The voice of the energy industry

Ofgem Working Paper #1: Setting the default tariff cap

Energy UK response

26 March 2018

Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 730,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests £12bn annually, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level industry view; Energy UK's members may hold different views on particular issues raised by the working paper. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive summary

We welcome the opportunity to have a view of Ofgem's early thinking with regards to the design of the default tariff cap and to be able to feed-in to its evolution. Energy UK has a wide range of membership including larger, medium and smaller suppliers, with differing views on the proposed cap. We do not, therefore have a view to the preferred method for the determination of an efficient level of costs.

Nonetheless, we have sought to comment on the design possibilities for the default tariff cap being considered by Ofgem in the working paper. As Energy UK has noted previously, the accuracy of the level of any cap becomes increasingly important the wider group of customers it impacts.

Given the significance of the cap for the domestic supply market and the volume of households it will impact, it is vital that the efficient costs benchmark is robustly designed to ensure suppliers of all sizes, with varying customer bases, costs and business models can continue to operate competitively. Each option currently being considered has obstacles that Ofgem will need to overcome in order to achieve an effective temporary cap that minimises detriment to competition in the domestic energy market.

Legislative Framework

Energy UK has concerns that Ofgem's current thinking as outlined in the paper has not given sufficient regard to Clause 1(6)(d) and how this will be achieved and we would welcome further clarity on the issue.

This financeability obligation goes beyond the scope of the costs that might be used to set the tariff cap and requires Ofgem to consider the impact of the cap at the licensee level and not just at the SVT/default cap level. That will require Ofgem to take into account all other costs and revenues of authorised activities. As such, it may be worthy of its own working paper so that industry and stakeholders can review Ofgem's initial thinking and feed in to the development process.

Ofgem notes that 2 further conditions are implied by the Bill which will be taken into consideration. Energy UK is concerned that the first of those implied conditions, that the cap must be designed in a way to be put in place quickly, could undermine the effectiveness of the cap if it leads to a rushed implementation. This series of working papers to help influence the evolution of the cap design are a very welcome step in that regard.

The second implied condition noted in the paper is that the cap should be designed in a way that reflects its intended (temporary) lifespan. Energy UK believes that clarity around the conditions under which the cap will be removed from the market is needed, as different success criteria would inevitably impact upon views towards the optimal design of a default tariff cap.

We would therefore welcome early clarity as to what would constitute a success that could see the cap lifted as early as 2020 or as late as 2023. Providing this information, or at least outlining Ofgem's current thinking on success criteria at this stage, would allow members and others to provide useful comments on the best design route possible for the cap to achieve its goals.

Payment Methods

Energy UK welcomes Ofgem's acknowledgement that suppliers face legitimate, differing costs based on the payment method of their customers. Energy UK believes that a general principle of cost-reflectivity should apply to the tariff cap. However, we expect Energy UK members to respond individually to the proposal to implement different caps based on payment methods.

Estimating an Efficient Level of Costs

We expect members to respond individually regarding their preferred options for the estimation of an efficient level of costs. In this response Energy UK would like to highlight a number of concerns that will need to be addressed regardless of the benchmarking option ultimately chosen by Ofgem.

We note that Ofgem will take into consideration comments made by respondents on the two options outlined in the December 2017 consultation (develop CMA's prepayment cap model and a basket of market tariffs). We also note that five other working papers are planned by Ofgem and we hope to see the concerns raised in this response to be addressed through them, where possible.

Energy UK believes that whichever of the four proposed options is ultimately decided upon it is important that costs are accurately accounted for to ensure the cap can deliver the conditions set in Clause 1 of the Bill.

For example, the smart rollout is a significant and growing cost for suppliers and their customers. The design of the cap will need proper consideration of the actual costs incurred by suppliers in delivering the smart meter rollout, and the costs to be expected as it continues through the tariff cap period. We think it is essential that Ofgem obtains more granular and up-to-date cost information on smart rollout direct from suppliers, rather than relying, for example, on information provided by BEIS which may not reflect the impact on suppliers' internal costs of the recent changes and delays to aspects of the programme.

We would also welcome transparency on how Ofgem will take into account the different level of costs that are likely to be incurred between companies with large and smaller rollout programmes, as the level/scale/maturity of their programmes is likely to be very different. We would like to see Ofgem's current thinking on these issues detailed in its planned working paper on operating costs, which Ofgem has already indicated will include its assessment of smart meter costs.

Equally, we would like to see how Ofgem is intending to take into account obligations put on suppliers such as the Energy Company Obligation (ECO) and the Warm Homes Discount (WHD), and specifically the differing level of costs that suppliers of different sizes may have in meeting those obligations. As a point of principle, Energy UK believes that obligations placed on suppliers should be fair for all customers, and we would welcome Ofgem's thoughts on how it will ensure fairness with its tariff cap design. Ofgem's assessment of supplier costs need to accurately reflect the range of impacts these policies have on suppliers' costs and consumers' bills. We hope this is properly considered in the working paper on the issue of external costs.

The recent draft RFI issued by Ofgem, which looks to gather cost and revenue information from suppliers in order to aid the design of the methodology to be used, requested information about 'buckets' of costs at a very granular level. As such it is likely that suppliers will individually need to make a number of assumptions as to how its costs should be apportioned across the low-level cost categories. The potential for differing assumptions to be used results in a risk that unreliable benchmarks could be compiled using non-comparable buckets of costs. Given this we believe it would be useful to receive from Ofgem an understanding as to how this granular information will be used and how such risks will be avoided.

Re-assessment and Error Correction

Equally important as to how the initial cap is set is how the allowance for efficient costs will be re-assessed and we again expect members to respond individually.

Whichever option is taken forward it must recognise that many costs are extensively shaped by external factors and be able to react accordingly to any increases or decreases to ensure the conditions of Clause 1 continue to be met.

While the Bill (as currently drafted) imposes a 6 month maximum period before re-assessment, we welcome Ofgem's recognition that each proposed model could require different update frequencies to be most effective.

Separate but related to re-assessment options is the ability of errors in the cap to be rectified. We would welcome clarity from Ofgem on their thinking regarding any process or option that could be available for identifying, highlighting or rectifying any errors made in either the initial setting of the cap or any subsequent changes as a result of re-assessment.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2965 or at daniel.alchin@energy-uk.org.uk.