Retail Market Policy
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17 May 2018

Dear Sir / Madam

Default Tariff Cap 4th Working Paper: Social and Environmental Policy Costs (non-confidential version)

First Utility welcomes this opportunity to respond to Ofgem's 4th Working Paper. As set out in our previous submissions, the success of the Price Cap rests on the accuracy and completeness of the underlying cost stack.

We agree with your analysis that suppliers are "unlikely to have material control" over five of the seven Social and Environmental costs they face, and that average scheme costs are therefore an appropriate pass through for these obligations (namely the Warm Home Discount (**WHD**), Contracts for Difference (**CfDs**), Feed in Tariffs (**FiTs**), the Capacity Market, and assistance for areas with high electricity distribution costs (**AAHEDC**).

However, suppliers likewise have little material control over the Renewables Obligation (RO). As such, the buy-out price should likewise also be passed through. Whilst, as your Working Paper notes, suppliers in theory have the opportunity to purchase ROCs in the market at a discount to the buy-out price, the level of discount secured is dictated by supply - and demand - both of which are set by BEIS, not suppliers, especially given that the RO closed to new generating capacity on 31 March 2017. **[✂]** This suggests supplier control over the scheme cost is minimal, and the RO buy-out price should simply be passed through.

We agree that suppliers currently have more control over the Energy Company Obligation (ECO). However, it is unclear how best to determine the allocation for "efficient delivery" for ECO 3, given it is still under consultation. In addition, the opportunity for Ofgem to correct the initial allowance post consultation is hampered by the fact that ECO 3 will run until March 2022, with suppliers able to phase their obligations late or early, potentially leading to gaming in order to influence the allowance under the price cap.

For these reasons, we propose Ofgem simply passes through the expected Impact Assessment cost on an annualised and per customer basis.

In terms of how the ECO and WHD are allocated, we remain concerned that more than 50 suppliers - now representing 8% of the market, and growing - will receive a £40 allowance for costs they do not face. This unearnt cost allowance will effectively triple a small supplier's headroom allowance, making a significantly "*different provision for different holders of supply licences"* in contrast to the legislation's stated aims.

We also remain concerned that the costs of the ECO and WHD will be increasingly spread across a smaller base as more customers switch to below threshold suppliers. ECO 3 will run until March 2022, a period concurrent with the SVT Price Cap. The majority of the 15 obligated ECO suppliers also have a large percentage of customers on SVTs, and it is likely they will significantly increase their cheapest fixed deals in order to protect margin once SVT prices are capped. As a rough calculation: 40% of Big Six customers (8 million customers) are on Fixed Deals which could expire on unfavourable terms, If just half of these (4 million) switch to sub threshold suppliers, these suppliers would see their market share treble to 22%. And 6 million customers would no longer contribute towards policies to support the vulnerable, leaving inactive, poorer customers paying an additional £220m more in policy costs (without an increase in allowances under the price cap).

We urge Ofgem to model and share with Government the impact of the current obligation thresholds on competition, and how far this will be exacerbated by the Price Cap.

In terms of using the OBR method to forecast policy costs, we agree Ofgem should convert OBR estimates to £/MWh or £/customer estimates and should also split out AAHEDC for transparency. We have concerns regarding sole use of the OBR data to forecast policy costs. The main disadvantage of the OBR method is it doesn't take into account changes in the charging base. For example, policy costs for the RO, CfDs, Small Scale FiTs, and the Capacity Market are taken from the OBR's latest forecast in £bn. But that trajectory does not take into account the recovery of costs from a smaller demand base. For example, the impact of the Energy Intensive Industries exemption is to increase domestic RO costs by ~3.5% - £2.34 per medium usage customer in 2018/19.

Additionally, OBR data is backward rather than forward looking, and sometimes substantially so. OBR data is only updated twice a year in March and November. This means a Price Cap set for 1 April, announced in mid-Feb, will use November's view rather than March's.

Ofgem should therefore complement OBR data with other sources where available (setting out the methodology clearly in advance), for example:

- **CfD FITs** - the Low Carbon Contract Company (**LCCC**) issues 15 month £/MWh forecasts.

- **RO** - BEIS's demand forecast, used to set the supplier obligation, is released on 30 September for the following April, meaning this should be available ahead of setting the Cap rather than relying on historical OBR data (assuming 6 month cap period, 2 months notice). The buyout price is indexed to RPI, for which there are also forecasts. There's a precedent for using the average of independent RPI forecasts published by the Treasury in the DNO's Schedule 15 cost information. This has the advantage of being updated monthly.

- **Capacity Market** - LCCC have annual demand forecasts which can be combined with user profiles or historical data to forecast the proportion of demand 4-7pm, working days Nov-Feb, which sets the Capacity Market demand. Clearing prices (indexed to RPI) and capacity volume are known.

In terms of additional social and environmental policy costs, we note this Working Paper does not consider smart charges. Smart DCC and Alt HAN costs have increased at a much higher rate than inflation, as indexed under the current PPM/Safeguard Tariff. A significant portion of the cost is fixed charges which suppliers pay regardless of roll out, and which Ofgem can easily identify as part of its Cost Control. Such costs should be passed through.

Also needed is a bucket of costs for industry programmes, e.g. Faster Switching. And it remains unclear how and when costs such as Unidentified Gas and Imbalance costs will be allocated.

Finally, 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 considered in your Working Paper. And it needs to be clearly stated which costs are treated as fixed/variable and their categorisation.

We look forward to exploring these issues with you further through the up-coming consultation paper.

Yours sincerely

[not signed]

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