consultation'). In that response we expressed serious concerns over Ofgem's tariff simplification proposals, including proposals to set a regulated standing charge for standard products. We explained that these proposals would be likely to have a range of adverse impacts on consumer engagement and on competition, and could ultimately be detrimental to consumers. We therefore suggested that Ofgem would need to conduct a rigorous and comprehensive economic appraisal of its proposals before it could justify intervening in this way.

We remain opposed to the imposition of a regulated standing charge, and our response to this consultation should be read in that context. With that caveat in mind, our main comments on the consultation are as follows:

- We disagree with the arbitrary distinction between a 'narrow' and 'wide' standing charge introduced in the December consultation and retained in the present consultation. Exclusion from the standing charge of costs that genuinely scale with customer numbers appears incompatible with Ofgem's stated objectives of methodological transparency, cost reflectivity and avoidance of cross-subsidy.

- We think Ofgem's current methodological approach for estimating 'other supplier fixed costs' is too simplistic. Instead, Ofgem should estimate such costs on a bottom up basis in the same way as it has done for other cost categories.

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- We strongly prefer Option 2 for dealing with regional cost variations (suppliers set regionally varying unit rates), as this is less interventionist, requires less explanation to consumers, and should not be materially worse than Option 1 in terms of any ‘nudging’ effect that Ofgem thinks would encourage consumers to engage with the switching process.

- We welcome Ofgem’s proposal to include the actual standing charge and any regional variation formulae in a schedule within the licence condition (as opposed to a direction issued by Ofgem).

- We think that the proposed arrangements for notifying changes in the standing charge to customers may be unnecessarily burdensome, given that changes are likely to be small and customers have limited scope to avoid them.

We have included our comments on the specific questions raised within the consultation in the Annex to this letter. We would be pleased to discuss any of our views with you in more detail. Please do not hesitate to contact me if that would be useful.

Yours sincerely,

Rupert Steele
Director of Regulation

ANNEX

ScottishPower response to the Consultation Questions

We responded on 16 March 2012 to Ofgem's main Domestic RMR proposals (the 'December consultation'). In that response we expressed serious concerns over Ofgem's tariff simplification proposals, including proposals to set a regulated standing charge for standard products. We explained that these proposals would be likely to have a range of adverse impacts on consumer engagement and on competition, and could ultimately be detrimental to consumers. We therefore suggested that Ofgem would need to conduct a rigorous and comprehensive economic appraisal of its proposals before it could justify intervening in this way.

We remain opposed to the imposition of a regulated standing charge, and our response to the questions below should be read in that context.

1. Do stakeholders agree with our proposed approach to those costs that should be recovered through a standing charge and those costs that should be recovered through a unit rate?

We agree with the principles behind the proposed treatment of suppliers' costs summarised in Table 2.1 of the consultation (reproduced below). In particular, we agree that where transmission and distribution costs scale with consumption (even if actual charges relate to consumption in a previous year), it is more efficient – assuming that the method of recovery is determined by regulation rather than the market – for suppliers to recover these through the unit rate rather than the standing charge. Our views on the detailed proposals are given in response to Question 2.

Table 2.1: Treatment of suppliers' costs

	Illustrative annual cost for average consumer (£)	Recovered through standing charge	Recovered through unit rate
Gas transmission	6	✗	✓
Gas distribution	122	✗	✓
Electricity transmission	19	✗	✓
Electricity distribution	81	✓(£13)	✓(£68)
Energy Company Obligation*	29 (gas), 29 (elec)	✓	✗
Warm Home Discount*	7 (gas), 7 (elec)	✓	✗
Metering*[i]	23 (gas), 15 (elec)	✓	✗
Other supplier fixed costs*	25 (gas), 25 (elec)	✓	✗

** If included in the standing charge.*
i Metering cost estimates are based on traditional meters, not smart meters.

However, we have serious concerns about the caveat below the table that asterisked items (ECO[1], WHD, metering and other fixed supplier costs) may not be included in the

[1] If the Government in due course decides that the incidence of ECO (or indeed any other of the listed obligations) should be based on kilowatt hours rather than customer numbers, then we would of course expect those particular items to drop out of the standing charge calculation; our comments are subject to this caveat.

standing charge. This caveat relates to the distinction introduced in the December consultation between a ‘narrow’ and a ‘wide’ definition of the standing charge, whereby the ‘narrow’ definition would exclude all these asterisked items.

Although Ofgem implies that issues of ‘narrow’ versus ‘wide’ are outside the scope of the present consultation, we do not believe it makes sense to consider them separately. In our response to the December consultation we said we would comment further on these issues once we had seen the full proposals. Having considered the matter further, we find this ‘narrow’ versus ‘wide’ distinction problematic for a number of reasons:

- The allocation of costs to the ‘narrow’ and ‘wide’ categories is arbitrary and lacks objectivity. The key test, as acknowledged elsewhere in the consultation, is whether a cost element scales with number of customers or energy consumption. This should be the over-riding consideration in determining whether a cost should be included in and recovered from the standing charge.[2]

- There is a lack of transparency as to how Ofgem would determine where in the range between ‘narrow’ and ‘wide’ to set the standing charge. In the absence of objective criteria, it becomes a matter of discretion for Ofgem, which creates uncertainty and puts an unelected regulator in the position of transferring wealth between classes of customers as it sees fit. We think that Ofgem may wish to be cautious about assuming such a role.

- Deviating from the ‘wide’ definition (ie excluding asterisked items) would result in non cost-reflective prices and cross-subsidies from high consuming customers to low consuming customers. This in turn would distort suppliers’ incentives, for example encouraging them to focus their marketing effort on high consuming customers and ignore low consuming customers.

Ofgem lists four criteria in the executive summary for setting the standing charge: tariff comparability, cost reflectivity for suppliers, methodological transparency and minimisation of cross-subsidies between consumers.[3] We agree that these are appropriate criteria and struggle to see how the ‘narrow’ versus ‘wide’ distinction can be reconciled with them.

As a practical point, we would observe that the more rigorous consideration of the incidence of network charges has largely removed the potential concern that the regulated standing charge would be very large. In these circumstances there seems little point in diverting from the principle of cost reflectivity in setting this element.

[2] So if the ECO or other environmental obligations were to be modified so that supplier costs were proportional to TWh sold instead of customers, such costs should then be recovered from the unit rate. But our understanding of the December consultation is that Ofgem is reserving the right to exclude these from the standing charge, even if costs are proportional to number of customers.

[3] Condoc page 5

2. Do stakeholders have any comments on the proposed broad assessment of the possible elements of the standing charge (set out in Appendix 1)?

We broadly agree with the assessment of the possible elements of the standing charge in Appendix 1, with the proviso that if Ofgem decides to proceed with this approach, it will be necessary to conduct a more detailed and rigorous analysis of all the relevant costs. Our comments on the methodology and suggested values are as follows:

- We agree that where transmission and distribution costs scale with consumption (even if actual charges relate to consumption in a previous year) it is efficient – if the incidence of such costs is to be regulated at all – for suppliers to recover them through the unit rate rather than the standing charge. We agree that there is a component of electricity DUoS charges that does not scale with consumption and should therefore be included in the standing charge. (We note in passing that, where network charges are recovered through the unit rate instead of the standing charge, suppliers face the risk that they may under-recover or over-recover costs as a result of variability in consumption from one year to the next. This uncertainty is exacerbated by inaccuracies in the current AQ process, which we are keen to see addressed.)

- In the case of CERT and CESP schemes, the average cost per customer has turned out to be significantly higher than the amount estimated in DECC's impact assessments. If the incidence of ECO is finally on a per customer basis, the same issue may arise again (the impact assessment of the Government's initial proposals looked to us to be highly optimistic). Accordingly, it could be necessary to calculate the standing charge contribution based on actual market costs rather than estimated Impact Assessment rates.

- We think the methodological approach for 'other supplier fixed costs' is too simplistic and lacks transparency. In essence, Ofgem has looked at the 'typical' standing charge currently levied by suppliers and subtracted the other cost elements to yield an estimate of £20-30[4]. Given the variation between different suppliers' standing charges, it is far from obvious what constitutes a 'typical' standing charge, which detracts from the transparency. Furthermore, once a regulated standing charge has been imposed, it will be impossible to apply this methodology in future. Instead, Ofgem should adopt the same approach as it has for other cost categories, and derive a bottom up estimate for a typical supplier with a typical mix of payment methods[5], recognising that this will necessarily be approximate. The main components are likely to be:

    - customer service (dealing with incoming calls);
    - processing and chasing of payments;
    - IT systems;
    - printing and postage (bills, annual statement etc);
    - customer acquisition.

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[4] Condoc page 29, para 1.47
[5] Supplier fixed costs (billing, customer service etc) vary widely with payment method

When all these costs are included, we think the estimate of £20-£30 may be on the low side.

3. Do stakeholders have any comments on the treatment of regional cost differences? Do they favour Option 1 or Option 2?

Ofgem's assessment of the pros and cons of Option 1 (Ofgem sets regional unit rate adjuster) and Option 2 (suppliers set regionally varying unit rates), as summarised in Table 2.3 of the consultation is a good starting point for assessment of the issues. However, we believe that some of the listed benefits of option 1 and some of the listed drawbacks of option 2 have little weight, and that taking account of this and some further considerations, the balance comes down firmly in favour of Option 2. Ofgem's table is reproduced below:

Table 2.3: Benefits and drawbacks of the January proposals

Option	Benefits	Drawbacks
1	Regional differences are cost reflective Regional differences are transparent Allows communication of supplier-set unit rates in a wide range of national media Easy for consumers to compare the supplier-set national unit rates	More complex: three elements of standard tariffs need to be considered More interventionist approach Will cause distributional impacts
2	Less interventionist approach Simpler – only two tariff elements need to be considered	May be difficult for tariff information to be published on a national basis Consumers may have difficulty in understanding which supplier-set unit rates are applicable (i.e. they may not know which region they are located in) Greater risk of cross-subsidies between regions

We would query the advantage for Option 1 "Allows communication of supplier-set unit rates in a wide range of national media". By virtue of the regional adjuster, any such price communicated would not reflect the price charged in almost all regions. It seems to us implausible that the regional adjuster will be readily communicated to customers.

We would also doubt the weight of the first two disadvantages listed for Option 2, as the issues could be dealt with by publishing averages of the regional tariffs. As neither this average, not the figure to be published under Option 1, reflects the price actually charged, it is unclear that Option 2 has any clear disadvantage.

We would also note the following additional drawbacks of Option 1:

- it would add complexity to supplier bills and point of sale communications, as they will need to explain how actual unit rates have been derived from the 'headline' rate plus the regional adjuster;

- it would create a need for additional consumer education, given that this represents a departure from tariff structures that consumers are currently familiar with;

- it would add an additional regulatory process burden for Ofgem in determining the adjuster and for suppliers in making representations and ensuring compliance;

- by requiring publication of the price for the cheapest region, with an Ofgem-generated adjuster uplift on top, Ofgem would be requiring suppliers to charge most customers above the advertised price. This could lead to serious trust issues;

- by ensuring identical (and not just similar) regional variation in pricing across suppliers, it could encourage suppliers to match each other's prices with a negative impact on competition.

Finally, although we recognise there could be benefits of being able to publish tariff information on a national basis, we are not convinced that Option 2 is significantly inferior to Option 1 in this respect. For example, it would still be possible under Option 2 to publish the average unit rates of different suppliers (averaged across regions). Given that suppliers face broadly similar regional cost variations, average unit rates should be reasonably representative of the price differentials between different suppliers.

Consumers would not be able to calculate exact price comparisons based on average unit rates, but as we argued in our response to the December consultation, we think that Ofgem has attached far too much importance to enabling such manual comparisons. In virtually every switching transaction, consumers will receive a computer-generated tariff comparison based on actual consumption data. In our view, the role of national comparison tables (assuming that they reveal any material differences in pricing at all) should be to act as a 'nudge', to alert consumers to the approximate magnitude of potential savings and motivate them to embark on the switching process. Average unit rates under Option 2 would be perfectly adequate for such a nudge.

Therefore we strongly favour Option 2 as it is less interventionist, requires less explanation and is unlikely to be materially worse than Option 1 in enhancing consumer engagement.

A further issue is that it appears that Ofgem envisages the regional adjuster applying to gas and electricity separately. Given that gas and electricity regions do not have common boundaries, we understand that suppliers generally (in the interests of simplicity) map the gas regions into the nearest equivalent electricity regions, rather than catering for all the permutations. There would be IT implications, as well as winners and losers among the customers, in seeking to change this approach.

4. Do stakeholders have any comments on the assessment of the individual elements of the possible regional adjuster (set out in Appendix 2)?

We note that Ofgem's regional adjuster relates only to differences in network costs in each region and we are broadly comfortable that Ofgem has captured the main concerns in terms of how a regional adjuster should be calculated. At a broad level, the load factors and definition of peak share would seem to cover the appropriate customer types that would be affected by the standing charge. However, load factors are determined by the various distribution networks and vary year by year, so will need to be reviewed and adjusted accordingly. This will need to be reflected in any methodology used to calculate a fixed Standing Charge.

We would however reiterate our strong preference for Option 2 in which there is no need for Ofgem to calculate a regional adjuster (see our response to Question 3).

5. Do stakeholders agree with our proposed treatment of the standing charge (based on a broad assessment) and possible regional adjuster (using a formulaic approach) in the licence conditions?

If Ofgem decides to proceed with a regulated standing charge, we would consider a schedule of standing charges with automatic adjuster for future years to be a generally pragmatic and suitable approach to implementing it within the licence.

Our main concern is that the regulated standing charges and automatic adjuster should be included within the licence condition itself, such that changes are subject to the licence modification procedure and suppliers' ability to appeal the substance (as well as the methodology) of such price control decisions is preserved. The December consultation proposed (in draft Condition 22A.3) that the actual prices would be relegated to an Ofgem direction, which would not be subject to suitable appeal.

We therefore welcome the apparent change of policy in the latest consultation, which states that the actual charges and/or a formula for determining them will be included in the licence condition.

6. Do stakeholders agree with the proposed timing of any potential changes to the standing charge and regional adjuster?

We are concerned about consideration within the document of requiring suppliers to provide individual customer notification in line with SLC 23 on two fronts.

- First, if the standing charge is set centrally by Ofgem, and is the same for every customer in an area, this should not be a matter that requires individual notification. This will only serve to add a further unnecessary level of cost to customer bills. Therefore, any announcement of change should be a general announcement by Ofgem and supported by suppliers, for example through publication on their websites.

- Second, customers won't have the same opportunity to reject the change as with a general price increase under current arrangements, as the impact is the same on any Standard tariff from any supplier. While consumers may be encouraged to consider Non-Standard tariffs, this does not equate to the same opportunity to avoid the increase as with a current price change. It is therefore not appropriate that suppliers should be required to give notice in accordance with SLC 23 of these changes, over which they have no control.

We do not consider that a short lag between the timing of the network charge changes and the Standing Charge change would have a significant impact on suppliers. An annual change on 1 June each year is probably reasonable. However, Ofgem should note a further consequence of this approach may be to create opportunities for tacit co-ordination between suppliers, if all price changes are managed at or around a particular point in time.

It is sensible that Ofgem monitors any mid-year changes in fixed costs, with the opportunity to allow a change to the Standing Charge if fixed costs vary significantly outwith the annual review period.

ScottishPower
4 May 2012