

Default Tariff Cap: Policy Consultation

Appendix 5 – Updating the cap over time

Consultation - supplementary appendix

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Overview:

The energy market works well for consumers who shop around. Suppliers compete for these engaged consumers, offering low prices to gain or retain their custom.

But the retail energy market is not working for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be.

To address this problem, Government has introduced legislation into Parliament which would require Ofgem to design and put in place a temporary cap on all standard variable tariffs and fixed-term default tariffs. We anticipate that Parliament will approve the Domestic Gas and Electricity (Tariff Cap) Bill in the summer, and the default tariff cap will come into force at the end of 2018.

We are now consulting on how we might design and implement the default tariff cap. This supplementary appendix to the main consultation document sets out our proposals in relation to how the level of the cap would be updated over time to reflect trends in efficient costs. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the main consultation document.

Associated documents

Policy consultation for Default Tariff Cap – Overview

https://ofgem.gov.uk/system/files/docs/2018/05/default_tariff_cap_-_policy_consultation_-_overview.pdf

Links to supplementary appendices

- Appendix 1 - Market basket:
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_1_-_market_basket.pdf
- Appendix 2 - Adjusted version of the existing safeguard tariff
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_2_-_adjusted_version_of_the_existing_safeguard_tariff.pdf
- Appendix 3 – Updated competitive reference price
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_3_-_updated_competitive_reference_price.pdf
- Appendix 4 – Bottom-up cost assessment
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_4_-_bottom-up_cost_assessment.pdf
- Appendix 5 – Updating the cap over time
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf
- Appendix 6 – Wholesale costs
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_6_-_wholesale_costs.pdf
- Appendix 7 – Policy and network costs
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_7_-_policy_and_network_costs.pdf
- Appendix 8 – Operating costs
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_8_-_operating_costs.pdf
- Appendix 9 – EBIT
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_EBIT.pdf
- Appendix 10 – Smart metering costs
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_10_-_smart_metering_costs.pdf
- Appendix 11 – Headroom
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_11_-_headroom.pdf
- Appendix 12 – Payment method uplift
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf
- Appendix 13 – Renewable tariff exemption
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_13_-_renewable_tariff_exemption.pdf
- Appendix 14 – Initial view on impact assessment
https://ofgem.gov.uk/system/files/docs/2018/05/appendix_14_-_initial_view_on_impact_assessment.pdf

Document map

This supplementary appendix to the main overview document set out our proposals in relation to how the level of the cap would be updated over time to reflect trends in efficient costs.

Figure 1 below provides a map of the default tariff cap documents published as part of this consultation.

Figure 1: Default tariff cap – policy consultation document map

Overview Document	
Supplementary Appendices	
<p>Approaches for calculating efficient costs</p> <ol style="list-style-type: none"> 1. Market basket 2. Adjusted version of the existing safeguard tariff 3. Updated competitive reference price 4. Bottom-up cost assessment 	<p>Discussions of specific categories of costs</p> <ol style="list-style-type: none"> 6. Wholesale costs 7. Policy and network costs 8. Operating costs 9. EBIT 10. Smart metering costs
<p>Reflecting trends in efficient costs</p> <ol style="list-style-type: none"> 5. Updating the cap over time 	<p>Potential additional cap elements</p> <ol style="list-style-type: none"> 11. Headroom 12. Payment method uplift
<p>Scope of the default tariff cap</p> <ol style="list-style-type: none"> 13. Potential renewable exemption 	<p>Impact assessment</p> <ol style="list-style-type: none"> 14. Initial view on impact assessment

Links to these documents can be found in the 'Associated documents' section of this document

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1. Approaches to updating the cap

In this chapter, we discuss three different approaches to updating the level of the default tariff cap so that it reflects trends in efficient costs. We set out our rationale for proposing the third approach, which is to update the cap with reference to a set of cost drivers that are outside of suppliers' control.

Context

1.1. Many of the costs of supplying energy to customers vary significantly over time, often for reasons outside of suppliers' control. For this reason, we propose to design the default tariff cap in a way that allows it to be updated periodically to reflect trends in efficient costs. The Domestic Gas and Electricity (Tariff Cap) Bill requires us to review the level of the cap at least every six months.

1.2. Given the requirements of the Bill, our key considerations in designing the process for updating the cap are to ensure:

- a) **that the cap tracks changes in efficient costs over time.** This will ensure that where costs rise, suppliers that operate efficiently are able to finance their activities – and where costs fall, that customers on default tariffs¹ are protected from excessively high prices according to the intention of the Bill.
- b) **that the cap does not create unintended incentives for suppliers that are detrimental for consumers.** This includes ensuring that the mechanism used to update the cap does not reduce the incentive for suppliers to improve their efficiency by cutting costs, or their incentive to compete for domestic customers.

1.3. In addition we have had regard to the uncertainty created by the different possible approaches, as well as the level of administration required. This is because where an approach creates undue risk for companies – or leads to disproportionate administration costs – we would expect this to ultimately lead to higher prices (and so less protection) for customers on default tariffs.

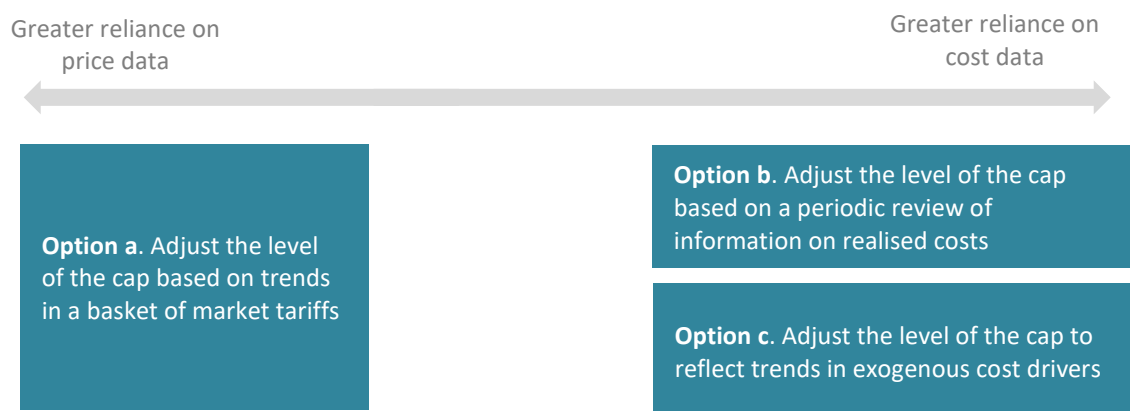
¹ ie Standard variable tariffs, and default fixed tariffs.

Options

1.4. As set out in our first working paper² (published 12 March 2018), we have identified three possible approaches to updating the level of the default tariff cap (summarised in Figure A5.1):

1. The level of the cap could be updated to reflect trends in **a basket of market tariffs**. The principle here would be that rivalry in the competitive market segment would ensure that movements in tariffs over time reflect trends in an efficient level of costs.
2. The level of the cap could be updated based on **a periodic review of suppliers' realised costs**. This would involve periodically collecting historic cost information from different groups of companies, making any efficiency adjustments that were required, and then using this to set the revised level of the cap.
3. The level of the cap could be updated based on **trends in exogenous cost drivers** – linked to third party data and/or a pre-specified allowance for certain cost items. An approach of this type is used under the existing safeguard tariffs, which are updated with reference to an index of wholesale prices, forecasts of policy costs and inflation.

Figure A5.1: Options for updating the allowance for efficient costs



² Ofgem, working paper 1 – setting the level of the cap - https://www.ofgem.gov.uk/system/files/docs/2018/03/working_paper_1_-_design_issues_-_for_publication.pdf

1.5. In principle, a hybrid approach could also be used, combining elements of the different options.

Our proposal

1.6. We have considered the merits of each of these approaches against the criteria set out in paragraph 1.2 above.

1.7. We do not propose to update the cap using a basket of market tariffs.

We think that a tariff basket approach would in principle provide a succinct way of capturing relevant trends in the market. However, as discussed in Appendix 1, we have concerns that prices may be affected by trends in the nature of price competition in the market, rather than just movements in costs. This could in turn be affected by the introduction of the cap.

1.8. We are also concerned by the risk that this approach could incentivise suppliers to avoid cutting their prices if they knew that doing so could lead to a lower level of the cap.

1.9. We do not propose to update the cap using periodic reviews of costs.

Using periodic reviews of suppliers' realised costs would have the advantage of ensuring that all trends in costs can be taken into account in the level of the cap – included those that are unexpected. In responses to our working papers, a number of stakeholders highlighted their support for this approach for this reason.

1.10. However, the information on costs would necessarily be backwards-looking, meaning that the level of the cap would move in line with historic rather than current trends, risking creating a distortion to competition in the market. Moreover, tying updates to the cap directly to trends in reported costs would risk reducing the incentive for efficient suppliers to cut their costs.

1.11. We propose to update the cap with reference to trends in exogenous cost drivers. This approach is similar in principle to that used to update the level of the existing safeguard tariffs. We consider that an exogenous indexation approach has a number of advantages over the alternatives:

- The accuracy of this approach is not sensitive to trends in the intensity of competition in the market, nor on the quality of supplier data. It will to a greater extent allow costs to be recovered in the period in which they are incurred, avoiding unintended distortions to competition.
- It avoids creating unintended incentives in relation to how suppliers price, and their efforts to cut costs. This is because suppliers cannot influence the indices via their actions in the market.

- It provides the greatest predictability to suppliers, and minimises the administrative burden.
- The key exogenous drivers of trends in suppliers' costs – accounting for the largest part of the bill – can be estimated accurately using third party data

1.12. We provide a detailed overview of the specific approach that we propose to take to updating the cap in the next chapter of this appendix.

QA5.1: Do you agree with our proposal to update the cap in line with trends in exogenous cost drivers?

2. Our proposal

In this chapter, we summarise the approach to indexation that we intend to use to update the level of the default tariff cap. Further details of how specific elements of costs would be treated are provided in the relevant appendices.

Price cap periods

2.1. Our proposal is to update the level of the cap twice a year, with price cap periods running from 1 April – 30 September (summer), and 1 October to 31 March (winter). This reflects the approximate frequency that customers on most default tariffs have historically faced price changes. Where they prefer stability, we seek to protect consumers from unnecessarily volatile or uncertain prices, and from the administrative costs of price changes, by limiting the frequency with which the cap is updated. However, we welcome further views on whether more frequent updates would be preferable, and particularly any evidence in relation to consumers' preferences for price smoothing.

2.2. The rationale for choosing periods that start in April and October is that they align most consistently with seasonal wholesale contracts for gas and electricity; network charging years; and the obligation periods of a number of environmental and social obligations. Alternative dates would require us to set the level of the cap with reference to an average across multiple contracts / years / obligation periods, introducing greater uncertainty.

2.3. Where possible, we propose to use the most up-to-date information available on expected costs in the relevant period, to reduce the risk of forecast error. This implies that we should publish the level of the cap as close to the start of the period as possible, subject to providing sufficient time for suppliers to make the necessary changes to their systems.

2.4. In general, we would expect to publish the level of the cap for the subsequent summer period no later than the 5th working day in February. The level of the cap for the subsequent winter period would be published no later than the 5th working day in August.

2.5. We note that the initial period of the cap is likely to run for a period shorter than 6 months. The exact timing will depend on the legislation, but would likely stretch from December 2018 until 31 March 2019. We expect to publish a notification of the cap level at the end of October 2018.

The historic baseline

2.6. Irrespective of the final methodology that we use to set the initial level of the cap, we will publish a historic baseline – ie the value of the cap for a given historic period. It is this baseline which we will update to set the cap for each price cap period, using the latest data on trends in exogenous cost drivers. Under a bottom-up approach, this would likely be for 2017. For a reference price approach, this would depend on the date to which the reference prices related.

2.7. We propose to update the cap to reflect the individual trends in each component of costs, recognising that they have different drivers. This means that we need to know what part of the initial baseline relates to what type of costs in order to update the cap. Under a bottom-up approach, we would calculate each component of the baseline level directly based on our assessment of each category of costs. Under a reference price approach, we would estimate the share of the reference price allocated to each component (the 'weight') using data on suppliers' costs. We discuss our approach to weighting under a reference type approach in more detail in Appendices 2 and 3.

2.8. We will determine different baseline values for nil consumption and typical consumption; and for gas, single-register electricity, and multi-register electricity. How these different baseline values would be calculated for different elements of costs under a bottom-up approach is summarised in Appendix 4. Our method under the two reference price approaches is discussed in Appendices 2 and 3.

Calculating updated values

2.9. As explained in Chapter 1, we propose to update the cap with reference to trends in exogenous cost drivers. As described above, different components of costs will follow different trends over time – and we will take this into account when updating the level of the cap.

2.10. We summarise how we propose to update the level of the cap to reflect trends in each component of costs in Table A5.1. Further detail on how the indices would be calculated, and how they would be used to update the cap, is provided in the relevant appendices.

2.11. Our proposed approach varies for different components of costs, and takes three different forms:

- For some elements, we propose to calculate the updated value by combining our estimate of a cost's share in the initial baseline level of the cap with an index.
- For some elements, we propose to calculate the updated value of the component of costs directly, in £/MWh and/or £/customer, and add this to the cap.

- For some elements, we expect to calculate the updated value as a percentage of predetermined allowance.

Table A5.1: Summary of proposed approach to updating different components of the cap

Component of the cap	Proposed approach to indexing	Detailed appendix
Wholesale costs	Updated with reference to the prices of wholesale contracts for future delivery. Indexed relative to wholesale prices in baseline period. Capacity Market costs updated using latest data on scheme costs and the demand base across which costs are recovered, indexed relative to costs in baseline period.	6
Environmental and social obligations	Updated using a combination of scheme data, OBR forecasts, and information on the expected demand base across which costs are recovered. Indexed relative to costs in baseline period.	7
Network charges	Allowance for each period calculated directly using network charging statements	7
Suppliers' operating costs, and a normal profit level	Indexed with reference to CPIH, plus an uplift to reflect the expected net impact of the smart meter rollout on costs.	8, 9, 10
Standard credit uplift	Partly set as fixed % of total costs (excluding headroom), partly indexed with reference to CPIH	12
Headroom	Set as fixed % of costs (excluding network costs)	11

QA5.2 Do you agree with our proposed choice of cap and baseline periods?

3. Dealing with uncertainty

In this chapter, we describe our approach to dealing with uncertainty in how the level of the cap is set.

Types of uncertainty

3.1. If efficient costs are materially overestimated for the purposes of setting the cap, then this may mean that customers on default tariffs do not receive the protection intended under the Bill, paying higher prices. If efficient costs are materially underestimated, then efficient suppliers may not be able to finance their activities.

3.2. Differences between efficient costs and those included in the cap could arise as a result of:

- systematic issues due to features of the design – either the initial level of the cap, the weights chosen, or the indices used
- uncertainty in the forecast of future costs used to update the cap.

Systematic issues relating to the design of the cap

3.3. In responses to our working papers, some stakeholders suggested that the design of the cap should include provision to allow it to be modified in the event of unanticipated trends in suppliers' costs.

3.4. Were there are any aspects of the design of the cap that caused it to materially and systematically over- or under-state efficient costs, we consider that we would be able to resolve these via a modification to the relevant licence conditions. The Bill includes specific provision for us to make supplemental modifications to the licence condition if required.

3.5. For example, we might consider making a modification were there a fundamental change to the environmental and social obligations that suppliers are subject to, that was unanticipated when designing the cap, and which had a material impact on suppliers' cost base.

3.6. We would only seek to make such a change were the effect material, given the risk of otherwise creating unintended incentives for how suppliers' operate in the market (as discussed in Chapter 1).

Forecast uncertainty

Background

3.7. As a general principle, we consider that costs should be recovered in the period in which they are incurred. To achieve this, we will update the cap with reference to our expectation of efficient costs in a given price cap period.

3.8. In some cases, costs will be known in advance, and so the risk of there being a material difference between realised costs and what is included in the cap will be low. This is the case, for example, for network costs – where the final charges are published prior to the beginning of each charging year, and so can be reflected when setting the level of the cap.

3.9. In other cases, there will be uncertainty about realised costs at the time the level of the cap is set. A number of stakeholders flagged this forecast uncertainty in their response to our working papers, and suggested that either an error correction mechanism or upfront allowance should be included in the cap to account for this risk.

3.10. We consider that the degree of uncertainty is likely to be particularly material for the costs of the Feed-in Tariff, Contracts for Difference and Energy Company Obligation schemes – all of which may not become apparent until after the obligation period has begun. It is also particularly likely to be the case for the wholesale costs that suppliers incur in relation to any forecast error and shaping to their demand profile, which will rely to a large extent on short term fluctuations in wholesale prices and demand – again not known until after the cap has been set.

Options

3.11. We have considered three options for dealing with uncertainty in the forward-looking estimates of costs used to update the level of the cap. These are described in Table A5.2, below.

Table A5.2: Options for accounting for forecast uncertainty

Option	Description
Automatic error correction mechanism	<p>Under this option, the level of the cap would include an additional component reflecting the extent to which the cap was above or below the intended level in the previous period (or periods, where information on outturn costs is lagged).</p> <p>This component would be calculated automatically, using a pre-determined set of data sources / rules. It could be subject to a materiality threshold.</p> <p>It could be either negative or positive, depending on the impact of forecast error in the previous period.</p>
Discretionary process for making adjustments where there is forecast error	<p>Under this option, a provision would be included within the licence condition for an adjustment to be made to the level of the cap – at our discretion – to reflect the extent to which it was above or below the intended level in the previous period(s). How the adjustment would be made would depend on the nature of the effect being considered, and would not be specified in advance.</p> <p>In assessing whether to include such an allowance, we would consider the materiality of any discrepancy, as well as the possible incentive effects of making a correction.</p>
No formal adjustment mechanism	<p>Under this option, no automatic or discretionary mechanism would be included within the design of the cap.</p>

Our current view

3.12. Our current proposal is not to include a mechanism in the cap to correct for forecasts that are observed retrospectively to have departed from costs.

3.13. In reaching this proposed position, we have taken into account the fact that forecast error is a risk that suppliers already face when setting their fixed tariff prices. Even with a variable tariff, suppliers are only able to update their prices subject to 30 days notice – and have rarely done so more than twice a year in the period since price liberalisation.

3.14. We are concerned that using an error correction mechanism would create a further distortion to the market. In particular, a negative adjustment (to correct for the cap being set too high in the previous period) could lead to a cap being set beneath an efficient level of costs. This would distort customers’ incentives to engage in the market, suppliers’ incentives to offer competitive tariffs, and the incentives of new suppliers considering entering the market.

3.15. Unlike in a network regulation context, a supplier’s default tariff customer base is not static. One implication of this is that we would expect any correction

mechanism to result in recovery that did not match benefits/costs in the preceding period – ie the correction would either be too high or too low:

- At the level of the market as a whole – this is because the correction would need to be set based on the expected number of default tariff customers, which will not be known in advance (and could be affected by the size of the correction).
- For individual customers – as customers flow between default tariffs and competitive tariffs, different customers will over- or under-pay to those that receive compensation
- For individual suppliers – this is because the number of default tariff customers served by a supplier will change from one period to the next. Suppliers gaining default tariff customers will therefore receive too large a correction, suppliers losing default tariff customers will receive too small a correction.

3.16. Both of these concerns apply equally to an automatic and a discretionary error correction mechanism.

3.17. We note that under a reference price approach, we would expect the expected costs of forecast error to already be reflected in suppliers' prices, particularly to the extent that the reference price benchmark was made up of fixed tariffs, where suppliers are unable to increase prices to reflect unexpected changes in costs.

3.18. Under a bottom up approach to setting the cap, we will consider including a specific upfront allowance to reflect any material risk faced by suppliers where this would be expected to systematically lead to higher costs. For example, we are considering including an allowance for wholesale costs to reflect the net expected impact of error in supplier demand forecasts, as described in Appendix 6.

3.19. We note that one factor that we will take into account in considering whether to include a headroom allowance in the cap – and if so, at what level - is whether there is a need to provide any additional allowance for uncertainty beyond that already captured in our estimate of efficient costs. We discuss our approach to headroom in more detail in Appendix 11.

QA5.3: Do you consider that further provision is required for us to re-open aspects of the design of the cap, beyond our licence modification powers – and if so, why?

4. Consultation response and questions

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can. The full list of consultation questions is available in Chapter 7 in the main consultation document.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

Chapter 1 – Approaches to updating the cap

Question A5.1: Do you agree with our proposal to update the cap in line with trends in exogenous cost drivers?

Chapter 2 – Our proposal

Question A5.2: Do you agree with our proposed choice of cap and baseline periods?

Chapter 3 – Dealing with uncertainty

Question A5.3: Do you consider that further provision is required for us to re-open aspects of the design of the cap, beyond our licence modification powers – and if so, why?