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Consumers & Competition
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28 March 2018

Dear Jemma,

WORKING PAPER #1: SETTING THE DEFAULT TARIFF CAP

Thank you for the opportunity to respond to the first working paper on setting the default tariff cap. Whilst we remain of the view that the default tariff cap will not be in consumers' interests, we are committed to working with Ofgem on its implementation, aiming to preserve effective competition, so far as possible.

Given the unprecedentedly short timescales on which Ofgem is required to develop the tariff cap, we think that Ofgem's approach of consulting informally via working papers is sensible, provided that it does not close its mind on issues ahead of the planned policy consultation. We have attempted to comment on the issues raised in the working paper as fully as we can in the short time available, but note that we may wish to submit further views and evidence on issues raised over the coming weeks.

Our comments are provided in Annex 1 attached, but in summary:

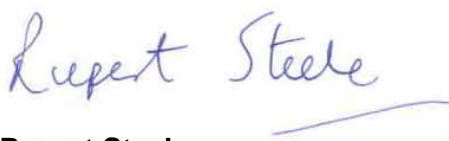
- We do not think either Option 1 (basket of market tariffs) or Option 2 (CMA benchmarks with cost adjustments) would be viable methodologies for setting the level of the cap. Ofgem would face the same challenges with Option 3 (updated competitive reference) as the CMA did (choice of comparators and transparency of adjustments) albeit with less room for error given the wider market coverage. We think Option 4 (bottom-up assessment) is most likely to be viable, with the greater transparency it affords making it easier for Ofgem to demonstrate that it has appropriately balanced the matters set out in Clause 1(6) of the Bill. We believe Option 4 should be preferred, but regardless of whether Ofgem uses Option 3 or Option 4, it will need to complement it with elements of the other.
- We think Ofgem needs to adopt a more sophisticated approach to direct fuel costs than the CMA, recognising that there are different components of the direct fuel cost which may be subject to very different trends. The indexation scheme developed by the CMA is appropriate to the component relating to forward contracts, but not to the costs of forecasting errors, imbalance costs, unidentified gas etc, which may be subject to very different drivers (such as volatility) and may be material.
- We are concerned at Ofgem's suggestion that it might use lower quartile (LQ) costs as inputs to its bottom-up cost model, which risks placing unrealistic targets on suppliers in terms of efficiency improvements. Ofgem mentions that LQ costs are used in other price controls, but we would note that in the RIIO1 price control

for networks, Ofgem used a 75:25 blend of LQ costs and companies' own cost estimates (which was less stringent for most companies than pure LQ and broadly equivalent in this context to a 75:25 blend of LQ and mean). More importantly, the price control applied over an eight year period. If companies were unable to achieve the targeted efficiencies immediately, they had the opportunity to overshoot the efficiency targets during the course of the eight years and therefore achieve them on average. The same opportunity will not be available for the default tariff cap whose duration may be as short as two years.

- On smart metering, we have separately provided Ofgem with a comparative assessment of costs implied by BEIS's 2016 CBA model and by ScottishPower's internal smart business plan, highlighting the wide divergence in many areas. Even if Ofgem uses a competitive reference price approach ('Option 3') for the cap, it will be necessary to complement this with detailed bottom-up modelling of smart rollout costs, in view of the rapidly changing landscape of smart rollout costs and the lack of any detailed analysis published by the CMA. The information we have provided to BEIS is not in our opinion sufficient to derive a full and up-to-date picture of net costs to suppliers, and we therefore think it essential that Ofgem undertakes a comprehensive information gathering process directly with suppliers. Were Ofgem not to do this, we think it would be very difficult for Ofgem to demonstrate that it had taken appropriate steps to discharge its obligations set out in Clause 1(6) of the Bill. We realise that this will require significant effort on Ofgem's part and we stand ready to assist as best we can.
- As we noted in our response to the December consultation, there is evidence (from Ofgem's social obligations reporting and elsewhere) that large suppliers have significantly higher incidence of un-creditworthy customers than mid-tier or small suppliers, resulting in additional bad debt write-off costs. These costs are a consequence of customer mix rather than inefficiency, and given that large suppliers have no realistic option but to keep supplying these customers, can be seen as a form of social obligation cost. This needs to be recognised in any competitive reference price benchmarking or efficiency benchmarking exercise.
- When considering social and environmental obligations costs (notably ECO and WHD), Ofgem needs to adjust not only for small supplier exemptions but also for the rate of growth or shrinkage of market share. Even if a smaller supplier is fully obligated, it may still incur a lower average cost per customer as a result of its growth and the significant lag between measurement of market share and delivery of obligations; similarly, if a large supplier is losing market share, it will incur a higher cost per customer than a company with static market share.
- As part of its work on the overall design of the cap, we would encourage Ofgem to consider what sort of process may be required for notifying and rectifying any errors in the methodology that come to light, or responding to unforeseen shocks.

Should you have any questions on this response, please do not hesitate to contact me.

Yours sincerely,



Rupert Steele
Director of Regulation

**WORKING PAPER #1: SETTING THE DEFAULT TARIFF CAP
– SCOTTISHPOWER RESPONSE**

1. Introduction

We have provided comments on the working paper under the following headings:

- Price cap methodology (section 2)
- Price cap design issues (section 3)
- Direct fuel costs (section 4)
- Operating costs (section 5)
- Other costs (section 6)
- Process issues (section 7)

2. Price cap methodology

Ofgem identifies four potential methodologies for estimating an efficient level of costs to set the initial level of the cap:

1. A basket of market tariffs (with limited adjustments)
2. Existing CMA benchmark with cost adjustments
3. Updated competitive reference price with cost adjustments to ensure comparability
4. Bottom-up cost assessment.

Option 1: A basket of market tariffs (with limited adjustments)

As noted in our response to the December consultation, we think there are serious issues of practicability in introducing a basket methodology in the short timescales available to implement the default tariff cap. It is important for regulatory certainty and predictability that Ofgem defines the methodology for constructing the basket in advance, in a deterministic way that can be replicated by market participants without any Ofgem discretion. Conversely, given the risks of gaming identified above, and the fact that (as far as Ofgem is aware) this approach has never been used in the UK before, it seems risky to move straight to such a cap without first piloting and testing the methodology. It does not seem to us a viable option for the default tariff cap.

Option 2: Existing CMA benchmark with cost adjustments

As noted in our response to the December consultation, there are a number of reasons why it would be inappropriate to use the CMA's benchmark:

- it uses a very small sample of only two suppliers (Ovo and First Utility);
- it was based on prices at a single date in June 2015;
- it will be more than three years out of date by the time the cap comes into effect;
- although the CMA attempted to adjust for the characteristics of these companies (loss-making, growth phase, extent of ECO/WHD obligations etc), this was not done in a transparent way and had to make do with limited historical data.

For all these reasons we do not believe that Option 2 should be considered further for the default tariff cap.

Option 3: Updated competitive reference price with cost adjustments to ensure comparability

“We welcome views on the criteria that could be used to select benchmark suppliers under this approach, and what (if any) cost adjustments would be required to ensure comparability” (para 5.13)

We can see significant problems with this option, given the difficulty of selecting an appropriate set of benchmark companies and the difficulty of performing the necessary adjustments in a sufficiently transparent way. Ofgem does not have the same latitude as was available to the CMA given that the default tariff cap will affect some 54% of the market directly (with an indirect effect on the rest of the market) compared to only 15% of the market affected by the CMA’s PPM cap.

If Ofgem were to proceed on this basis, we would suggest that the competitive reference should be based on a sample of mid-tier suppliers. The sample size should significantly more than two (say, 5) and suppliers should not be excluded without a compelling rationale. (We considered that the CMA’s reasons for excluding Co-op Energy were weak.)

Ofgem would potentially need to make adjustments for:

- Profitability: in general there is a trade-off between profitability and growth; to the extent that suppliers are still targeting growth, their prices are likely to be below the long term sustainable level.
- Social and environmental obligations costs (notably ECO and WHD) and the rates of growth or shrinkage of customer numbers: even if mid-tier suppliers are fully obligated, they may still incur a lower average cost per customer as a result of their growth rate and the significant lag between measurement of market share and delivery of obligations. Similarly if large suppliers are losing market share, they will incur a higher cost per customer than a company with static market share.

It is important that any competitive reference price is based on the average price being paid by the supplier’s portfolio of customers at a point in time, rather than the average price of the tariffs on offer, which could be subject to gaming and/or distortions from marketing campaigns. Of course, if there has been a recent change in wholesale costs, this may not be fully reflected in the average portfolio price (which may reflect costs hedged many months previously) and would need to be reflected via careful design of the wholesale cost indexation scheme.

Option 4: Bottom-up cost assessment.

We agree that Ofgem should be giving serious consideration to bottom-up cost assessment, and we think on balance that this should probably be Ofgem’s preferred approach. Even if Ofgem were adopt a competitive reference price methodology, we think it would be important for Ofgem to triangulate between the reference price and bottom up estimates, both as a sense check on the overall figure, and as a means of disaggregating the total into separate components which may then be subject to different indexation schemes. We think bottom-up modelling is likely to be particularly important for:

- smart meter rollout costs, where bottom-up modelling offers the only robust approach to estimating costs in future years (which are likely to be greater than current costs)

- direct fuel costs, where different components may be subject to very different cost trends (see Section 4).

Ofgem has not yet consulted on how it will assess the criteria set out in Clause 1(6) of the Bill (creating incentives for efficiency, enabling effective competition, maintaining incentives to switch and ensuring financeability of efficient operators), but it seems unlikely that Ofgem could have appropriate regard to these items without having conducted bottom-up cost assessment.

The approach to cost categorisation set out in Table 1, based on the structure of the consolidated segmental statements (CSS) seems a sensible starting point. It has the advantage that all the large suppliers have reported on this basis for a number of years, so comparisons can readily be made. Unless there are compelling reasons to do otherwise, we would suggest that Ofgem follows the CSS structure in any bottom-up cost assessment. As Ofgem has noted, there needs to be an additional allowance for return on capital employed.

We comment on individual cost categories in sections 4 to 6 below.

3. Price cap design issues

How the cap varies with consumption

“We would welcome any further views on how the level of the cap should vary with consumption in the context of a wider default tariff cap” (para 4.5)

The CMA price cap methodology specifies maximum prices for customers with nil consumption and with medium consumption, which is equivalent to setting separate caps for the standing charge and the unit rate. Ofgem has raised the question of how best to balance these two elements of the cap.

As a general principle, we believe that the balance between the standing charge and unit rate caps should reflect the underlying cost. The CMA estimated that the cost differential between DD and PPM was around £63 for a dual fuel customer (£24 electricity; £39 gas). This differential largely comprises costs which do not scale with consumption (costs of metering equipment, bespoke payment infrastructure, and issues specific to PPM customers, such as problems in topping up the meter, which mean they are more likely to call their supplier). This suggests that, other things being equal, the dual fuel standing charge for DD customers should be around £63 less than the prepayment cap standing charge.

We would also note that there are practical considerations arising from the fact that some of the default tariffs in the market may not fully reflect fixed costs in the standing charge. (Indeed suppliers may deliberately position tariffs in this way in order to cater for customers with very low consumption, who may be more likely than the average to be vulnerable). If Ofgem sets the standing charge element of the cap too high, this may have the perverse outcome that some customers see their energy bills increase (albeit by relatively small amounts) if their supplier chooses to price their default tariffs up to the cap. We therefore suggest that Ofgem should err on the side of setting a lower standing charge cap and a correspondingly higher unit rate cap (yielding the same cap at medium consumption).

Multi-register tariffs

“We welcome any submissions on how multi-register tariffs should be treated under the default tariff cap” (para 4.6)

We agree with Ofgem that the approach used for the PPM price cap, whereby caps are based on assumed consumption splits is a practical approach which avoids the complexity of specifying multiple caps. However, we would encourage Ofgem to ensure that processes for submitting estimated consumption splits are aligned so far as possible with the PPM price cap to reduce the administrative burden for suppliers.

Payment methods

“We have collected views on allowing a payment method differential in our December consultation, and would welcome any further views in the context of a wider default tariff cap. This includes in relation to the question of whether payment method differentials should continue to apply where customers have smart meters”. (para 4.7)

We commented on the merits of having different caps for customers paying by direct debit (DD) and standard credit (SC) in the context of the ‘Phase 2’ vulnerability price cap, and our views are broadly the same in the context of the default tariff cap. In summary, we think that:

- Any cost differences that are intrinsic to the payment method in question should be reflected in different levels of the cap. For example, the working capital costs of DD and SC are very different, and if these costs are not reflected, it could create inefficient incentives for customers to favour SC over DD, even though the costs to the supplier are higher.
- Cost differences which are more to do with the mix of customers on the payment method could be socialised. For example, the bad debt costs associated with the SC payment method are generally caused by a subset of customers in a poor financial position.

However, given the risk of market distortions, we think Ofgem should be very cautious about adopting a single blended cap.

Should payment method differentials continue to apply for customers with smart meters?

There is no doubt in our mind that payment method differentials should continue to apply where customers have smart meters. Installation of smart meters in a customer’s premises will reduce some but not all of the relevant costs to serve. It should substantially eliminate meter reading costs and achieve some reduction in bad debt write-off (because it will be possible to take earlier action to help customers manage their debts) and in inbound call centre costs (at least in respect of estimated bills). However, material payment method-related cost to serve differences will remain:

- The DD-PPM cost to service difference will be reduced in respect of the meter rental costs, but there will still be significant additional costs for prepayment meters associated with new electronic payment systems. (Under the current system newsagents etc can effectively subsidise their services in exchange for increased foot-fall, but this will not be possible with smart meters.)

- The DD-SC cost to serve difference will potentially see some reduction resulting from improved debt management for SC customers. But the working capital cost difference will remain, as will much of the bad debt write-off cost difference.

Furthermore, as smart meter rollout progresses further, certain costs of the remaining dumb meters may increase significantly on a per meter basis, as for example the costs of PPM communications infrastructure are spread over fewer and fewer dumb meters. In such circumstances we do not believe it would be appropriate for increasing per meter costs to be borne by customers with dumb meters, but rather they should be socialised across smart and dumb.

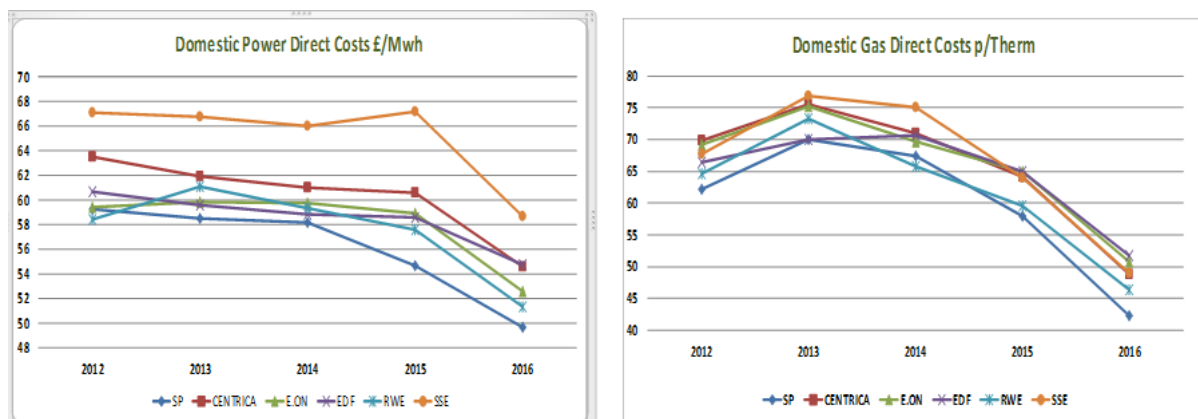
We believe the appropriate approach in the near term is to apply the same cap for dumb and smart meters, leaving it up to suppliers to decide whether to offer customers on smart meters a lower price.

4. Direct fuel costs

We will consider whether any changes to the index would be required, given the wider scope of the default tariff cap compared to the existing safeguard tariffs, and given that the model was designed to index the level of a cap, rather than set an absolute allowance for wholesale costs. The design issues we will consider (and would particularly welcome views on) include: (para 5.33)

Bottom-up vs benchmark

Direct fuel costs are the largest component of the cost stack (43% of the dual fuel bill based on Ofgem’s Table 1) and also show significant variation from year to year (see figure below based on CSS).



In view of the above, and given the much wider market coverage of the default tariff cap compared to the PPM cap (57% versus 15%), it is essential that Ofgem develops a more sophisticated approach to setting this component of the cap than the CMA was able to do.

In our view the only viable options are a fully bottom-up model (Ofgem’s option 4) or a hybrid approach where a bottom-up model is used in conjunction with a competitive reference price (Ofgem’s option 3). In the latter case the bottom-up model could be used to (i) determine how much of the reference price was deemed to relate to direct fuel costs and (ii) inform the indexing scheme for updating the cap between price control periods.

Key advantages of a bottom-up approach in the context of direct fuel costs are:

- **Transparency:** suppliers can see how the direct fuel cost stack has been built up and gain confidence that all the relevant costs have been included; this will potentially allow them to reduce hedging risk by matching their hedging to the strategy implicit in the model.
- **Objectivity:** the competitive reference approach is potentially sensitive to the choice of benchmark companies; this is particularly an issue for direct fuel costs where costs can vary significantly between companies as a result of some companies' hedging decisions proving more successful than others.¹

Approach to indexation

The cost allowance for forward purchase element of direct fuel costs should be based on a well-defined and transparent hedging strategy, which should be fully replicable by suppliers if they wish to do so.

A weakness of the CMA's PPM price cap methodology is that a single index based on forward market price is used to adjust the *total* direct fuel cost. This ignores the fact that there are a number of components in the cost stack which are unlikely to track this index. These include:

- Costs associated with forecast errors, including
 - costs of adjusting position up to gate closure
 - imbalance costs
- Shaping costs.

In general these costs will increase as weather conditions (or other drivers of demand) become more unpredictable and as wholesale market prices become more volatile. For example, there is reason to believe that extremes of wholesale prices and demand (such as were seen in early March 2018) may arise more frequently as coal-powered generation is phased out and the UK gas market becomes more dependent on imports. There is no reason why changes in these costs should be correlated with the index developed by the CMA – indeed they could potentially move in opposite directions. As part of its bottom-up modelling we would suggest that Ofgem obtains data on how these costs have evolved over time and conducts analysis to test whether there are any discernible trends. The allowance for imbalance costs could then be based on a historical simulation of the imbalances that would have been incurred under the assumed hedging strategy, with an appropriate allowance for risk.

Smoothing

We agree that there is potentially a trade-off between more frequent updates to the cap (which requires greater administration on the part of Ofgem and suppliers) and less frequent (which creates additional commercial risk for suppliers). However, given the wider scope of the default tariff cap it is particularly important that commercial risk to suppliers is minimised. We would not support an update cycle less often than every 6 months, other than in exceptional circumstances.

¹ To the extent that differences in costs are due to differences in hedging approaches, these differences will reflect the different timing of hedging decisions rather than any fundamental difference in efficiencies between suppliers.

Seasonality

We agree with Ofgem that the mismatch between the time horizon for indexation (forward contracts covering an annual period) and the duration of the charge restriction period (6 months) creates some risk for suppliers, and would welcome further by Ofgem consideration of how this could be mitigated. This could perhaps be the subject of an industry workshop.

Price data

Ofgem says it will consider what the most appropriate source of wholesale price data would be for a wider default tariff cap. We do not have any particular concerns with the current approach of using data from ICIS, but agree that it would be sensible to consider if there are better options.

Unidentified gas

In contrast to electricity losses which are reasonably predictable, the costs of unidentified gas (UIG) are volatile and unpredictable, and there is evidence to suggest they may have increased significantly following project Nexus. Xoserve estimated the annual average cost of UIG at around 1% prior to Project Nexus² but we estimate that since June 2017 UIG has averaged above 5% and spiked on occasions to over 10%. The measurement of UIG after Nexus cannot easily be compared to UIG risks and allocations before Nexus, due to the significant change in estimation and allocation methodology which has taken place. But whether Ofgem adopts a competitive reference price or bottom-up modelling approach, if the reference prices or cost data relate to the period pre-Nexus, an adjustment may be required to reflect any increase in costs post-Nexus.

We would also note that UIG costs are likely to vary by supplier according to the distribution of their customers across LDZs. Given that this is not a matter of efficiency, the cap should be set on the basis of the supplier with the highest UIG costs.

5. Operating costs

Efficient 'frontier'

We are concerned at Ofgem's suggestion that it might use the lower quartile (LQ) cost (either of the Big 6 or of a larger sample of companies) as the basis for cost estimates going into a bottom-up cost model.

In our view using LQ costs of the Big 6 suppliers risks placing unrealistic targets on suppliers in terms of efficiency improvements. Ofgem mentions that LQ costs are used in other price controls, but we would note that in the RII01 price control for networks, Ofgem used a 75:25 blend of LQ costs and companies' own cost estimates (which was less stringent for most companies than pure LQ and is broadly equivalent in this context to a 75:25 blend of LQ and the mean). More importantly, the price control applied over an eight year period. If companies were unable to achieve the targeted efficiencies immediately, they had the opportunity to overshoot the efficiency targets in the course of the eight years and therefore achieve them on average. The same opportunity will not be available for the default tariff cap whose duration may be as short as two years.

² <http://www.xoserve.com/wp-content/uploads/XCE1625-Sian-Baldwin-CEO-provides-a-further-update-on-UIG.pdf>

It would be even less appropriate to use LQ costs derived from a sample of companies that includes mid-tier suppliers. These companies have a different cost structure to the “Big 6” suppliers, for reasons which cannot be equated with efficiency differences. For example, they have much lower incidence of customers likely to fall into debt.

In summary, where lower quartile costs are used in other price controls, it is generally as an indication of the level of costs that companies should be incentivised to move towards averaged over an appropriate period of time. To the extent that Ofgem is seeking to use the level of the cap to incentivise suppliers to improve their efficiency (as per Clause 1(6)(a)) it should consider a less stringent target than LQ and/or apply a glide path rather than an abrupt change, taking account of the potential shortness of the control.

Finally, in terms of the approach to ‘frontier’ benchmarking, it is important that:

- It is done at a sufficiently high level of cost aggregation. As Ofgem notes, different suppliers may have different cost allocation policies, and if an efficient frontier is determined at too granular a level, this may confuse differences in efficiency with differences in cost allocation policy.
- It is done at an appropriate level of temporal aggregation. Companies’ costs should be averaged over, say, a five year period – and certainly not a single year – as the results could otherwise be distorted by the way that costs are allocated between years.
- In selecting a sample of companies for efficiency benchmarking, the greatest weight is given to larger suppliers, since their operating costs are more likely to have stabilised over time, and since they are most likely to be impacted by the cap.
- Account is taken of relevant differences in business models. For example, some suppliers may spend more on call centres than others in order to achieve a better customer experience. Conversely, some new entrant suppliers have chosen to avoid the costs of a call centre entirely by insisting that customers contact them online or by post.

Controlling for different suppliers’ customer profiles.

The most important factor to control for will be differences in the mix of payment methods used by suppliers’ customers, and on-line/offline account management.

In addition to this, it is likely to be necessary to control for differences in the socio-demographic make-up of customers. For example, In ScottishPower’s case a substantial proportion of bad debt write-off costs relate to properties occupied on a short term basis by tenants (who largely fall within a particular ‘transient’ demographic profile), and we have limited options manage such bad debt risk. To the extent that companies have a higher (or lower) incidence of such customers than other suppliers, this would need to be controlled for.

As we noted in our response to the December consultation, the CMA found that ScottishPower had a particularly high average bad debt cost per standard credit (SC) customer. The CMA implied that this was due to inefficiency, but we showed in our response that this could equally well be explained by ScottishPower having a higher proportion of un-creditworthy customers within its SC base than the other Big 6 companies, as a result of having been more successful in migrating creditworthy customers from SC to DD.

Smart meter rollout costs

One of the most important areas for Ofgem's cost modelling will be smart meter rollout costs. This will be particularly challenging for a number of reasons:

- Little consideration was given to smart costs by the CMA, so there is scant read-across from the prepayment price cap
- Costs have been increasing rapidly (and expected savings arising much more slowly) as the programme progresses, so that historical data will be of much less use than in other contexts
- Many of the costs scale with rollout progress, so companies that have been most efficient in complying with their rollout obligation are also likely to have the highest per-customer net costs.

We have separately provided Ofgem with a comparative assessment of costs implied by BEIS's 2016 CBA model and by ScottishPower's internal smart business plan, highlighting the wide divergence in many areas. Even if Ofgem uses a competitive reference price approach ('Option 3') for the cap, it will be necessary to complement this with detailed bottom-up modelling of smart rollout costs.

Given the challenges noted above, and the significant limitations associated with any information that Ofgem is able to obtain from BEIS, we think it is essential that Ofgem undertakes a comprehensive information gathering process directly with suppliers. Were Ofgem not to do this, we think it would be very difficult for Ofgem to demonstrate that it had taken appropriate steps to discharge its obligations under Clause 1(6) of the Bill.

6. Other costs

Environmental and social obligations

We agree that it should be possible to estimate an allowance for environmental and social obligations costs based on historic data combined with forecast trends in these costs over time. The calculation will need to take account of:

- The fact that obligation periods typically straddle companies' accounting years, and if companies front- or back-load their delivery of the obligations, costs may not be evenly distributed between years.
- The growing market share of small suppliers who are wholly or partially exempt from obligations; this, together with the 'lag' effect referred to above, means that a the costs of the obligations are recovered from a diminishing base of customers, meaning that the cost per customer is materially higher than it would otherwise be.

Transportation costs

We agree with Ofgem's proposed approach of using the same methodology as in the CMA's prepayment price cap to calculate the allowance for network charges

Other direct costs

Ofgem suggests that it may be appropriate to include DCC charges and costs of funding Xoserve in an 'other direct costs' category. As long as there is clarity as to where the costs are included, we do not see that it is particularly important how the different costs are grouped, other than for convenience of indexation.

7. Process issues

As part of its work on the overall design of the cap, we would encourage Ofgem to consider what sort of process may be required for notifying and rectifying any errors in the methodology that may come to light, or responding to unforeseen shocks.

This was less of an issue for the CMA prepayment cap, since it only covered 15% of the market and it would be easier for suppliers to absorb the impact of errors across the rest of the market. The default tariff cap will apply to some 54% of the market directly (and will constrain most of the rest of it indirectly) so there will less scope to absorb the impact of such issues and a greater need to deal with them swiftly.

ScottishPower
March 2018