Name Paul Finch
Phone 07795 353787
E-Mail paul.finch@npower.com

3rd May 2018

Dear Retail Price Regulation Team,

Working paper #4: environmental and social obligation costs

Thanks for the opportunity to comment on this working paper.

It is essential that Ofgem clarifies its position on the recovery of Smart costs. For such a significant obligation driven by Government policy, this has been a notable omission from the working papers. The cap should include an explicit and transparent allowance for all associated costs, separated out from business as usual indirect / metering costs. The programme is subject to specific risks and cost drivers. It would be manifestly inappropriate to simply include within opex and index to CPI. The current cap will not include DCC overruns and increased costs, or the higher costs of a compressed roll-out. DCC costs charged to suppliers should be included in the index.

We share the concerns noted at paragraph 6.4 about the impact on suppliers' costs of the falling base across which the costs of the different schemes are collected.

Customers taking advantage of the obligation cost differential by switching to exempt suppliers causes the SVT-FTC differential to increase as the unchanged total cost of the obligations fall to a smaller number of customers. For example, as the share of small suppliers grows, the obligated supply volume will shrink, leaving obligated suppliers with an ever increasing unit cost due to the lag involved in setting the ECO obligation. Since supplier efficiency cannot change the obligation cost, then the increase in its cost as the obligation base falls must be taken into account in the cap. In our view, it would clearly be better in policy terms to sort out this problem at source, by amending (and improving) the exemptions regime.

Generally, it is important to mitigate uncertainty given the potential for large differences between forecasts and outturn costs. There is a risk of unintended consequences if the cap is set against uncertain costs, which could be detrimental to competition, customers and suppliers. This merits appropriate recovery mechanisms.

Please see the Appendix to this letter for our views on setting the initial baseline and updating the cap for the costs of each environmental/social obligation.

npower

Oak House
Bridgwater Road
Worcester
WR4 9FP

T 07795 353787

Registered office:
Npower Group plc
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

Registered in England
and Wales no. 8241182

We also have the following additional comments:

- **Renewables Obligation** - we agree that the majority of social/environmental scheme costs are outside of suppliers' control. Further, we do not believe that suppliers have material control over RO costs. Suppliers' discretion is very limited between the market price of available ROCs or the prescribed buy-out price. The best approach for setting the cap would be to consider the obligation level and the buy-out price, providing some incentive for efficiency. By analysing the previous forecasts provided by OBR and comparing this to outturn costs, we do not think this is a good source or forecast to be considered. The obligation level published by BEIS 6 months before the compliance period is more suitable for this purpose.

- **Final credit balances** - we note the reported comments of Ofgem's CEO at a recent conference[1] about the possibility of a shake-out in the industry and a reduction in the number of suppliers. The socialisation of final credit default (forced mutual insurance) costs via the SOLR levy, should be reflected in the network charges component of the cap.

- **Energy Company Obligation** - whilst suppliers exercise discretion over when and how the obligation is delivered, clearly there is a significant unavoidable cost. We maintain that historic information on average realised costs across the industry is not a reasonable approach to take to setting the initial level of the benchmark, as ECO3 is fundamentally a new scheme with new rules. The BEIS Impact Assessment is the best starting point for costs. Further, the difficulty with benchmarking based on supplier reported costs is that suppliers use different methodologies to produce the reports, leading to potential inconsistencies across the data provided. Another issue with assessing costs is that it presents each supplier's price for delivering ECO at that time, which is not the same as the price for complying and could therefore understate the cost allowance, penalising compliant suppliers. Suppliers will also phase delivery of ECO measures/spend differently across the numerous scheme periods ("Phases"), making a meaningful comparison of incurred costs in any one phase problematic. We are concerned that the operation of the price cap does not in any way reduce suppliers' flexibility in delivering their obligations and the cap should incentivise suppliers to do so efficiently.

- **Warm Home Discount –** it should be noted that the cost per account appears to have risen between 17/18 & 18/19 by around 6.4% from £6.70 per account to £7.13 (figures subject to confirmation). There are two elements to the increase: the obligation has increased by around 3% due to the larger inflationary increase; the remainder relates to the increasing market share of non-obligated suppliers which has increased the obligation by 3% for the new scheme year versus the previous scheme year (subject to confirmation).

- **Feed-in-Tariff** – it should be noted that on top of the payments generation owners are receiving for the volume they are exporting back to the grid (as noted in Table 2), they are also receiving generation payments for the total generation regardless of whether they use that energy or export back to the grid. Any impact of a switch to metered export would need to be factored in to ensure the recovery of costs, as some suppliers may be more exposed to these costs.

[1] Westminster EET Forum "Priorities for the UK energy market", 26th April 2018

- **Contracts for Difference** - by analysing the previous forecasts provided by OBR and comparing this to outturn costs, we do not think this is a good source or forecast to be considered. Furthermore, given that the CfD cost depends on the market price and latest generation volumes assumptions, the forecast should be updated frequently which makes the OBR inadequate. The LCCC produces a quarterly forecast of costs for the next 4 quarters. This is the best available and most accurate view of costs associated with CfD and should be the source of data used.

- **Capacity Market** - by analysing the previous forecasts provided by OBR and comparing this to outturn costs, we do not think this is a good source or forecast to be considered. The T-4 auction usually fixes most of the CM costs and the T-1 is one year before the delivery year, with total payments published by National Grid. Auctions parameters are published a few months before the auction which reduces the uncertainty on the amount of capacity bought so this would be enough to forecast the CM costs and there is no need to use the out of date OBR forecast which does not include the latest assumptions on inputs.

  Further, we do not consider that using OBR data (April-March) for the initial baseline would be appropriate, given that the CM delivery year is October to September and the Interim Levy Rate for CfD is set quarterly.

  CM costs are based on peak hours consumption and so different £/MWh rates on annual consumption may need to be applied to customers with different consumption profiles. All the schemes (apart from WHD) require some forecast of national consumption (NPB annual consumption (CfD), GSP peak hours consumption (CM) and metered annual consumption (RO). In our view National Grid are the best placed to provide this data.

- **OBR forecasts** – whilst we believe that the use of third party data is the most appropriate basis for indexation, as noted in this letter we have some reservations over the use of OBR forecasts for this purpose and identify more robust alternatives. If elements of the cap are to be based on OBR forecasts, a high-level summary of the forecasting methodologies would aid transparency.

- **Recovery mechanism** – as Ofgem recognises at paragraph 4.15, in most cases the full costs to suppliers will not be known in advance. Whilst we agree with a general principle that where possible costs should be recovered in the period in which they are incurred, we reiterate that there is a strong case for a recovery mechanism to ensure full pass-through of outturn costs and mitigate supplier risks.

This response is not confidential.

Yours sincerely,

Paul Finch
Regulation

Cc: Chris Harris, Head of Regulation