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Transcription

Title: Ofgem Investor Call

Date: 06.09.2018

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Conference Ref. No: EV00077362

Duration: 57:24

Presentation

Operator

Hello and welcome to the Ofgem investor call. Throughout the call, all participants will be in listen-only mode and afterwards there will be a question and answer session. Just to remind you, this conference call is being recorded. Today, I'm pleased to present Dermot Nolan, the CEO, and Rob Salter-Church, Interim Executive Director of Consumers and Markets. I'll now hand you over to Martin Young. Please begin.

Martin Young

Thank you, Jerry, and thanks to everybody for joining us this afternoon. As you know, today we have published the statutory consultation on the default tariff cap. It's my great pleasure to introduce Dermot Nolan, our CEO, and Rob Salter-Church, who's the Interim Executive Director for Consumers and Markets. They will run through a brief presentation covering the key points of today's publication before we move to Q&A.

Just in case you haven't received the email with the presentation, it is available on our website, www.ofgem.gov.uk. If you navigate to the investor relations page by clicking on 'About us' followed by 'How we engage' and then 'Investor relations', you will find the presentation. I'd just like to point out that when we do move to questions later, we only have until four o'clock this afternoon, I'm afraid, but with that, I will hand over to Dermot to run through the presentation. Dermot.

Dermot Nolan

Welcome everybody. Good morning, good afternoon, hopefully not good night depending on where you're ringing in from, but very glad you're all here. I'm just going to briefly go through things. Rob may come in on some details, and then Rob and I will jointly try and answer whatever questions you have.

So, as you know, in February, the government introduced proposals for legislation to Parliament to introduce the tariff cap for customers on standard variable tariffs and default tariffs. In early March, we outlined the consultation process and the legislation was then passed in July.

So, broadly speaking, looking at slide one, I'm going to summarise that first. I'm going to say that we've used a bottom-up cost assessment approach to set an efficient cost benchmark from 2017, but with different payment method costs for both direct debit and standard credit customers. So, we've included a profit allowance of 1.9% before interest and tax, which was derived from the CMA study from a couple of years ago. We also have a headroom allowance of 1.45%, so that would be equivalent to £10 of the direct debit baseline from 2017.

We aim to have the cap in place by the end of the year, with the actual levels announced in November, and the current proposal suggests an initial level of £1,136 for direct debit customers and £1,219 for standard credit customers. We plan to update the cap every six months, so we will have it dovetailed with the prepayment meter cap, and so that will mean updates in April and October. Overall, we think, looking at some of the analysis, that had the cap been in place in 2017, 96% of SVT customers would have paid less and bills would have been reduced for them by £1.3 billion.

Okay, that was the first slide. Before I move on to how we will set the cap, I want to take a couple of moments to remind you again of the key points of the legislation, what are the design principles of the cap, and why Parliament decided a cap was needed.

So, on the second slide, it suggests, as I said earlier, Parliament actually passed the legislation on the 19th of July. The Act requires Ofgem to introduce a temporary cap on standard variable tariffs, or default fixed tariffs, as soon as reasonably practical. Our primary aim is to protect customers, and that is the primary aim, but we need to have regard to four different matters. One of which is the need to create incentives for holders of energy supply licences to improve their efficiency. Two is the need to set the cap at a level that'll enable such suppliers to compete effectively for domestic supply contracts. Third is the need to maintain incentives for customers to switch to different supply contracts. And the fourth is to ensure that holders who operate efficiently are able to finance activities authorised by their licence. So, the cap won't apply to consumers on the prepayment safeguard tariff, and it won't directly to apply to people who are already protected by existing caps.

The caps will be enforced until the end of 2020, but have the possibility of extension. We're required to make a recommendation to the Secretary of State by the end of August 2020 on whether the cap should be extended or not, having reviewed whether the conditions are in place for effective competition. Extensions will be for one year, with a further potential review in 2021, and if required, 2022. The cap ceases to have effect at the end of 2023 at the latest.

So, moving briefly to slide three, we set out some of the key design principles. And I'm going to ask Rob to take over now and talk a little bit more about that.

Rob Salter-Church

So, in essence, the cap has two components. One, it looks at the efficient costs or the efficient benchmark, and two, we have a level of headroom, which is an amount that might need to be added to the efficient benchmark to take account of variances between suppliers and various uncertainties.

So, this slide essentially talks at a high level about how the cap is set. What we've set is a standing charge and a unit rate. This slide brings out the various different types of cap that are set within the price caps. You can see there is a different level which is set to reflect the different network charging regions across the country, and separate caps for those people that are on multi-rate meters, and for payment method. As Dermot mentioned, we'll be updating every six months, and we've found 11 million households will see their bills reduced as a result of the cap.

If you move on to slide four, I think hopefully the background to the requirement for this cap is quite straightforward. People are well aware of the problem of disengaged customers paying more than they should. This slide just picks out graphically some of the history and some extent of the overcharging that we believe has been in the market for customers that are on default deals.

If you move on to slide five, this just sets in a bit more detail the point I mentioned before about the efficient benchmark and headroom. So, we have used a bottom-up approach in setting the cap. So, what we have done is look at the various component elements of cost, and we've looked to work out what we consider to be an efficient level of cost for wholesale, for network, for the organisation's operating costs. Also, picking up policy costs and allowing, as Dermot said, a reasonable return, which we've set at 1.9% based on the approach that the CMA has taken to profits.

Now, we have sought, where possible, to include allowances within the efficient cost benchmark for uncertainties and for variations between suppliers. So, for example, within our wholesale benchmark, you can see on this slide that we've included an allowance for uncertainty. Notwithstanding those uncertainty allowances, we still think there is a case to include a headroom allowance that is set at £10 in the baseline to include for other, wider uncertainty, potentially external events that might happen, to ensure that we've given due consideration to the regard for an efficient operator to be able to finance themselves.

At the bottom of the page, you can just see where we've set things in relation to nil consumption and what the baseline is for the efficient benchmark.

The next slide, slide six, talks about how we will update the cap. The cap is set based on a 2017 baseline, which is the year that we have all of the complete information that we need, and you can see for each of the component elements of the efficient cost stack what the approach will be for updating those costs. We will update the cap, so the first cap period is only in place for three months to align this with the prepayment meter cap update to take effect on 1st of April and 1st of October of any given year.

Slide seven is just a table of numbers, so, you can see how the cap breaks down. We set separate caps for electricity and for gas. So, where we have talked about dual fuel, we're in essence just implying that and adding the two caps together for electricity and for gas. Then on the right-hand side you can see our dual fuel cap level, which is at £1,136, as Dermot set out before.

The next slide talks at a high level around some of the analysis that we've done to look at the impact of the cap. Our approach to this is to view this through the framework which the relevant legislation sets out, which Dermot outlined before. I won't go through each of the bullets at the bottom, but that just gives you a headline message of some of the analysis that we've done as part of giving due consideration to all of the matters in the bill that we have to.

On slide nine, a little bit more detail here on the point that Dermot said about the future of the cap. It's in place until 2020 and there is a process which is defined for Ofgem to make recommendations to the Secretary of State on whether the cap should be extended in annual chunks up until a backstop date until 2023. Worth noting that we have a programme of work which is just alongside the price cap, which is looking at what the future market should look like, such that when the cap is removed, we have a market where competition is delivering benefits for all consumers.

Slide ten talks about the overall scope of the cap. I think there are only two things I will draw out on this slide in particular. One is in relation to vulnerable customers. So, we introduced a temporary cap for customers in receipt of Warm Home Discount last year. We are proposing, as we did in our previous consultation, to remove this safeguard tariff because these customers will be protected under the default tariff cap. We're proposing to move all the Warm Home Discount customers onto the direct debit level of the cap, because that way they won't see a step change in their bills.

We are also providing for a derogation mechanism for suppliers to apply to us for a derogation for a standard variable tariff to be exempt from the cap, i.e. to be priced above the level of the cap. We will give consideration to any requests where it is clear that the renewable tariff is adding benefits over and above the mandated government schemes for renewables. Those are the things I wanted to point out on that slide.

In terms of next steps, the consultation is launched today, will run on through until 8th of October. We're seeking views on the policy, the methodology and our impact assessment, and indeed the actual drafting of the licence itself. In parallel to the statutory consultation process, there is a targeted disclosure data room that we are running to enable advisors of interested parties who hold licences to be able to view some of the more commercially sensitive information in relation to smart metering and wholesale allowances.

I will leave our ideas for you there. I haven't run through every point on the slides, but hopefully the concept will speak for itself.

Martin Young
Okay. Thank you, Dermot. Thank you, Rob. Jerry, if we can poll for questions, and just to reiterate that we only have until 4:00pm this afternoon, so please can I request that you limit yourselves to a maximum of two questions each. So, with that, Jerry, please can we take the first question.

Q&A

Operator
Thank you very much. Again, just to remind everyone, if you would like to ask a question, please press zero one on your telephone keypads. You can withdraw your questions any time by pressing zero two to cancel. Our first question comes from the line of Sam Arie of UBS. Please go ahead. Your line is open.

Sam Arie
Thanks for a helpful presentation. My two questions are, firstly, just thinking about the impact of the cap when you introduce it. I think you mentioned in your documents this morning that you expect switching levels in the market could reduce. So, I'd just be interested in a bit more explanation of your thinking there, and whether, for example, it's your view that default tariffs have subsidised other products in the past, and therefore the cost of other products might have to go up in the market when the cap comes into place.

Secondly, the other thing which has come up already talking to some of the companies today is that, obviously, you're moving very quickly on this, as you have to, but it means that the cap will be in place before suppliers have a chance to adjust their hedging. So, I'm interested if you would see any scope for a, kind of, transitional period in which the cap is introduced but taking account of where the hedge positions of suppliers currently are, or whether the cap goes in on your timeline, you know, and any suppliers who have effectively the wrong hedging for the wholesale cost you're expecting will just have to absorb that? Those are my two questions. Thank you very much.

Dermot Nolan

Thank you, I'll do my best to answer them. On the first question, the CMA spent a lot of time looking at this particular question. I think, broadly, and I, you know, characterise it in broad terms, they suggested that for the bigger companies, yes, they were making higher profits in standard variable tariffs and therefore offering lower fixed-price tariffs. The cap will drive down the level of standard variable tariff and presumably reduce the revenue. We explicitly acknowledge that.

As to how the bigger companies react to that, that is something we have looked at some scenarios for in the impact assessment, but we're clearly not going to precisely say what they do. I do think there is a challenge. The cap is challenging to the larger companies, and how they respond may vary and they may have different strategic choices. Some may particularly focus on making efficiency cuts. Others may try and increase the price of their fixed-deal products. That, in some sense, is a strategic decision for them.

On the point, however, of the overall market perspective, which remember is the point we're looking at, we've seen many new suppliers enter the market, including some who have become reasonably substantive players now, who seem to be particularly efficient and have low costs. I'm not going to name them necessarily, but there are quite a few new players. They do not have this SVT core base, and as a result, we still see in the fixed deal section of the market, we still imagine there will be cheap deals. We still imagine those companies will be able to offer such cheap deals. Now, this will offer a challenge to the bigger companies, but frankly, that is part of the whole arrangement of the price cap.

The second point about hedging is, I think I'll just have to say broadly, we will see what companies come up with. However, the broad idea of hedging, the hedging patterns we've chosen, mostly reflect some of the CMA analysis. By and large, we will obviously listen to what companies say, but I don't immediately think we will, sort of, change the policy we have in there, though stressing that we will obviously respect whatever the companies, or indeed other stakeholders, respond to in the consultation.

Sam Arie

Okay. Thank you very much.

Operator.

Thank you. Our next question comes from the line of Deepa Venkateswaran of Bernstein. Please go ahead, your line is now open.

Deepa Venkateswaran

Hello.

Dermot Nolan

Hello.

Deepa Venkateswaran

Hi. Can you hear me?

Dermot Nolan

Yes.

Deepa Venkateswaran

Yes. So, I have two questions as well. So, firstly, you've given this preliminary level of cap. I wanted to see if there were particular elements that you think might change between now and November. Anything that you think you need to firm up or anything that needs more extensive consultation.

Second question is on smart metering costs. I believe that you will be reviewing those later. Again, could you maybe discuss a little bit about your thinking of how you incorporated smart metering costs now, and then what you intend to actually review in the next year or two years? Thank you.

Dermot Nolan

Okay. On the first question, my broad answer, I'm afraid, will be no. I think we feel we've done a huge amount of analysis for this. We've done, I think, very concrete proposals and these are our proposals. So, there's nothing special or specific that we imagine will change, subject to the fact that this is a statutory consultation and any responses from all stakeholders, not just the energy supply companies, are things we will be legally bound to take into account before making a final decision. I don't think there's anything specific we feel is likely to change, or more likely to change than anything else. We've done a huge amount of work and we feel these proposals are a solid set of proposals.

On the second question, I'll hand to my colleague Rob.

Rob Salter-Church

So, smart metering is included as part of the operating cost baseline. Smart metering is a fully-fledged activity within the large suppliers, and therefore we would expect that there are costs of smart metering already within the operating cost stack. Now, what we recognise is that whilst the main operating cost allowance will inflate in line with inflation, we recognise that smart metering is slightly different and there are different drivers that suppliers are going to have in the coming years as they complete the rollout.

So, what we are proposing is a separate increment of the smart metering net cost allowance, which will be added in when we update the cap every six months. That allowance consists of two parts. One part relates to the pass-through central costs. So, those are the costs of the DCC and some of the other associated central bodies. There is also an element which relates to suppliers' own costs around the procuring and installation of meters. We have recognised that there is some uncertainty around how the smart metering rollout will progress over the coming months in terms of completion rates for the rollout, and also for the costs of installing smart meters. So, we have set a proposal for what the smart metering increment will be for the first two cap periods. Then in time for the third cap period, we will have a look at what further information is available about rollout rates and around installation costs, so that we can see if we need to change the methodology or any of the input numbers in time for setting what that smart metering increment cost will be within the third cap period.

Deepa Venkateswaran

Thank you.

Operator

Thank you. Our next question comes from the line of Iain Turner of Exane. Please go ahead, your line is now open.

Iain Turner

Can I just ask whether you think possibly you're setting yourselves up here for a bit of grief in February? Because I think the cap will come in beginning of the year and within a couple of months you're going to have to be recalculating it again. I think, you know, from what I can see, it looks as if you're going to be probably announcing another price rise in that cap of perhaps £100. And whether you've thought about having a slightly longer hedging period on the wholesale cost as a way of damping that?

Dermot Nolan

I think a couple of points. I mean, wholesale costs, clearly, have risen over the last period of time. I'm not going to speculate about what prices might be in April. I take the point that the trend is upwards. I think we've said, for a variety of reasons, that we thought it was best to try, in many ways, to have a price cap that had some strong similarities to the PPM cap. Given the CMA has spent significant amounts of time thinking about these hedging methodologies, we felt it would be wrong to opt to depart from them. So, I think we are likely to be in the place we are.

As to whether there'll be grief or not, I can't comment. I think we've said this morning that one of the things we don't control is wholesale cost, and that the cap, however, will ensure that cost changes, either upwards or downwards, are channelled in a transparent and understandable fashion.

Iain Turner
Thank you very much.

Operator
Thank you. Our next question comes from the line of Fraser McLaren of Bank of America Merrill Lynch. Please go ahead, your line is now open.

Fraser McLaren
Hello and good afternoon. Two questions from me, as well, please. Firstly, on headroom. Your previous analysis suggested that switching rates would reduce substantially at the sort of levels that you've chosen to set headroom at. What led you to opt for that relatively low number?

Then just following on from previous questions about the inevitability of the February cap being higher as a consequence of wholesale prices, given that that's so foreseeable, have you had any thoughts about the costs that the industry will incur having to change tariffs again so rapidly?

Dermot Nolan
I mean, on the first issue on headroom, Rob might want to come in, but we thought very long and hard about this. This involved the overall balancing of judgements as to what price cap we set. Our main issue, our main goal in the legislation is to protect consumers. We felt on balance, looking at all the analysis we had done, that we thought that the level we've chosen with the level of headroom that you've just spoken of, was the best overall deal for consumers. We have said in the paper that we do see a very strong probability that switching rates will fall, at least in the short to medium run, but as I said earlier, I think we believe that parts of the market, particularly the fixed parts of the market, will remain vibrant, will remain strong incentives to switching, and we see competition, in some sense, developing partly from the new challenger models that are coming forward, that frankly will challenge, that are already beginning to challenge, the big energy companies and we think will continue to do so. Broadly, we welcome that.

On the aspect of the second question, Rob…

Rob Salter-Church
So, you were asking about whether we've considered some of the transaction costs that suppliers might face as a result. What the cap does is set a maximum price. It does not require the suppliers to change their price if their price happens to be below a particular level. So, it's really, for suppliers, whenever the cap level is reset, to decide for themselves what they think is the right thing to do and trade off their revenues associated with the costs of changing any tariffs. So, I think it's not something we think we need to give specific consideration to because we're not ultimately determining exactly how suppliers behave when cap levels are reset, save that if the price has gone down, that they have to reduce them.

Operator
Thank you. Our next question comes from the line of Martin Brough of Deutsche Bank. Please go ahead, your line is now open.

Martin Brough
Questions. One was just following up on the comment you made about still leaving the door open, potentially, for exemptions from the cap if there are genuine added benefits for renewable tariffs that go beyond government requirements. Could you just give a little bit more information about that? Is just simply going into the market and buying guarantees of origin, would that be enough, or would it have to be more substantial than that? Would it have to cover gas as well as power? What kind of threshold are you thinking about there?

And then the second question is, could you just give us a bit of an update about the other initiatives that there have been in the past few years about ways of trying to encourage higher levels of engagement with the market? Obviously, in the past, there was this discussion about giving information to third parties about customers that weren't switching, although I understand there was a, sort of, slight backing off of that. Equally, there were ideas about maybe reverse switching and allowing parties to, sort of, bid for serving customers, or other ways of forcing companies themselves to start experimenting with ways of increasing engagement. So, could you just give us a bit of an update about those initiatives? Thanks.

Rob Salter-Church

Of course. So, your first question about the derogations for renewable tariffs. Suppliers would be able to submit derogations either for a gas tariff or for an electricity tariff. It wouldn't have to be both. There are three core principles that we will be judging whether or not we think it is in consumers' interest to issue a derogation. The three things are, firstly, around additionality. We're setting that as a principle. We're not setting a series of prescriptive requirements on how suppliers should seek to demonstrate to us that there is additionality. We are leaving that up to suppliers to make that case and we will give it due consideration in relation to that additionality principle.

The second is around the initiatives or the type of support that suppliers are giving to renewables. They have to be shown to come at an extra cost, because if there is not an extra cost associated with giving that level of renewables support, then there would be no justification for pricing above the cap. So, that's the second area where suppliers would need to demonstrate their case. The third aspect is around ensuring it can be easily tracked, monitored and proved that the tariff is operating in that way. So, those are the three principles around which a derogation request would need to be made.

Your second question in relation to an update on our consumer engagement activities. So, we are continuing with our approach of testing and trialling a series of different interventions to help customers to engage. Our most recent intervention was a simplified collective switch, where we used data that suppliers hold from customers to create a series of personalised projections as part of a collective switch, and that had a very successful impact, increasing the switching rate by eight times. What we're doing is rolling out a larger trial of that, covering some 200,000 customers over the autumn.

We're also continuing with our initiative in relation to the disengaged customer database, where we are hoping to roll that out at a regional scale in the coming twelve months. What we will be doing is taking stock of these various initiatives and considering how they should be built into the regulatory framework for the future. So that as well as providing some support to customers to engage now, we're learning about what needs to be a part of the regulatory framework as we transition out of the price cap, such that there are fewer customers which are on default deals and there is a greater engagement and competition within the market.

Martin Brough

Okay. Could I just follow up briefly on that first one around the renewables? So, does it specifically rule out just simply buying guarantees of origin? Because that can be tracked and monitored. It is additional in the sense that you can't double count because it's guaranteed origin, and it does come at an extra cost, albeit it's a very small extra cost. But, is it possible for you to rule that out under European law because, I mean, that's what the guarantee of origin is there for, or is that something that companies could apply for?

Rob Salter-Church

The suppliers would have to make their case, and if their case was based on solely providing REGOs then we would give that due consideration. We're setting the requirements out at a principles level as opposed to a prescriptive level, reflecting there are lots of different approaches that suppliers take in relation to supporting renewable generation.

Martin Brough

Okay. Thanks.

Operator

Thank you. Our next question comes from the line of Dominic Nash from Macquarie. Please go ahead, your line is now open.

Dominic Nash

Hi there. I've got two questions, please. The first question I've got is are there any scopes for any appeal processes from the utility companies themselves between the end of consultation, October, and the November start, if there's any sort of recourse? Secondly, comparing the numbers that you've got in this one with the PPM number, which coincidentally is also £1,136, could you just give me a bit of colour as to why there's a difference between the wholesale energy allowance in the PPM and the standard variable tariff? Also, whilst you argued eloquently for the £10 headroom or the £12 headroom in the SVT, why it should be significantly higher in the prepayment meters, please?

Rob Salter-Church

Yes, I can take those three questions. So, the appeal route as set out in primary legislation for the cap is judicial review. Your second question in relation to wholesale cost and why there is a difference. Whilst, broadly speaking, we are following the prepayment meter approach, there is one key difference in that we include capacity market charges within the wholesale cost allowance, whereas they sit within the policy allowance in the prepayment meter cap.

Your last question about headroom, and why headroom is higher in the prepayment meter cap. The prepayment meter cap has a £30 headroom, which is their only allowance for uncertainty and variation between suppliers. The approach that we've taken to consider variation and uncertainty is to include elements within the efficient benchmark where possible, and within the headroom where that is not possible. So, if you take our allowances around efficiency and uncertainty, taken together, they sum £36, which is obviously a lot closer to what the prepayment figure is than if you just looked at the headroom figure of £10.

Martin Young

Dominic, it's set out in the consultation overview document on pages 28 and 29, so, it, sort of, takes you through the components that sum together to give that £36.

Dominic Nash

Okay, great. But do you actually have one where you compare and contrast the two different methods, or do we just have to, sort of, go through it and guesstimate a lot of these things?

Martin Young

If you're asking, 'Have we stacked up the PPM-,'

Dominic Nash

Yes, against SVTs, so they're like-for-like.

Martin Young

No, we haven't. If you want to have a discussion about that, give me a call later.

Rob Salter-Church

And that's partly due to the difference in methodologies. So, the prepayment meter cap is price-reference based and then extrapolates backwards with a series of different assumptions, whereas ours is bottom-up. So, it's not as straightforward as pulling together tables to show the differences, but do follow up with Martin offline if you want to have further discussions on that.

Dominic Nash

Great, will do. Thank you.

Operator.

Thank you. Our next question comes from the line of Nick Ashworth of Morgan Stanley. Please go ahead, your line is now open.

Nick Ashworth

Hi. Afternoon, everybody. Firstly, can you just talk about the mechanism around recommending that the cap be removed from 2020 or thereafter? You talk about effective competition. What do you actually mean by that? Is it the market has to be acting in a competitive way with the cap in, and so you can see that when the cap is removed, or are there certain elements, structure of the market that you need in place, that you can see will work once the cap's removed? So, could you just talk a little bit about what you mean when you talk about effective competition?

And, then secondly, in terms of the saving, you said this morning in the document that it was about £70-£75, I think, relative to the average standard variable tariff, and that's come down, looking at if you back tested this over the last few years. The reason for that coming down, can you give a little bit of colour? I think you said in the document that it's because wholesale costs haven't been fully reflected, but is it also partly that some of these suppliers are becoming a little bit more efficient? Is it partly cost, as well, or would you say it's all on the wholesale side? Thank you.

Dermot Nolan

Yes, the first point was, actually, pardon me, it's been a very long day, but I was focussing so much on the second question, I've temporarily forgotten the first, which I'm embarrassed to say now, so could you just briefly repeat it?

Nick Ashworth

Yes, of course. Not a problem. It was around the end of the cap, and this effective competition, and what you need to see to recommend an end to the cap.

Dermot Nolan

My apologies. It's been a very long 24 hours. The conditions for effective competition, we have not specified them in advance at this point, and I think you will see more from us on this in the next few months, and potentially in the next year or so. In particular, we will publish something we call a 'State of the Market' report, which we published first last year, and will publish again in October, which will give more clarity about the kinds of analysis we will do. I would say that there will be some necessary conditions, but not sufficient conditions, if you like, in the sense that I think we'll have to see a situation where the smart metering rollout is, if not fully done, at least perceived to have been, sort of, more or less completed. We'll need faster switching. We'll need, I think, a general reduction in complaints, and we'll need general evidence of the ability for people to engage more effectively in the market.

I realise that is not a trivial task. I suspect, just jumping in in advance, you may say, 'Well, hold on, if people are on SVT tariffs anyway, how do you measure the sense of whether or not they would be prepared to engage if they were removed?' I think that's a good question, if you're asking it, perhaps I'm asking it myself, but I think we don't have a specific answer to that, but we will develop methodologies and publish more on that, I think, in the coming periods of time. But as I said, certain things, faster switching, smart metering, things like that, I think, will be absolutely necessary but not by themselves sufficient. On the second question…,

Rob Salter-Church

As to the £75 saving figure and why that is less than previously. I think at a headline level, prices have risen by less than our model suggests costs have. That is in part wholesale costs, but there may be other factors at play. The baseline in 2017 is the last date where we have complete information. So, it's not possible for us to really make a clear prediction about what has changed in all of the different elements between then and now. I'm sure people on the call will be well aware that various suppliers have announced efficiency initiatives since then.

Dermot Nolan

I mean, I think, as you say, we're not being determinative, nor necessarily at this point can we be determinative about why the value has fallen. I think, in some ways, it's positive that it has. I mean, you could take a view that it's a question of timing, that retail costs are tracking wholesale costs in a delayed fashion. I hope that's not the case because the other two factors are more positive from a regulatory perspective. That companies are starting to make efficiencies and passing that through, or indeed that the market, even for standard variable tariffs, is constraining the increase in standard - constraining the ability of companies to raise their standard variable tariff by a bit more. I don't think we're able to say which of those three explanations are at play, but there will be, I think, some combination that suggests why it's gone from £1.3 billion to £1 billion.

Nick Ashworth

Okay. Very useful, thank you very much.

Operator

Thank you. Our next question comes from the line of Sam Arie of UBS. Please go ahead, your line is now open.

Sam Arie

Hi, thank you. I'm just coming back on for one more question, and that's just a follow-up to your answer just now on how you think about the conditions for competition when you decide if the cap will be extended in the future. I suppose I just wanted to join that up with your comments about expecting, you know, short- to medium-term reduction in switching levels. So, I mean, it seems to me that those two things, kind of, oppose each other. And if once the cap is enforced, we'll probably see less switching in the market and then you'll be asked to judge whether the market is more competitive than it was before. Can you, kind of, rule out that your assessment of the conditions for competition is going to include the overall switching level in the market, or just give us a sense of how you trade those two things off against each other? It does seem to be potentially quite a difficult question to answer.

Dermot Nolan

I think I did acknowledge that it was a difficult question to answer in the sense that we do expect switching levels to fall, at least in the short to medium run. I'm not sure if that will be maintained over time. I think we will do it through a number of ways. As I said, I'm not trivialising the extent of the problem. What we will try and do is the immeasurably difficult task of trying to look at counterfactuals of what switching rates would have been in the absence of a price cap, which is a very difficult question but one we will try to address.

We'll also supplement that with various factual issues. As I said, industry processes to make sure switching is faster, more reliable. They would be necessary conditions. Plus, we will do a lot of survey evidence and, sort of, qualitative evidence as to whether or not customers feel they can engage. There won't be one magic bullet and I can't pretend that it's not a difficult question, but I think we will adopt a range of approaches to look at whether or not competition and engagement is easier in a market of, say, a few years' time rather than it is today.

Sam Arie

Okay. Understood, but does that mean, just to be clear, that if, for example, the overall rate of switching in the market is significantly lower in a couple of years post-cap than it is now, that wouldn't prevent you, via other metrics, from concluding that the conditions for competition are better than they were and that the cap doesn't need to be extended? Is that a fair…

Dermot Nolan

That is a fair comment. I mean, I'm not saying that if switching levels fall that we will automatically conclude, but it will not prevent it. Yes, I think I can be clear on that.

Sam Arie

Right, very good. Thank you for your answer and thanks again for the call today.

Dermot Nolan

Cheers.

Operator

Thank you. Our next question comes from the line of Deepa Venkateswaran of Bernstein. Please go ahead, your line is now open.

Deepa Venkateswaran

Thank you for taking my additional question. I guess I had a philosophical question on the headroom and what its' purpose was. I thought that when the CMA set the headroom, it was to give an appropriate headroom between the cap so that customers would be incentivised to switch. Now it seems to have evolved into some kind of a catch-all for uncertainty or variation. So, I was just wondering whether the headroom, as you see now, is just to cover any contingencies that you couldn't already, or is it genuinely so that there is a difference between the cap and what could be a competitive switching point? I acknowledge that there are many cheap deals in the market from smaller suppliers, but I think many of them still have exemptions and many are heavily loss-making if you look at their pricing versus your own bottom-up analysis. Even if you ignore the operating costs and assume the operating costs are lower, they're still making huge negative margins. So, I was just wondering how the headroom actually squares up? Thank you.

Rob Salter-Church

Headroom can be included for a number of different reasons, as your question suggests. So, it could be in relation to dealing with uncertainty. It could be dealing with variations in suppliers' customer bases that might lead to different levels of what you would consider to be an efficient cost. It might also be needed for the reason that you describe around maintaining competition within a market and maintaining incentives for customers to switch. As we set out in the document, we think that there is a requirement for some additional headroom, primarily for the first of those reasons around uncertainty. We don't think that there is a strong argument for additional headroom in the cap in order to continue to provide incentives for customers to switch supplier, or to allow holders of supply licences to compete effectively. That is based on the analysis that Dermot explained earlier on, where we've looked at a range of difference sources of information around what might happen to switching levels, what might happen to the provision of cheaper fixed-term deals by those suppliers who are smaller and more efficient, and we've reached the conclusion that we do not think there is a strong argument for headroom in this cap for the purposes of providing switching incentives. It is around the first of those, around uncertainty, primarily.

Deepa Venkateswaran

Okay, thank you.

Operator

Thank you. Our next question comes from the line of Jenny Ping of Citi. Please go ahead, your line is now open.

Jenny Ping

Hello, hi. A couple of questions. Firstly, have you had any feedback from the government on the level of the cap that's been announced today? Secondly, I was just wondering, the revenue reduction of £1.3 billion, do you now feel that essentially satisfies what the CMA have flagged as the £1.4 billion of inefficiencies and the size of the detriment?

Dermot, you mentioned previously in one of your appearances at the BEIS committee that Ofgem will be updating and publishing on the reduction of the size of this detriment as you go forward. Is that going to be part of the State of the Market report, or how should we think about that publication going forward? Thank you.

Dermot Nolan

Yes. The first point, we have had public comment from government, the public statements made from politicians, both in the government and the opposition politicians. That's all we've heard, to be honest. You know, we're an independent regulator, so we note the comments that have been made. That's all I would say on that.

On the second point, there is the £1.3 billion, a strong analogy to the £1.4 billion. It is a somewhat different – it is not explicitly calculated through the same methodology. There are some elements of it that have a similarity. We will talk a little bit more about the detriment probably in the State of the Market report, but to a large extent, yes, we are seeing the price cap as, to some extent, responding to the detriment figure and our response. The level was not picked to respond to that detrimental figure. It was picked on our overall judgement of what was an efficient cost, but nonetheless, there are some, certainly, analogies between the £1.3 and the £1.4 billion.

Operator

Thank you. Our next question comes from the line of Ashley Thomas of Millennium. Go ahead, your line is now open.

Ashley Thomas

Yes, hi there, good afternoon. I had a question about the starting point for the basis of efficient operating costs. If I look through the consultation document, it looks like you were just, when looking at the, sort of, efficient lower quartile operators, you make adjustments on accounting for sales and marketing, sort of, capitalised acquisition costs. But, if you're looking at the CSS for, sort of, reported 2017 costs, are you making adjustment on the accounting for DCC and smart metering costs, which sort of differ across the operators? Because I understand going forward you're just going to have a standardised cost for DCC, but in terms of looking at the historical benchmark and, sort of, what is the level for an efficient operator, I just wanted to check that you'd made that adjustment because that could have brought down the reported operating cost of some of the operators.

Rob Salter-Church

So, the starting point for the efficient cost benchmark in looking at the operating cost stack is from information that we requested from suppliers over this year. So, that's information we've gathered this year but relates to 2017. What we have had to do in a range of areas from the information we've seen from suppliers is to make various adjustments to make sure that certain costs are not double counted. So, we have made appropriate adjustments and given appropriate consideration as to how we have seen DCC costs, for example, come through in the operating costs benchmark information because we have it in a separate stack.

So, yes, we've included it separately. So, we have had made consequential changes and we've done that in a number of areas where we have put things into different areas of the benchmark.

Ashley Thomas

So, I guess my specific question is, the document explicitly says you've adjusted for the accounting difference on customer acquisition accounting. I guess specifically, when working out the lower quartile, have you adjusted for the differing accounting treatments on DCC costs, looking at the reported figures?

Rob Salter-Church

So, I think it's probably best for us to take this question offline. There's a degree of specificity that is probably worth picking up with you separately, if that's okay?

Ashley Thomas

Okay. Thank you.

Operator

Thank you. Our next question comes from the line of Martin Brough of Deutsche Bank. Please go ahead, your line is now open.

Martin Brough

Thank you. I know time's pressing. One more, sort of, quick question was, do you expect companies to change their marketing behaviour now that they've seen this proposed level of a cap? So, if companies start marketing to customers based off current standard variable tariffs whilst knowing, obviously, the cap is likely to come in from the start of next year at a lower level, is that okay with you? What views do you have about marketing for the next few months of this year? Thanks.

Dermot Nolan

I can't really give a specific answer to that in the sense that, you know, I think how companies market their deals is really a matter for them. I wouldn't care to suggest to them what they should do. I think there will be general consumer law protections and licence protections that they cannot engage in misleading marketing. I'm sorry, I really can't be any more specific than that at this point in time.

Martin Brough

That's okay. Okay, thanks.

Operator

Thank you. Our next question comes from the line of Chris Laybutt of JPMorgan. Please go ahead, your line is now open.

Chris Laybutt

Thank you, very much, and good afternoon. Just one question from me. It's a related subject, I guess. Could you provide a comment just in relation to the rate of small supplier failures that we've seen so far? Has this rate been higher or lower than your expectations when you put the small supplier exemptions in place? Can we expect any further changes to those exemptions and/or licence conditions in the future? Thank you.

Rob Salter-Church

Okay. So, your first question around expectations of small supplier failures, I don't think we have any expectations of failures of small suppliers or how many there may be. In any market, sometimes participants will fail. We have a market now of some

70-something suppliers, so I think it is not a surprise that you see merger and acquisition activity, like the things that were announced this week, and other forms of market exit. That is just a natural pattern that we would expect to see. There has been an increase, but in recent years, that increase is also reflected in the number of participants within the market. Your second half of the question, sorry, has escaped me. So, remind me.

Dermot Nolan
For once, I'm able to remember it. The point about small supplier exemptions is, actually, the small supplier exemptions in terms of policy cost are set by the Department for BEIS. I will come back if I get the numbers wrong with this, but they have announced that the ¼ million exemption will go down to, I think, 50,000 next year.

Rob Salter-Church
One fifty.

Chris Laybutt
One hundred and fifty. Yes.

Dermot Nolan
Will go from ¼ million to 150,000. I don't think they've set a specific pattern beyond that, but I think they have given a general indication that they are likely to reduce it over time. Beyond that, I can't speak for that, but clearly, I think they're trying to give a degree of certainty about how small supplier exemption will function.

Chris Laybutt
I guess if I could follow up, Dermot. Just in terms of your view as a regulator of this market, are you comfortable with the level of failures that we've seen so far, and can you provide a comment on that? Because it does seem that there are exemptions in place. Consumer balances are protected, and so that would, I assume, impact their marketing strategies, which has impacted this process and many processes before it. So, any comments you could make from Ofgem's point of view would be very welcome.

Dermot Nolan
Okay. I'll say, I think, two things. I do think a market, any market, there's going to be companies that are going to fail. I know I'm stating the obvious here. A market where companies didn't fail, where new entrants didn't fail, would strike me as a, sort of, bizarre market to have. I mean, one of the things that might happen, one scenario is there'll be a shakeout. Often, in some industries, you see an extreme expansion in the number of brands for a period of time, then there's a shakeout and a reduction in that. That might happen here. Alternatively, the energy sector might change radically in the sense that we certainly would see the possibility of smaller scale firms, of community energy, and that's another possible future. I mean, broadly speaking, small suppliers will enter the market. Hopefully many will succeed, will grow. Others will probably either fail or be swallowed up.

The point you made about credit balances though, I say, we have said that we will address the issue of entry requirements and you can expect to hear something more from us on that during the autumn. So, basically, what we suggested is we will review the entry requirements to make sure, I think – I suppose to guard against the, or certainly limit the possibility of moral hazard, that somebody entered – I think the phrase has been used, I'm not necessarily endorsing it, is 'hit-and-run entry.' I think we will do more on that. We've already indicated that we'll have a consultation out on this before the end of the year.

Martin Young
On that subject, Chris, and for everybody on the call, what Dermot is referring to is a letter that we put out on the 11th of June of this year reviewing our approach to licencing suppliers. So, you can find that on our website if you have interest in that particular topic. I guess it's an ideal opportunity to suggest that we move to the last question, given that we have to wrap up at four o'clock. So, if we could take the last question please, Jerry?

Operator
We have no further questions in the queue.

Martin Young

Perfect. I think, on that note, a big, big thank you on my side to both Dermot and Rob. A big, big thank you to everybody else for joining the call this afternoon and all of their questions. I'm sure that Jerry reminded you in the introduction that this call is recorded. We will make the recording of the call available on our website in the usual fashion. There should be a transcript, as well. As Dermot said earlier, of course, if you've got any more questions, just give me a call or send me an email. With that, thank you to everybody and good afternoon.

Dermot Nolan

Thank you all very much.

Rob Salter-Church

Thank you.

Operator

This now concludes our call. Thank for your attending. Participants, you may disconnect your lines.