



Retail Market Policy
Ofgem
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By email to: retailpriceregulation@ofgem.gov.uk

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Dear Sir / Madam

Default Price Cap - First Working Paper

First Utility welcomes the opportunity to respond to Ofgem's first working paper on the market-wide default price cap ("**default Cap**").

In summary:

1. Any programme of price caps must ensure extra protection for those who "can't" rather than "won't" engage, in order to ensure suppliers meet their licence condition to treat domestic customers in a vulnerable situation fairly.
2. Government and Ofgem must remove the policy cost exemption for sub 250,000 suppliers, without which it will be impossible to fulfil the Domestic Gas and Electricity (Tariff Cap) Bill ("the legislation")'s demand that "tariff cap conditions may not— (a) exempt holders of supply licences from their application, or (b) make different provision for different holders of supply licences".
3. The components under the Cap, whether third party costs, wholesale prices or operating costs, must be set transparently by Ofgem; regularly reviewed and contain both Risk Premia and a Correction Factors where necessary.
4. In terms of removing the default Cap, Ofgem and Government should agree as soon as possible a set of measurable outcomes, together with concrete steps for ensuring those outcomes are met. If engagement is the ultimate objective, suppliers' communications must form a core part of Ofgem's delivery plans.

Taking each of these in turn:

1. To protect the vulnerable, two price caps are necessary

Ofgem has stated it will remove the current vulnerable customer Safeguard Tariff once the default Cap is in place. We recognise the rationale for this, which is presumably to ensure price protection is simple to understand (for consumers) and also to implement (for suppliers).



However, we are concerned that the principles behind the Safeguard Tariff and the default Cap are quite different, and combining the two could see vulnerable customers losing out.

Ofgem created the Safeguard Tariff in recognition that energy is an essential service and *“however easy it becomes to engage in the market, there will always be some households, particularly the vulnerable, who struggle...consumers with vulnerable characteristics—on low incomes, social housing renters, aged 65 or over, or living with a disability—find it difficult to engage in the market...That’s why we may decide to leave in place price protection for the most vulnerable even after the wider price cap is withdrawn”*.

By contrast, the legislation makes it clear that the default Cap should be set so as *“maintain incentives for domestic customers to switch to different domestic supply contracts”*. Such incentives might require significant “headroom” above the default Cap, which could unfairly penalise the vulnerable: those who “can’t” rather than “won’t” engage.

First Utility therefore continues to back the expansion of the Safeguard Tariff this winter, irrespective of the introduction of the default Cap, provided data-matching regulations allow the Safeguard Tariff to be applied consistently across the market.

2. Government and Ofgem must remove the policy cost exemption for sub 250,000 suppliers

The legislation is clear that the default cap must be applied consistently across all suppliers, stating that *“tariff cap conditions may not— (a) exempt holders of supply licences from their application, or (b) make different provision for different holders of supply licences”*

Section 5.34 of the Working Paper sets out how Ofgem could account for policy costs under the default Cap, and yet there is no discussion of the fact some 50 suppliers - now representing 8% of the market, and growing - will receive a £40 allowance for costs they do not face.

This un-earned cost allowance will effectively triple small suppliers headroom allowance, making a significantly *“different provision for different holders of supply licences”* in contrast to the legislation’s stated aims, and exacerbating the already significant competitive distortion whereby new entrants can offer deals even the most efficient larger suppliers cannot match.

Indeed, recent analysis from First Utility suggested that 93/100 cheapest tariffs on the market were offered by suppliers who do not pay the Warm Home Discount or Energy Company Obligation. This situation will only worsen should the larger suppliers increase their cheapest fixed deals in order to protect profitability at the expense of market share as the default cap starts to bite.

In conversations with officials, there seems to be a view that policy costs are a matter for Government, whilst setting the default Cap and reforming competition is a matter for Ofgem.



The two are, in fact, intricately entwined and we urge Ofgem to support moves to remove the supplier threshold as Government reforms the ECO and the WHD this summer

3. The components making up the default Cap, from third party costs through to wholesale prices and operating efficiencies, must be set transparently by Ofgem; regularly reviewed and contain both a Risk Premium and a Correction Factor

First Utility's response to the Safeguard Tariff consultation, which we re-attach, sets out in detail our concerns with how the current PPM / Safeguard Tariff model has significant design flaws which will be unacceptably magnified should it simply be tweaked and applied to a further 11 million households.

We continue to argue that a bottom up cost assessment is the most appropriate means of determining efficient operating costs.

Any "efficiency factor" must enable scale growth (i.e. the competitive benchmark can't be set based on acquisition tariffs).

Ofgem should be clear about the assumptions used to calculate wholesale costs. In particular, the wholesale costs that individual suppliers face go beyond just the wholesale price, as this does not capture the cost of hedging, the cost of balancing and unidentified gas costs etc. These additional costs can vary by suppliers and depend on their specific portfolio.

As a general principle, Ofgem must publish an open, transparent methodology statement as to how it will determine and reviews the costs going into any caps it puts in place, including transparent source information. This is unfortunately not the case with the PPM / Safeguard Tariff, which is very opaque. There should be at least an annual check the model is fit for purpose, given anticipated changes to network cost structures and the potential new costs, and a Correction Factor included in the Cap as proposed in your Working Paper. And it needs to be clearly stated which costs are treated as fixed/variable and their categorisation.

4. In terms of removing the default Cap, Ofgem and Government should agree as soon as possible a clear set of measurable outcomes, with concrete steps for ensuring those outcomes are met. Customer communications must form a core part of this.

The Government has made clear it believes the default Cap should be temporary until the conditions for effective competition are in place, and that these conditions should be monitored annually by Ofgem from 2020 to determine whether the default Cap should be removed. It is critical Ofgem sets out in advance what it believes success will look like (e.g. a majority of consumers moving away from default tariffs) and updates Government on the work Ofgem is undertaking to ensure this happens.

If increasing engagement is the objective, this will require not only faster switching and the smart meter rollout but also a significant improvement in the quality and regularity of supplier communications. In particular, Ofgem should require monthly billing as a default.

Conclusion



We welcome Ofgem's early and full consultation on the default Cap, and believe your first Working Paper provided a thoughtful overview of the key design questions to be considered.

However, we are concerned that one critical issue was ignored - the competitive distortion created by the 250,000 account policy cost threshold - and another critical issue, the need to conduct a "bottom up" review of costs, has been downplayed due to concerns about speed, and putting the Cap in place as soon as "practicable".

In addition, it would be good for Ofgem to set out not only the "conditions for effective competition", with metrics for achieving these, but also how Ofgem plans to ensure these conditions are met. We believe this exercise will make it clear suppliers communications must be given more weight to guarantee engagement (if that is ultimately what Ofgem is wishing to achieve); and also that two caps rather than one is needed, as some customers will always struggle to engage in the market.

We look forward to engaging with you on this and other working papers. If there is any information you need in the meantime, please do let us know.

Yours sincerely

[not signed]

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