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By email to: retailpriceregulation@ofgem.gov.uk

NON-COMMERCIALLY CONFIDENTIAL VERSION - AMENDED AUGUST 2018

Dear Anna

POLICY CONSULTATION ON THE DEFAULT TARIFF CAP

First Utility welcomes the opportunity to respond to this consultation.

As one of the largest challenger suppliers, we strongly support competition as the means to drive efficiency and innovation for British consumers.

Nevertheless, we recognise that not all consumers have felt the benefits of competition. We will therefore work constructively with Government and Ofgem to deliver this temporary price cap, and welcome this opportunity to comment on your proposals.

In summary:

- **A "bottom up" review of costs should be used to set the Cap.** Any competitive benchmark, even with / especially with adjustments, is unlikely to accurately apportion costs.

- **If a competitive benchmark must be used, Ofgem should build a 2017 benchmark using "steady state" suppliers with a high % of engaged customers.** We do not support artificially adjusting the prices of suppliers who are otherwise unreflective of the market. This process requires a high (and potentially erroneous) degree of judgement, as Ofgem has itself acknowledged.

- **Given the inherent uncertainty in setting a Cap covering 60% of the market, we encourage Ofgem to apportion a generous headroom allowance as an "uncertainty uplift".** This allowance could be lowered over time as Ofgem monitors market conditions and gains a clearer sense of the impact of this mass-market intervention. By contrast, little or no headroom gives Ofgem no room for manoeuvre (excepting a wholesale overhaul of the Cap) if the Cap's initial price proves too tight.

- **First Utility has serious concerns about the proposed treatment of Standard Credit ("SC") costs under the Cap.** Such costs are significant (£114 according to Ofgem analysis). With a proposed £22 uplift under the Cap, there will be no incentive

for suppliers to compete for these disengaged customers. We are also concerned that reverse-engineering 2017 or 2015 tariff data to re-socialise SC costs across Direct Debit ("DD") prices will be both difficult and unrepresentative of the allocation process (or competitive market) at the time.

- **We broadly support Ofgem's proposed approach to updating the Cap over-time**, albeit with the need to also include missing costs such as Unidentified Gas, Faster Switching and mandatory Half Hourly Settlement. We support the Smart Meter Net Cost Change Index, but with important qualifications; these are included at the end of this document.

Setting the cap

Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

Of the three options under consideration[1], First Utility's preference remains for a "bottom up" review of costs. Given this Cap will cover 12 million customers (treble the number on the PPM Cap) it is no longer appropriate for Ofgem to use a 2015 based proxy for efficient costs.

Of the two competitive benchmarks, an updated competitive benchmark is the least worst option.

The data would be more recent than under an adjusted version of the PPM Cap (2017 vs 2015), which is critical given each baseline will be indexed to reach the first cap period. Indexing 2015 data risks creating a first cap period which is unrepresentative of the costs suppliers currently face, from smart costs through to wholesale prices (above all, a sharpening of imbalance prices).

In addition, an updated competitive benchmark allows Ofgem to select "steady state" challenger suppliers with representative operating and policy costs. Given the state of the market at the time, the CMA had little choice but to use below-scale suppliers and then make adjustments to their prices to make these more representative of the wider market. In today's market of over 70 suppliers, 15 above the policy cost threshold, Ofgem can instead select from a much wider pool of scale challengers. This is important because Ofgem has itself acknowledged that selecting unrepresentative suppliers and then artificially adjusting tariff data is prone to error, with the consultation proposing that the CMA's 2015 assumptions around Ovo and First Utility's operating costs could need updating or overhauling.

[1] Namely (i) an adjusted version of the current PPM Cap using Ovo and First Utility data from 2015; (ii) a new competitive benchmark using 2017 tariff data from potentially a wider set of competitors and (iii) a bottom up review of costs)

It is therefore perplexing that, in setting a new competitive benchmark for 2017, Ofgem is ready to select unrepresentative suppliers and then, once again, make adjustments. Proposed adjustments around smart, operating costs and making a "normal" rate of return will be inherently uncertain. And, in terms of the latter, we note, first, that a number of new entrants are pricing significantly below even the cost of energy, suggesting wholesale prices have not been adequately factored in; and, second, that a number also have extremely poor customer service ratings which, again, could feed into an artificially low competitive benchmark.

Instead of making such significant adjustments, Ofgem should select those suppliers with over 250,000 customer accounts who also have a large % of engaged customers in their base. This is the approach already proposed by Ofgem under the Bottom Up Review of Costs model, with the consultation paper excluding below threshold suppliers because *"Small companies may have a significantly different cost base to suppliers that are at scale – particularly if they are growing rapidly. For this reason, we have only sought information companies with over 250,000 customer accounts as of April 2017 (with dual fuel accounts counting twice) – a total of 15 suppliers. We consider that including smaller suppliers in our benchmarking would risk that the cap could be set at a level that would not reflect the per customer operating costs of a company at scale, in steady state."*

We would add the further caveat that Ofgem should exclude suppliers which have had 250k supply points for less than two years, as these newly obligated suppliers will not have had the opportunity to understand their costs (e.g. obligation threshold costs; inheriting Home Move customers; bad debt) and price appropriately.

Question 2: What are you views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

We agree that, under any model and given the level of assumption and uncertainty, Ofgem should include headroom, set as a % of all costs except network.

Significant headroom is needed as an "uncertainty uplift", to guard against any errors in Ofgem's calculations which could result in an efficient supplier being unable to recover costs.

A relatively generous headroom allowance could also be adjusted over subsequent cap periods, once Ofgem had a clearer sense of the impact of this mass-market intervention.

By contrast, little or no headroom gives Ofgem no room for manoeuvre (excepting a wholesale overhaul of the Cap) if the Cap's initial price proves too tight.

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

No, we have significant concerns about the proposed treatment of Standard Credit (SC).

Our understanding is that Ofgem will seek to reallocate some of the costs currently assigned to SC customers (e.g. bad debt, and additional contact centre costs) onto Direct Debit (DD) customers.

In the case of the two competitive benchmarks, this would require Ofgem artificially adjusting historical DD prices upwards when setting the benchmark, to reflect this different allocation

The uplift for SC customers proposed by Ofgem is c. £22 on top of the (slightly higher) DD Cap.

We believe this low uplift would carry across into the Fixed Market, given our Standard Licence Conditions in this area and our desire to treat different customer groups the same when applying credits or discounts. This would be deeply problematic.

As shared in our February submission, First Utility estimates that our additional cost to serve for SC customers is £redacted including bad debt (redacted per fuel excluding bad debt), excluding additional working capital.

While (as noted below) we recognise that our SC customer base is likely to be more risky / expensive than the market as a whole, **limiting the price differential to just £22 would risk severely reducing competition in the market for SC customers.** Larger suppliers would be unable to recover the additional costs of serving these customers but also unable to socialise the bulk of these costs and still successfully compete in the Fixed / DD market against suppliers with little or no SC customers.

We urge Ofgem to consider a more cost reflective approach when setting this uplift and avoid building in such a material distortion.

We are also concerned that reverse-engineering 2017 or 2015 tariff data to remove the socialisation Ofgem presumes already happens, and then resocialising costs using this new method, will be extremely difficult and unrepresentative of the cost allocation process (including with reference to the competitive market) in operation at the time.

More broadly speaking, First Utility sets tariff prices based on a balance of of potential acquisition / retention volumes vs a gross margin aspiration, which means our ability to

socialise SC costs - and indeed, our inability to fully socialise these or other costs - varies at different points in time related to the competitive environment.

Re-engineering historical DD tariffs to re-allocate SC costs risks creating a competitive benchmark divorced from competition, which is why we continue to argue a "bottom up" review of costs as the most appropriate model for the Cap.

In terms of modelling the genuine cost to serve SC customers, we recognise FUL is likely to have higher than average costs, given:
(i) FUL is primarily an online / DD supplier.

(ii) Higher customer churn makes it harder to collect debt for challengers vs the Big Six (recovery rates on lost customers are far lower than live customers)

(iii) First Utility bills monthly, which means we bill three times as often as the typical Big Six supplier.

We would propose that Ofgem sets any SC uplift based on the £114 figure quoted in the consultation, or the range of £88 to £158 proposed by the CMA.

Without an appropriate uplift, suppliers will not compete for SC customers, leaving these customers trapped on their legacy supplier's SVT: the opposite of Ofgem's goal as it seeks to reform the market.

Updating the cap

Question 4: Do you agree with our proposals for how we will use cost data to update the cap?

We broadly support Ofgem's proposed approach to updating the Cap, and agree that updating it every six months seems appropropriate.

We agree CIPH (inflation plus housing cost) is the right index for updating operating costs.

For indexing policy costs, we welcome the fact Ofgem will use forward-looking scheme administration data and charging statements rather than OBR estimates as under the current PPM Cap. However, given that CfD FITs and Capacity Market are charged on gross demand, the indexing model also needs to take into account distribution and transmission losses. These are already pulled together for the network charges calculations for the PPM model.

Costs must also consider transmission and distribution losses during times of domestic grid usage: using the average annual losses rather than over 4-7pm for TNUoS and Capacity Market will understate the cost.

For indexing smart costs, we agree a specific "Smart Meter Net Cost Change" index seems appropriate, but have a number of specific observations and concerns. Please see our detailed response at the end of this document.

For indexing wholesale costs, we support using the CMA's 6-2-12 model (6 month observation; 2 month lag and then 12 month forward view). However, we note that, since the SVT applies to domestic customers, using base and peak products only seems to ignore the fact that peak delivers only Monday-Friday, and domestic demand is at least as high at weekends; the 6-2-12 model therefore needs to also include shaping products.

Likewise, using the industry average share of Capacity Market and TNUoS peak consumption will understate peak volume and therefore the costs for domestic consumers.

We note that some respondents have raised concerns that the imposition of the CMA's model could impact liquidity. We do not think this is the case, but only because the suppliers with the highest proportion of capped customers are also significantly vertically integrated and are more likely to reflect the cap in their internal transfer pricing between generation and demand, rather than trading through the market.

Related to this we note that, while Ofgem's Secure and Promote regulation resulted in an improvement in GB liquidity, the overall level of liquidity in the wholesale market in GB remains poor compared to equivalent European power markets.

In terms of additional costs, Unidentified Gas, Faster Switching (including DCC charges and code fees) and mandatory Half Hourly Settlement must be considered under the Cap, given all of these are being, or will be, incurred over the Cap period.

Faster Switching is already included under DCC charging statements, although this will not include all additional supplier costs.

Unidentified Gas historical data is available from Xoserve via UK Link. It's calculated as a % of credited volume here so would need to be converted to a % of consumed volume. UIG over domestic categories only should be used. The cost of buying this additional volume needs to be factored in to the model, we would propose an average of daily UIG since 1 June 2017 given the volatility (c.-7% to 18% for industry) and limited data.

Mandatory half-hourly settlement is as yet unscoped; we suggest Ofgem considers the uncertainty (both in terms of timing and cost) when setting the headroom allowance

Likewise, potential calls on the Supplier of Last Resort Levy should form part of Ofgem's consideration when setting the headroom allowance.

Potential exemptions from the cap

Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?
There are a number of suppliers who claim green electricity through the purchase of REGOs without making any further contributions to the overall reduction of carbon.

We broadly support Ofgem's approach here. There are a number of suppliers who claim green electricity through the purchase of REGOs without making any further contributions to the overall reduction of carbon. The commitment to additionality is also mixed at best, with definitions unhelpfully wide ranging.

We agree there should be no blanket exemption for green tariffs, and that the bar for derogation should be set sufficiently high. SVT prices should be price capped unless the tariff incurs additional costs and genuinely supports the development of green energy.

Conditions for effective competition

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

A Price Cap will likely dampen engagement, leading to the risk that switching declines and therefore that the Cap becomes an everlasting feature of the market.

We therefore propose Ofgem focuses on inputs rather than outputs when setting the conditions for effective competition, such as progress on the faster switching programme or the progression of the smart meter rollout.

We would also suggest Ofgem specifically creates metrics to measure the effect of the Cap itself on competition, and respond with proposals to either remove the Cap or reform wider policy as required.

This could include Ofgem monitoring on an annual base:

- % Increase / decrease of customers on SVT vs Fixed Tariffs
- Average price of Fixed Deals (and % increase / decrease)

- Number / % of customers on SVT vs Fixed, and movements between/into these defaults per capped supplier, linked to an assessment of supplier/ customer communications

- % of customers switching within and between suppliers, including to below ECO and WHD threshold suppliers, with plans to remove these thresholds if this portion of the market grows dramatically

- % of vulnerable customers on SVT vs Fixed Deals and average prices paid. We note that engaged vulnerable customers could see their cheap fixed tariffs removed and be unable to switch without losing their Warm Home Discount

- % of Customers on Standard Credit vs Direct Debit

- Customer service levels

- Wholesale market liquidity

Given the proposal to create a new index for Smart Costs, we now answer in detail the questions posed in Appendix 10:

Specific Comments on Smart
Detailed Response to Appendix

Question A10.1: Do you agree with our minded-to position to include a separate smart metering index to reflect the changes in costs from the baseline (2017) to the initial year of the cap (2018)?

We agree with the need to create a specific smart meter net change index

However, indexing the initial baseline will not be a simple matter. We do not agree with your conclusion that smart metering has been fully incorporated into business-as-usual activities. There are significant transitional, structural and cost differences between SMETS1 smart metering, and the operating model for SMETS2 and, DCC-enrolled and adopted, SMETS1 smart meters.

Below we also highlight additional areas of cost, including material non-efficiency costs, that also need inclusion.

Question A10.2: Do you agree with our minded-to position to include an adjustment to the Reference Price (SMRPA) in the event a material difference is identified between the smart metering net costs of the suppliers making up the reference price and the model?

Yes, we agree that tariffs selected will need adjusting to reflect the net costs facing obligated suppliers.

Making such adjustments will require a significant level of judgement (especially should Ofgem adjust the current CCMA PPM Cap, which relies on 2015 data), which is why we continue to argue for a “Bottom Up” review of costs vs either of the two competitive benchmark options.

Question A10.3: Do you agree with our initial assessment for the Smart Metering Net Cost Change, including our inclusion and assessment of the costs of SEGB, SMICoP and DCC charges?

We agree these costs should be passed-through.

However, we do seek clarification regarding how Explicit Charges are calculated for the DCC. Para 1.49 of Appendix 10 says "*We have used the DCC charging statement assumption of Explicit Charges and have divided by the total number of electricity and gas metering points to establish a per customer per fuel value for Explicit Charges".* Our understanding is that these explicit charges are incurred transactionally rather than per meter point, which suggests that to derive a cost (to apportion over customer per fuel) Ofgem are modelling some form of transactional model for a typical / average supplier. Please could this be clarified.

Question A10.4 Do you agree with the judgements we have set out regarding smart costs; in particular our choice of data and model, identification of relevant costs and benefits, and approach to variation?

As part of adjusting the BEIS SMIP CBA, we would urge Ofgem to use data gathered as part of the National Audit Office's (NAO) ongoing Value for Money assessment.

In terms of additional costs, we disagree with Ofgem’s proposal to ignore “non-efficiency” factors such as stage of rollout when calculating net costs under the Index. For example:

- Cost erosion over time - we disagree installation costs will consistently fall over time; after an initial reduction, there will likely be a law of diminishing returns in efficiency improvements with costs finally escalating as the customer density degrades, travel times extend and associated number of installs per day per engineer declines.

- Difficult-to-reach customers - We note that industry solutions for c. 30% of customers (e.g. rural; tower block) are planned, but until available and proven, risk having to be left to the end of the rollout and could be disportionately more costly.

Question A10.5 Do you consider that there will be any significant change in the costs or benefits of smart metering from 2017 onwards? For example, installation costs or asset costs. Please provide evidence to support your view.

Yes, we have identified a number of areas where costs are likely to increase:

Rollout profile

- We would question the reliability of applying the "up to date industry average rollout profile derived from supplier reporting to Ofgem", given the current SMETS1 end date and SMETS2 readiness challenges, and the increasing refusal of Customers to accept SMETS1 meters until these are fully interoperable (which is separate and potentially expensive operation under the DCC's / BEIS's Adoption and Enrolment proposals.)

Installation Costs

- Subject to an ongoing BEIS consultation, suppliers could incur the additional cost of procuring and installing additional equipment to extend the range of the HAN (2.4GHz Zigbee Repeaters alongside existing 2.4GHz SMETS2 Smart Metering equipment). We note a recent decision (since submission of this paper) by BEIS to suspend this activity.

- After-hours installations at premium rates will be required to meet consumer expectations / complete the rollout by the end of 2020, leading to increased costs.

Asset costs

- There is an issue with radio frequency noise interference being generated by a range of SMETS2 electricity meters, made by different meter manufacturers, which is in conflict with the acceptable noise level that can be tolerated by the Arqiva Communications Hub without impacting their contracted Wide Area Network (WAN) coverage target. To resolve this issue, either:

    - the minimum acceptable noise level has to rise, meaning poorer WAN coverage, which may necessitate more CSP WAN infrastructure costs to offset the loss in coverage; or

- an increased minority of customer will need to be serviced on the increasingly expensive-to-service legacy arrangements; or

- SMETS2 electricity meters will need to be re-designed, re-tested and recertified leading to significant delays and additional costs to smart metering deployment. All of these options pose more cost

- Electronic component shortage - we are already aware of extending asset lead-times due to global component supply and demand, which could increase meter costs, and throttle overall installation productivity due to lack of availability. This will be exacerbated with the entire smart metering rollout effort, across all suppliers, focussed on a narrowing timescale. Currently, this issue is being masked, by the transitional hiatus from SMETS1 to SMETS2, caused by the protracted delivery and challenging fragility of a scalable SMETS2 solution. Once the revisions to the SMETS1 End Date cease, and the staged SMETS2 deployment begins, then increases in supply chain costs will materialise. Ofgem should engage the Utility Networks division of the Energy & Utilities Alliance (EUA) to obtain cost driver input from Meter Manufacturers in order to appropriately forecast and value asset costs for this eventuality.

<u>Rental agreement termination costs</u>

- The Smart Index should include rental costs / termination costs.

- This should include the treatment of non-enrolled SMETS1 meters. Government is consulting on whether suppliers SMETS1 meters not enrolled in the DCC should be replaced with a SMETS2 meter before the 2020 deadline. As well as significantly increasing installation costs, this proposal would generate significant meter rental termination costs for non-enrolled, relatively new SMETS1 meters.

<u>Enrolment and Adoption of SMETS1 meters operating in Prepayment mode</u>

- SMETS1 prepayment customers that are subject to enrolment and adoption will require the creation, issue and postage of new, replacement payment cards, as part of the transition and migration of their meters to be operated under the DCC arrangements. There will also be increased customer contact, and the need for emergency call outs to attend to unintended self-disconnection where Customer vends / top-ups have not been successful. These costs on suppliers have been borne out of a failure by the Enrolment and Adoption project to deliver a suitable transition solution.

<u>Increased enquiries and servicing costs for third-party Consumer Access Devices (**CAD**)</u>

- Suppliers are required to establish and maintain a HAN interface between the smart meter and a Customer's CAD (SLC 49.4) free of charge to the Customer. There are costs to be borne by a Supplier as a result of these third-party CAD service providers, which will increase as smart metering and interoperability of the CAD devices with smart meter models broadens.

Timing on Use of actuals

- We agree with the proposed use of actuals, and welcome the recognition (2.46) that 2018 is a crucial point in the rollout, with transitions to new technology and operating models.

- Ofgem must publish openly and transparently - and open for consultation - the full set of cost assumptions underpinning the initial baseline. There is otherwise a risk that an under-representative forecast of imminent costs is baked into the price cap, putting efficient supplier margins at risk, despite the proposed 6 monthly indexing of the baseline. We would like to see this time-cost-shock uncertainty being sized and a mitigation allowance applied to the proposed 'headroom'.

Question A10.6 Please comment on the proposed methodology for calculating the efficient cost of rolling out a smart meter, indicating a preference with supporting rationale, on the efficiency option (average cost approach, pure frontier cost approach, lower quartile approach).

We have no comments here.

Question A10.7: Do you agree with our approach to updating smart costs? In particular, our intention to specifically index smart cost changes, based on net cost analysis (option 3), and whether any other approaches would be preferable to option 3.

We agree that option 3 is the best option. However, Ofgem needs to include a significant uplift for uncertainty, given unforecasted developments post-summer 2018 are likely to have a significant bearing on outturn and costs. As suggested earlier, this could be mitigated through a 'headroom' allowance.

Yours sincerely

[not signed]

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