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Default Tariff Cap – Statutory Consultation

Investor call

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Summary of proposals

- Bottom-up cost assessment approach used to set an efficient direct debit baseline cost benchmark for 2017…
- …standard credit cost benchmark includes an allowance for additional costs to serve
- Profit allowance of 1.9% before interest and tax
- £36 in baseline for uncertainty and variation in efficient costs (excluding VAT impact), including specific headroom allowance set at 1.45% (£10 in the direct debit baseline)
- Cap in place by year-end, with initial level to be set in November; we currently estimate a cap level of £1,136 for direct debit customers, and £1,219 for standard credit customers
- Cap will be updated every six months in April and October, with announcements in February and April (first cap period is shorter to align updating approach)
- Clear methodology for updating the cap
- Cap is temporary; in force until end 2020, but with a possibility of extension to end 2023 at the latest
- Warm Home Discount customers currently protected by the prepayment meter safeguard tariff to be protected by the direct debit default tariff cap
- In 2017, 96% of SVT customers would have paid less under the proposed cap, reducing their bills by £1.3bn
- Savings in first cap period will depend on supplier pricing at that time, but we currently estimate >11m households on default deals will see reduced bills – a customer with typical consumption could save around £75

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Summary of the Act

- Parliament passed the Domestic Gas and Electricity (”Tariff Cap”) Act (the Act) on 19 July 2018
- The Act requires Ofgem to introduce a temporary cap on standard variable and default fixed term tariffs as soon as reasonably practicable; objective is to protect customers on default tariffs
- In designing the cap, Ofgem has to have regard to
  - The need to create incentives for holders of supply licences to improve their efficiency
  - The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts
  - The need to maintain incentives for domestic customers to switch to different domestic supply contracts
  - The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence
- Ofgem can exempt some customers from the default tariff cap
  - Will not apply to customers on the prepayment meter safeguard tariff
  - May not apply to any customers who benefit from a cap because they appear to be to be vulnerable by reason of their financial or other circumstances
  - May not apply to SVTs chosen by customers, if Ofgem considers that they provide additional support to renewable energy
- Cap in force until end 2020, but with a possibility of extension
  - Ofgem to review by 31/8/2020 whether the conditions are in place for effective competition, with recommendation to Secretary of State on whether the cap should be extended or not
  - Extensions would be for one year, with further reviews in 2021, and if required, 2022
  - Cap ceases to have effect at end 2023 at the latest

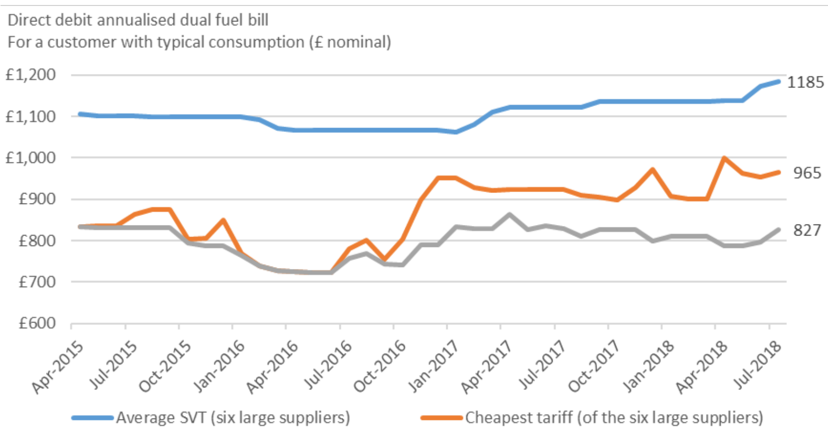
What is the default tariff cap?

- The cap places a restriction on the amount suppliers can charge their customers on SVT and default tariffs for a given level of consumption
- The maximum amount in £ (pounds) depends on
  - Consumption – the cap is set at both zero and typical consumption, in effect setting a maximum standing charge and maximum charge for each unit of energy that customers consume
  - Location – network charges differ across the 14 regions, and in each, the cap is set to reflect the appropriate charges
  - Payment method – separate caps for direct debit customers, and those paying by standard credit
  - Meter type – separate caps for multi-rate meters, such as economy 7
- Initial level of the cap to be set in November 2018, and updated in February 2019 to align with timing of prepayment meter safeguard tariff
- Subsequent updates will be six monthly, and aligned with timing of prepayment meter safeguard tariff updates
- At inception >11m households will see bills reduce because of the cap
- Unless otherwise stated, we refer to a single cap level based on the amount a dual-fuel customer with a single rate meter, paying by direct debit, and consuming a typical amount of energy, would pay, using a national average network charge

Why a tariff cap is needed

- The domestic retail energy market works well for customers who shop around…
- …but not for those who remain on their supplier's default tariff, and who are paying more than they should
- Excluding prepayment meters, >50% of household customers are on SVT/default tariffs…
- …the largest suppliers have 40%-80% of their customers on SVT/default tariffs
- Average direct debit price of Six Large Energy Firms (SLEF) SVT was £1,185 in July 2018…
- …differential vs. cheapest SLEF fixed-term tariff was £220 in June 2018, and £358 vs. cheapest tariff in the market

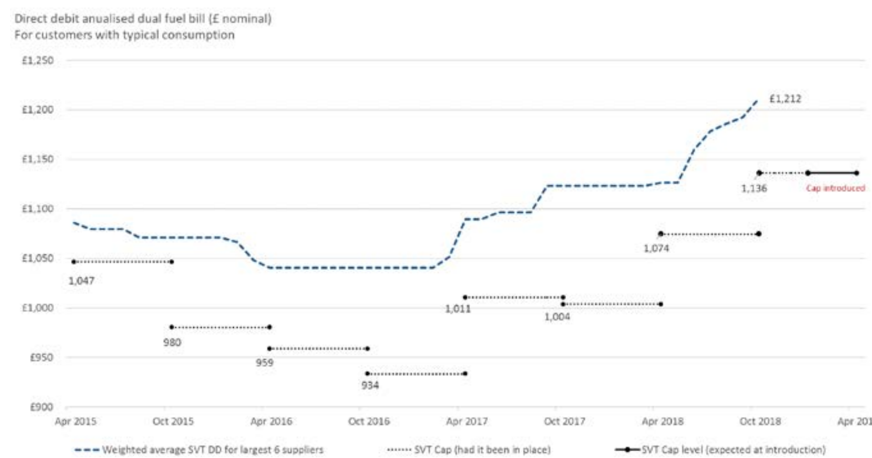
SVT prices offered by the six largest suppliers (2015 to present)



Notes: £ annualised bill for a direct debit customer with typical consumption

Source: Energylinx (Until May 2017) & Energy helpline (June 2017 onwards)

SVT prices for six largest suppliers, and cap levels (2015 to 2019)



Source: Ofgem

How we will set the cap – 2017 baseline

- 2017 baseline comprising benchmark for efficient costs based on a bottom up cost assessment, and an additional allowance for headroom
- Efficient cost benchmark set at £996, comprising:
  - Wholesale costs
    - Direct fuel allowance of £325, with methodology/observation period matching PPM cap
    - Additional allowance for shaping, forecast error, imbalance, and transaction costs (6.7% electricity/4.6% gas)
    - 1% additional uncertainty allowance for volatility and risk
    - Uplift of 0.96% to allow for unidentified gas, and an uplift in each region to reflect appropriate electricity losses
    - Capacity payment costs passed through
  - Network charges – in line with the CMA methodology applied in the existing safeguard tariff, based on published network charges with assumptions about demand and losses to estimate the charges incurred in each region
  - Environmental and social obligation costs – data published by administrators of the different schemes to calculate the cost per customer and per MWh in the base period
  - Operating costs – £169 based on lower quartile of the ten large and medium suppliers, with £5 efficiency factor
  - Payment method - £21 included in direct debit (DD) benchmark, £91 included in standard credit (SC) benchmark
  - EBIT margin – 1.9% for a supplier that does not use a third party intermediary to manage wholesale costs, equally applied to electricity and gas
- 1.45% (£10) headroom allowance applied costs ex network costs, uncertainties included in efficient costs
- Nil consumption baseline set in line with 2017 market prices at £166
- TDCV baseline of £1,007 for DD consumers, £1,082 for SC consumers (3,100kWh electricity, 12,000kWh gas)

How we will update the cap

- We need to update the cap to ensure
  - That the cap tracks changes in efficient costs over time, allowing efficient suppliers to finance their activities
  - That the cap does not create unintended incentives for suppliers that are detrimental for consumers
  - We meet the requirement in the Act to review the level of the cap at least every six months
- When we will update the cap
  - Every six months on 1 April and 1 October, with the updated cap level announced two months before it comes into force, although first and last cap periods will be shorter
- How we will update the cap
  - Wholesale costs – direct fuel cost allowance for forthcoming period calculated, based on forward energy contracts, with additional allowances applied as a fixed percentage of that allowance; Capacity Market costs updated using latest data on scheme costs
  - Network charges – allowance for each period calculated directly using network charging statements
  - Environmental and social obligations – recalculated using a combination of scheme data, OBR forecasts, and information on the expected demand base across which costs are recovered
  - Operating costs – operating cost component in 2017 baseline indexed with reference to CPIH, profit recalculated at 1.9% EBIT margin
  - Smart meters – uplift in first two cap periods to reflect the expected impact of the smart meter rollout on net costs, but reviewed before updating cap in October 2019
  - Payment uplift – partly set as fixed % of total bill (excluding headroom), partly indexed with reference to CPIH
  - Headroom - fixed as % of costs excluding network costs
- No error correction mechanism, nor intention for a formal review – licence modification powers can be used
- Initial single rate, dual fuel cap estimated at £1,136 (DD), £1,219 (SC), with initial cap level confirmed in November

2017 DD default cap, and 2019 comparator (£)

Cost component	Electricity single rate	Gas single rate	Dual fuel (implied)	January 2019 cap
Wholesale	170	197	367	444
Policy costs	97	19	117	137
Network	135	122	258	258
Operating costs	79	90	169	189
Payment method	11	9	21	23
Normal profit	9	8	18	20
VAT	25	22	47	54
Benchmark	**527**	**469**	**996**	**1,124**
Headroom	5	5	10	12
Cap level	**533**	**474**	**1,007**	**1,136**

Source: Ofgem (VAT is applied to headroom)

Impact of the cap

- Considering the requirements of the Act, namely the objective to protect consumers and the other matters to which we must have regard, we have assessed the potential impacts of the cap as they would have been in 2017, had the cap been in place
- We have used a range of different analyses and drawn on the evidence gathered through the consultation to consider the potential impact of the cap
  - This includes some hypothetical, scenario based analysis to help us understand potential levers that suppliers may have to respond to the cap
- Key findings of our analysis
  - Protecting customers – in 2017, 96% of default tariff customers would have seen reduced bills, with an average direct debit customer with typical consumption paying £94 less
  - Wider types of protection – we expect that any reduction in engagement during the life of the cap would reverse when it is lifted, and we do not consider that the cap level requires suppliers to reduce service quality
  - Incentives to improve efficiency – benchmark encourages suppliers to reduce costs, as suppliers' revenue would have reduced by £1.3bn
  - Incentives for customers to switch – cheapest fixed tariff in the market would have been around £150 lower than the SVT cap, providing strong incentives to switch, although switching rates would have been lower
  - Incentives to compete – a range of different sized suppliers would have been able to compete for customers, and be profitable
  - Enabling suppliers to finance their activities - the cap is above the efficient benchmark and includes an EBIT allowance of 1.9%, so efficient suppliers will be able to finance the cost of default tariffs

Assessing whether to extend the cap

- The default tariff cap is a temporary measure and is not intended to replace competition in the market
  - It is intended to protect disengaged consumers until the right market framework is in place for competition to be effective for these consumers
- We are required by the Act to carry out a review of the conditions for effective competition in the market after the cap has been removed
  - Requirement to publish this review on or before 31/8/20, including a recommendation on whether the cap should be extended or not
  - The Secretary of State makes the decision whether to extend the cap or not
  - If the cap is not removed, we would carry out a further review in 2021, and if required, in 2022
  - The cap cannot be extended beyond end 2023
- We will continue to develop our approach and engage with stakeholders in 2019 on what we might consider when assessing whether conditions are in place for effective competition in the domestic energy market
  - We will develop a framework that is based on a broad set of market indicators that allows for a wide view of the market, and one which is both evidence based and transparent
- Ofgem has a programme of work operating alongside the price cap, aiming to reform the market to enable consumers to engage more easily and allow more innovation and expansion of new business models
  - This will help the transition from the price cap into a market where competition delivers better outcomes for all consumers

Exemptions from the cap

- The Act allows Ofgem to provide exemptions from the cap
  - For customers that receive protection for other tariff caps in virtue of being deemed to be vulnerable due to their financial or other circumstances
  - For SVTs chosen by customers, if the tariff appears to Ofgem to provide support for renewable energy
- Protection for vulnerable customers
  - Prepayment meter safeguard tariff will remain in place
  - Customers receiving the Warm Home Discount currently receive price protection via the existing prepayment meter safeguard tariff
  - When we introduce the default cap, we propose to transfer Warm Home Discount customers onto the default cap for direct debit customers
- Derogation from the cap for tariffs that provide support for renewables; supplier needs to demonstrate that its tariff:
  - Provides support for renewables, materially beyond support provided through subsidies, obligations or other mandatory mechanisms
  - Involves materially higher costs
  - Can be clearly defined and robustly monitored
- Customers with prepayment meters
  - Conventional or SMETS1 prepayment meter customers are exempt, and covered by the existing safeguard tariff
  - We propose applying the direct debit default cap to SMETS2 prepayment customers
- Suppliers are required to reduce default fixed tariffs if the cap falls below the default fixed price offer

Next steps

- The statutory consultation will run through to 8 October
- We are inviting views on our minded to policy and methodology, draft impact assessment, proposed licence modifications (including annexed models) and draft notice of baseline values and initial values of CPIH index
- Disclosure room which will include the information and underlying data for the smart metering costs model and the wholesale allowance models in operation from 17 September to 3 October
- Intention to publish our decision with the final versions of the impact assessment, licence modifications, and notice of baseline values and initial values of CPIH index in November
- Ofgem is working to have the cap in place at the end of the year

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for energy consumers

Our core purpose is to ensure that all consumers can get good value and service from the energy market. In support of this we favour market solutions where pratical, incentive regulation for monopolies and an approach that seeks to enable innovation and beneficial change whilst protecting consumers.

We will ensure that Ofgem will operate as an efficient organisation, driven by skilled and empowered staff, that will act quickly, predictably and effectively in the consumer interest, based on independent and transparent insight into consumers' experiences and the operation of energy systems and markets.

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