Ofgem Policy Consultation: Default Tariff Caps
Response by ENGIE Power Limited

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About ENGIE

ENGIE is a leading energy and services company focused on three key activities: production and supply of energy, facilities management and regeneration. Our 17,000 employees combine these capabilities for the benefit of individuals, businesses and communities throughout the UK & Ireland.

We enable customers to embrace a lower carbon, more efficient and increasingly digital world. Our customers benefit from our energy efficient and smart building solutions, the provision of effective and innovative services, the transformation of neighbourhoods through regeneration projects, and the supply of reliable, flexible and renewable energy.

ENGIE improves lives through better living and working environments. We help to balance performance with responsibility, enabling progress in a harmonious way.

Globally, the ENGIE Group employs 150,000 people worldwide and achieved revenues of €65 billion in 2017.

Executive Summary

Thank you for the opportunity respond to the policy consultation on default tariff caps, please find our main points below:

- ENGIE recognises the twin objectives of the price cap which are to protect those on the poorest value tariffs whilst maintaining a level of healthy competition in the supply market. Although there is tension between these two objectives, ENGIE believes that it is possible for Ofgem to get the balance right when setting the cap in order that both can be met. There is a risk however, that if the cap is set too low this could severely restrict competition as headline savings level become unattractive to customers and they become more disengaged with the energy market. Government and Ofgem should be wary when setting the level of the cap that that any intervention does not inhibit the ability for smaller suppliers to grow, nor should it unwind the inroads made by smaller suppliers to challenge the incumbents that we have seen over recent years. Based on the initial Ofgem views expressed in the consultation, ENGIE has concerns that healthy competition could suffer in this way.

- We therefore support a headroom at the upper end of Ofgem's range, as this would better preserve a

functioning market.

  - Determining the level of headroom should be evidence-based, with some reference to the minimum savings needed to incentivise customer switching. We have not seen evidence in Ofgem's consultation to demonstrate that a headroom level above £70 should be discounted. Indeed, our own customer research points towards a realised savings level, where consumers continue to be incentivised to switch, at around £150 per year.

  - It is clear that the calculation of other cost components in the proposed methodology is subject to a degree of uncertainty and complexity, as, for instance, operating costs and wholesale costs will vary from supplier to supplier. Because of this it is important to allow a reasonable degree of headroom to take account of this range.

- Additionally, Ofgem's process should allow for the headroom to be varied, for instance if there is a notable deterioration in the rate of switching then the methodology should allow for the headroom to be raised at the next review point.

- It would be preferable for the headroom calculation to be based on a percentage of costs rather than an absolute number as this would better reflect variations in the underlying cost components.

- In addition to close monitoring of switching rates and market health to inform whether a cap is too low, there should be a clearly defined set of conditions by which the cap is removed. These should be linked explicitly to improvements in market developments, such as the extent of smart meter rollout and/or the enablement of faster switching. Otherwise the risk of an uncertain and potentially protracted timeline for the price cap could damage competition more significantly by severely inhibiting the business plans of challenger suppliers or by acting as a barrier to market entry.

- We are uneasy about of the potential impacts on the wholesale markets from the proposed price calculation model. This six-monthly price assessment method instinctively encourages similar purchasing behaviour from suppliers who will naturally try to hedge the price risk to mirror the calculation. Whilst this model may work for a limited number of consumers, such as those currently on pre-payment meters, it may be more disruptive to wholesale market trends if hedging practices are replayed at scale for majority of the domestic market volumes. Further, this may in turn result in a less diverse range of products offered to consumers on fixed term deals because suppliers may be reluctant to price any product above the cap. Longer duration products are most at risk from this approach as they may appear to be less competitive relative to a standard SVT despite providing better budgeting certainty for consumers.

- Our preference for the operating cost model would be a bottom-up cost assessment as this gives a better reflection of the prices faced by all suppliers and gives a more diversified data source. The alternative adjusted reference price models, even when updated to 2017, could place too great an emphasis on individual supplier prices rather than costs, and is therefore still subject to individual market pricing behaviors.

- We support Ofgem's proposal for a derogation process for green tariffs, but this process must be clearly defined and more expedient than the current derogation process to allow for market innovation. It is important that the Ofgem's assessment process recognises cases where there is a significant and proven increase in costs, in particular to green gas products supported by valid certificates.

Detailed response

Overall level of the cap and Tariff cap bill objectives.

The overall level of the price cap be a crucial indicator in the energy retail market for the foreseeable future and so both the level of the cap itself and the calculation method is critically important to a wide range of stakeholders. Consumers, energy companies, potential new entrants and investors alike are likely to base their decisions on this number. The overall price cap level is likely to become the basis on which competition will operate, replacing the current highest SVT as the "headline number", the benchmark by which customer benefit (£x per year) is calculated. The level of the cap will inform the savings message communicated to customers via the market, in the media and by political and regulatory bodies.

ENGIE recognises the overall objective of the Price Cap Bill, to reduce costs for those on the worst value tariffs and equally we prioritise the bill consideration for having regard to maintaining competition in the market. These two objectives create a challenge for policy makers and are finely balanced, but they do not necessarily have to conflict if the level of the cap is set fairly.

There is also a recognition that the overall level of the cap will not only provide a cap for SVT and Default tariffs as prescribed but will effectively provide a cap for all tariffs in the market. This is because it is unlikely that suppliers will price above the cap even in the non-constrained fixed term tariff market because it would be cheaper for customers to revert to the SVT. One consequence of this is that consumer choice may be restricted to fewer product offers, particularly in relation to longer term products where the end date extends past the tariff cap period (>12 months duration). Longer term products are popular in the market currently and allow consumers to fix their price and bring more certainty to household budgets.

Headroom

We comment on the individual cost components of the cap later in this response however if we assume the cost components are calculated to correctly give a reasonable proxy for costs then it is the headroom allowance which drives the overall level of the cap. So, it is the level of headroom which ultimately prescribes the level of price competition in the market and the switching rate is most sensitive to this component.

To maintain a continued level of competition in supply we support a headroom level which is evidence based, one which encourages consumers to engage and achieve cost savings in line with their expectations. We recognise that it is also important, in line with the Bill's objectives, to protect disengaged consumers from the impact of higher SVTs, however it is critical for the viability of the market, and individual suppliers, that the headroom delivers an outcome which allows switching levels to continue to flourish. Our own evidence suggests an expectation of around £150 cost saving is sufficient to maintain an incentive to switch. On this basis we believe a headroom level towards the upper end of Ofgem's range would best serve the objectives of protecting consumers from the highest prices whilst maintaining an incentive to switch.

Given that the level of headroom is the most sensitive factor likely to affect competition we would urge Ofgem to adopt a flexible approach to the calculation of headroom over time. This may prevent unintended consequences such as supplier failure and a very high level of supplier consolidation should the headroom be set too tight initially. Ofgem's process should allow for the headroom methodology to be varied, for instance if there is a notable deterioration in the rate of switching then the methodology should allow for the headroom to be raised at the next review point.

Additionally, it would be preferable for the headroom calculation to be based on a percentage of costs rather and absolute number as this would better reflect variations in the underlying cost components.

Efficient cost model

We favour option 4, the bottom-up assessment of costs because this gathers a fuller representation of costs across all suppliers. Currently, under the existing PPM price cap the cost assessment is limited to two mid-tier suppliers and this places a high dependency on a limited data source. This adjusted reference price approach places too great an emphasis on individual supplier prices rather than costs and is subject to individual market pricing behaviours.

We realise these costs are adjusted to account for other supplier's costs however we note that the result may not accurately reflect the costs of all parties, particularly smaller suppliers who are growing. Whilst a wider data source is preferable we recognise the time constraints involved in this process and that it may not be feasible to gather a full range of data over summer.

If this is the case, then option 3, an updated competitive reference price is an alternative, but only as an interim solution. We believe option 3 is more desirable than option 2 because it is important to re-base costs on 2017 data rather than simply index 2015 costs. It is important that a wide price cap which affects more than half of the market is founded on a thorough cost assessment which considers the most recent market developments, for example the unforeseen costs of unidentified gas.

Updating the cap over time

We agree that option c, to update the cap reflecting current trends in cost data and indices is the preferred option. This option is likely to more accurately reflect the costs suppliers face in future periods than the alternative options.

In terms of the cap review period we prefer a twelve-month review period, in our view this is less likely to cause consumers price disruption. In our business model consumers who reach the end of their initial fixed term contracts are automatically placed onto our lowest priced fixed term deal that has similar characteristics to their initial product choice. This is ENGIE's "rollover promise" and we believe this guarantees best value for our customers. We do not default people onto expensive SVTs like most other suppliers. The idea of our rollover promise is threefold, firstly to automatically give our customers the best deal we can, secondly to prevent the hassle of having to find the best deal and finally to give customers budget certainty, with a fixed price over a defined period.

However, because such automatic deals are classed as default contracts they remain within the scope of the price cap. The effect of retaining a six-month review of the price cap could result in the customers price changing part way through a fixed term deal if the price cap forces this and factors such as a significant variation in the wholesale price could trigger this. This is not ideal, nor is it what customers expect from a fixed price, fixed term deal and is likely to cause confusion.

Wholesale costs and predictability

Under a price cap environment is expected that energy suppliers will to try to mitigate the risk of losses arising from higher costs from those calculated in the price cap methodology. The largest controllable cost component is the wholesale cost and to mitigate risk it is likely that suppliers will try to adopt a hedging strategy that mimics

the wholesale reference price method used for the cap. This is a naturally conservative behavioural response at individual level but when followed at scale may have unintended consequences in not just the wholesale energy market but also consumer prices.

The tendency for companies to hedge to the wholesale reference price used to derive the index could initiate similar purchasing behaviours where companies are incentivised to follow the same tactic to achieve the same outcome. The diversity of different company hedging strategies would be lost. Additionally, because the scale of the volume associated with the current SVT and default contracts is so high (~60% of domestic demand) this could cause higher than expected market prices as companies buy in bulk.

This potential inefficiency in the wholesale market price is likely to follow-on into the prices that suppliers offer to consumers. Effectively the price cap methodology sets the price for all and the prices offered to consumers converge to the cap. Such price convergence has already been demonstrated to a lesser extent with the PPM cap. In relation to forecast error and imbalance allowances it is worth noting that these costs will be higher for new entrants who are growing than those who are either losing customers or in a steady state. It is more difficult for a growing supplier to be able to predict with any certainty how quickly they will gain customers, simply because of unknown competitive pressures in the market from rivals. It is easier for a larger supplier to predict how many customers it will lose, based on historic switching rates etc. because they do not need to know the recipient. For smaller growing suppliers it is much more difficult to predict gains because on average it has a slim chance (one in sixty based on current number of suppliers) of being the recipient.

Network and Policy costs

We agree with Ofgem's proposals to set the network charge allowance in relation to the published regional charges and assumed load profiles.

We also agree that policy costs should be based on a fully obligated basis as this best reflects most suppliers in the market, particularly legacy suppliers involved in SVTs and default contracts.

Efficient operating costs

It would be unrealistic to expect suppliers to be efficient in each segment of the operating costs bundle. Naturally costs will vary from supplier to supplier for a variety of reasons. For example, a supplier who is new to the market will have higher acquisition costs and higher costs associated with system set-up than an established supplier, but they may exhibit lower costs from legacy issues. Ofgem's assessment of operating costs must recognise this and allow accordingly. Similarly, the assessment of operating costs can never be an exact science because no two suppliers are the same, therefore there should be sufficient headroom to absorb any estimate error arising from the operating cost modelling approach.

A fully functioning retail market should exhibit sufficient competitive pressure to drive down operating costs and that is probably true for newer market entrants. Hence, legacy suppliers with marginally higher operating costs should be the target the review of costs as opposed to challenger suppliers.

Green Tariffs

We support having a derogation framework whereby a truly green product can operate outside of the cap. The market for such products is niche and this is an area where consumers actively choose green products according to their personal values, it is not an obvious area where price protection is required. However, green products may inadvertently be captured by the default tariff definition where a supplier has rolled a consumer onto a

further fixed term green tariff at the end of their initial contract period. This is because the green tariff is a similar product to the original one and in line with the customer's preference.

The scoring criteria for the derogation process should be clear and robust and disallow simple renewable electricity products, which are supported by existing policy frameworks CfD, FiT etc. and only allow products to be derogated which offer true additionality such as investment in environmental schemes outside of those areas financed by existing policy. Green gas products are a good example of this. The production of green gas is low currently and properly certified green gas certificates attract a significant cost premium due to scarcity and other external influences. This is one specific area that Ofgem should address in their derogation framework.

The derogation process itself should be expedient and much quicker to gain approval than the existing licence derogation timeline, otherwise offers to consumers could be delayed.

End of response.

Contact Details

I trust you will find this response helpful and if you have any questions please get in touch via email phil.broom@engie.com or call me on 0113 306 2104 or 07733 322 460.

Yours Sincerely,

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