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# Executive Summary

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1. Centrica welcomes the opportunity to respond to Ofgem's minded-to proposals in its statutory consultation on the Default Tariff Cap, given the significance of these proposals for competition and energy consumers. In this Executive Summary, which forms part of our response, we describe our headline views, including key concerns and alternative proposals to assist in the construction of a cap that will best attain the duties and obligations in the Tariff Cap Act. Our additional comprehensive response to Ofgem's statutory consultation is included in the Appendices to this document[1], two Disclosure Room reports from Frontier Economics, two legal annexes from Towerhouse LLP, and two legal opinions from external Counsel.

2. Centrica remains concerned that a price cap on default tariffs will have adverse consequences for consumers both in the short and longer term. We believe that any perceived benefits of a short-term price reduction will be outweighed by the adverse impacts on incentives to compete on price and customer service and invest in innovation. Instead of direct price regulation, we have proposed an alternative package of pro-competitive actions and measures[2] designed to reform the UK energy market and benefit consumers on an enduring basis. These actions and measures focus on engaging customers, improving competition, and more fairly distributing social and environmental costs.

3. We have made good progress with the actions that we proposed. As part of our ongoing efforts to engage energy customers, we have replaced our Standard Variable Tariff (SVT) with our fixed term Temporary Tariff (TT) and over a million customers have signed up to our Rewards programme designed to recognise loyal customers. The Government has also made some progress towards eliminating existing distortions in competition in more fairly distributing social and environmental costs, by reducing future thresholds for supplier participation in the Warm Home Discount and Energy Company Obligation schemes. Competition has also continued to intensify without a price cap. There are now over 70 domestic suppliers, switching rates continue to rise and the market share of smaller and medium sized suppliers is now over 25%, all indicators of a competitive market. Retail price regulation in such market conditions clearly poses a risk to the intensity of competition and interests of energy consumers.

4. We recognise, however, that Parliament has intervened to introduce a price cap. We accordingly have, throughout this process, advanced proposals and evidence to support the construction of a cap that seek to: (a) reflect the balance the Act requires between short-term reductions in prices and preserving incentives to compete and innovate; and (b) to ensure the timely rollout of smart meters, in order to deliver the benefits of technological innovation for consumers in the long term.

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[1] The numbering of which aligns with Ofgem's in the statutory consultation

[2] https://www.centrica.com/news/centrica-sets-out-proposals-deliver-fairer-and-sustainable-energy-deal-customers

5. There are some aspects of Ofgem's statutory consultation that we welcome. Ofgem's choice of a "bottom up" cost allocation methodology is in principle a transparent and reasonable basis on which to construct a price cap, if applied correctly. We also welcome the fact that Ofgem has chosen to undertake the benchmarking analysis for operational costs on a dual fuel basis, given the inaccuracies that may result from doing so on a single fuel basis. We also agree with the principle of excluding from the sample firms with atypical customer bases, which would not be a reasonable basis upon which to estimate the notional efficient operator benchmark.

6. However, we have concerns that some aspects of Ofgem's proposals would not meet the various duties under s.1(6) and s.7(2) of the Tariff Cap Act 2018, and specifically those relating to the future of the smart meter programme, future competition and the ability of efficient suppliers to finance their activities.

7. In particular, we are concerned that Ofgem's current approach will likely inhibit investment in the rollout of smart meters by energy suppliers and therefore defer the benefits of this important technology upgrade to consumers. This is a significant cause for concern given: (a) the role that the smart meter rollout enjoys in the hierarchy of the Act as one of the criteria for the removal of the cap; and (b) the fact that the CMA and Parliament both recognise smart meters to be a key driver of competition in the retail market.

8. Equally importantly, Ofgem's current approach does not have sufficient regard to the need to ensure that: (a) efficient suppliers can finance their services to customers; and (b) the potential implications for these customers if the costs of these services are not appropriately provided for in the cap.

9. Consequently, we believe that consumers will be better protected if some important changes are made to the proposals Ofgem has put forward. Specifically:

   a) **The smart meter costs allowance** will not be sufficient to fund Centrica's smart rollout plans for 2019 or attain the rollout profile proposed by Ofgem. As explained below and in detail in the appendix, based on the assumptions that we have drawn:
      - We consider that there will need to an uplift in smart funding of £✂ per dual fuel credit customer, and prepay smart funding will need to be revisited.
      - Absent these changes, the level of investment in the rollout of smart meters would potentially be reduced ✂

   b) **The extra costs of supplying Standard Credit (SC) customers** should be allocated equally across fuels because this reflects current market practice and there is no clear economic rationale for a differential treatment of electricity and gas customers.

   c) **The wholesale cost allowance for Q1 2019** should be realigned to the transition index Ofgem proposed in its May consultation for the following reasons:
      - Suppliers will have placed weight and acted on the signals issued by Ofgem. ✂.
      - Ofgem's new proposal (which has previously not been subject to consultation or any request for information) would therefore have a material impact on suppliers denying the recovery of costs. ✂[3].
      - The proposal would also have the effect of exacerbating the bill shock consumers will experience in Q2 2019 when an adjustment will need to be made to reflect the upwards trend in wholesale costs.

d) **There are shortfalls in bottom-up cost allowances and uncertainty headroom** that should be factored into the overall cap level to reflect the costs of serving the preferences and requirements of different types of customers and thus enable existing quality of service levels to be maintained.

e) **Ofgem should revisit its interpretation of the Act with respect to competitive headroom.** Based on Ofgem's current proposals, we anticipate that switching levels will reduce to record low levels, which we do not consider to be consistent with the intent of the Act.

10. Finally, we encourage Ofgem to publish the criteria for effective competition that will need to be met for the cap to be lifted by the end of Q1 2019 to maximise the prospects of the cap being removed at the end of 2020 in line with the objective of the Act. One of the conditions for effective competition should be the adoption of a decision by Ofgem by the end of 2019 to prohibit the use of rolling or evergreen tariffs. As we have explained to Ofgem previously, such action would make a material contribution to driving customer engagement and in turn the intensity of competition. This is a decision that Ofgem is able to adopt and it should take steps to ensure that it has a clear position on this proposal by the end of 2019.

11. The need for clear conditions for effective competition is especially compelling in light of Ofgem's own analysis which suggests that switching rates may fall by 50% or more following the introduction of the cap. We believe this is at odds with the Act's requirement for Ofgem to maintain incentives to switch, and creates a material risk that the market may be subject to price regulation beyond the target date of 2020. A clear path to the removal of the cap by the end of 2020 will therefore be critical to limit the detrimental impact of this policy intervention on competition.

12. In totality, Ofgem's approach to the treatment of the above-mentioned elements of cost under the cap raises material legal concerns in both procedural and substantive terms. The documents included within our submission contain our legal analysis, including opinions from external counsel, articulating these concerns and the reasoning underpinning them.

## *Smart meter rollout*

13. Ofgem's proposed approach will have a damaging impact on the rollout of smart meters by significantly dampening investment by suppliers in the smart meter programme.

14. The risk to the smart meter programme resulting from the price cap manifests itself most obviously in the following ways:

    a) Insufficient funding to support Ofgem's desired rollout profiles for 2019 and 2020; and

    b) The application of the default tariff cap to prepay customers.

15. In spite of our requests, Ofgem has failed to disclose the information to allow suppliers to understand precisely how the 2019 smart meter allowance has been set. However, we have been able to estimate this allowance by making a number of assumptions from publicly available data. Based on this analysis, ✂ an increase of £✂ per dual fuel customer is necessary ✂.

[3] ✂.

16. ✂.

17. To the extent that Ofgem has an alternative view of the assumptions and the forecast we have derived, we would welcome a clear exposition of Ofgem's view together with full disclosure of the reasoning and the data that underpins that position.

### *Consequences of insufficient funding of smart meter rollout*

18. In modelling the Smart Metering Net Costs Change (SMNCC), Ofgem has proposed a rollout profile of 55% for electricity and 54.3% for gas in 2019 ✂. We have been able to estimate from publicly available information that the combination of the operational costs benchmark and SMNCC is significantly lower than:

    a) What we consider is needed to achieve Ofgem's desired rollout profile ✂
    b) ✂.

19. We estimate that the overall allowance provided by Ofgem under the cap for the smart meter rollout is £43 per dual fuel customer in 2019[4]. ✂.

20. Centrica's ability to invest in the rollout of smart meters in a way consistent with the "all reasonable steps" obligation will be constrained necessarily by what it is able to afford under the above-mentioned allowance. ✂

21. ✂

22. Although Ofgem did not publish non-confidential data for comment, did not provide all the necessary data in the Disclosure Room and redacted key information from the Disclosure Room reports which our advisers were allowed to show us, we have been able to identify some key reasons why the overall smart allowance does not reflect the real costs of smart rollout. These are:

    a) Insufficient allowance in the baseline operating cost allowance;

    b) ✂;

    c) The benefits of smart meters are likely to be out of date and overstated, both in size and when they will have an effect; and

    d) Ofgem has elected not to provide for additional demand generation (engagement) costs which will clearly be necessary to offset the fall in customer engagement that Ofgem recognises will occur.

23. Ofgem has stated that it will review the progress in smart meter rollout before deciding what the SMNCC will be from October 2019. It is critical that Ofgem consults on the SMNCC and smart allowance as a whole – particularly if some or all of the concerns set out above are not addressed by Ofgem in full before the November Final Decision. Given the potential impact of an unchanged SMNCC and overall allowance on smart meter penetration rates in 2019, we would urge Ofgem to bring forward and commence this review in January 2019. Since the SMNCC review is an absolute requirement, it should not be subject to any materiality test (in the licence conditions or elsewhere) before Ofgem undertakes it.

[4] ✂

### *Impact on the rollout of Smart Prepay meters*

24. We are concerned about the unintended consequences of Ofgem's proposal for PPM customers with traditional and SMETS2[5] meters to be subject to different caps (reflecting the fact that the CMA has already introduced a cap for prepay customers on the basis of a different methodology).

25. Two caps for PPM customers will create an unnecessarily disruptive, complex and confusing customer journey, and lead to an increase in costs for some customers, both of which will adversely impact on the propensity of customers to accept a smart meter and create the risk of customer detriment.

26. Under Ofgem's proposals as things stand:

    a) The smart switching journey will need to include a tariff switch, adding complexity to the customer experience. As a consequence of this switch,✂. These factors will disincentivise the take-up of smart meters by PPM customers given that suppliers would naturally need to be fully transparent with consumers about the impact of accepting a smart meter (in line with the transparency obligations under the Informed Choices principles and the SMICoP framework).
    b) When a customer wants to switch supplier, they will need to provide the correct meter type to ensure a personal projection based on the correct cap. This will be difficult for a customer to identify and worsen their experience, which will further disincentivise customer acceptance of the smart meter.

27. Centrica has already highlighted and shared with both the CMA and Ofgem in January 2018 the limitations in the methodology used to compute the cap for PPM customers (including in relation to the funding of smart meter rollout). The introduction of the price cap for default tariffs therefore provides an opportunity for Ofgem and the CMA to develop a single cap for PPM customers that resolves these previously articulated concerns and importantly includes sufficient provision for smart rollout. As an interim measure, Ofgem should apply the PPM rates to all PPM customers on default tariffs, including those with SMETS2 meters to mitigate the risk to the rollout of smart prepay meters that we have identified.

28. Ofgem's proposed treatment of smart meter costs in the default tariff cap also fails to provide for the rollout of smart meters to PPM customers. The combination of an insufficient allowance for rolling out smart meters to PPM customers in (a) the default tariff cap and (b) minimal allowance in the PPM cap, will have immediate and significant implications for rollout in this segment of the market. This further shows why it is essential that a co-ordinated position between Ofgem and the CMA is necessary to properly address the existing and known deficiencies in the PPM methodology relating to the treatment of smart-related costs, and the lack of adequate provision in the default tariff cap for smart meter rollout.

## *Operational costs and Standard Credit (SC) costs across fuels*

29. We support Ofgem's approach to determining the split of operational costs across fuels. We agree with Ofgem that benchmarking gas and electricity separately risks setting an efficiency allowance that cannot be achieved, because of inconsistent cost allocation

[5] Or fully interoperable SMETS1 meters

between suppliers. The difference in baseline operating costs between electricity and gas appears to be appropriate, with gas around £11 more per customer. In our experience gas entails higher operational costs than electricity, for example because the rental charges for traditional gas meters are around £✂ per customer higher than electricity meters.

30. However, we continue to have reservations about Ofgem's approach to socialising the extra costs of supplying SC customers. While it has been common practice for suppliers to socialise part of the extra costs of serving SC customers, we would expect a price cap set according to a "bottom-up" methodology to reflect the costs of serving SC customers accurately. This is simply consistent with well-established principles of cost causation. We would recommend that a more appropriate SC uplift would be £90 per customer, this being the average differential across the largest suppliers as of 20 June 2018, as we highlighted in response to Ofgem's May consultation.

31. We do not agree with Ofgem's proposed approach to allocating the socialised element of the SC costs across fuels, which we consider to be unjustifiable from an economic perspective. We consider it would be inappropriate for more of the socialised costs to be borne by either gas or electricity DD customers, and there does not appear to be any compelling justification advanced by Ofgem to support the proposed allocation. Under Ofgem's current proposals, the majority of the £23 that would be socialised would be allocated to electricity customers. Our proposed alternative of equal allocation across fuels (£11.50 for each based on current level of socialisation) would not have any effect on the overall level of the price cap.

32. We also disagree with Ofgem's proposed approach to allocating the non-socialised element of the SC costs across fuels. We believe that the non-socialised SC costs should be benchmarked using a single supplier and allocated equally across fuels because:

    a) Equal allocation across fuels is in line with market practice, and would therefore be consistent with Ofgem's justification for partial socialisation of SC costs; and
    b) The efficiency benchmark should be achievable, since it removes the risk of inconsistent cost categorisation between the benchmark suppliers. This approach would therefore be consistent with Ofgem's approach to the split of operational costs across fuels.

33. There is no economic rationale for Ofgem's current proposal, which would allocate a disproportionate amount of costs to electricity customers. For example, we see no reason why an electricity customer is less likely to pay their bill than a gas customer. Our proposed alternative to allocating the non-socialised element of the SC costs across fuels - i.e. applying it equally between them - would also have no effect on the overall level of the price cap.

## *Q1 2019 wholesale allowance*

34. Ofgem's departure from its previously proposed approach – the only option advanced in the May consultation – to the commodity index for Q1 2019 governing transitional arrangements for wholesale costs raises a number of material concerns:

a) It does not reflect wholesale costs and would therefore mean that an efficient supplier cannot recover its wholesale costs for this period;
b) There is no evidential basis for Ofgem's change in approach, and Ofgem has made no attempt to obtain evidence needed to justify a change in approach;
c) ✂. ✂[6];
d) The effect of Ofgem's approach will be to introduce an even more significant increase for consumers to the cap in April 2019 when Ofgem will necessarily be required to take into account the clear trend in wholesale costs.

35. Ofgem states that it does "not consider it likely"[7] that suppliers would have unwound previous hedges and adopt the transition index proposed in the May consultation. However, Ofgem has not provided any evidence that supports this assertion and the change in its proposal. Nor are we aware that Ofgem attempted to obtain such evidence. ✂[8].

36. The effect of Ofgem's proposed change in stance is that:

a) Efficient suppliers will be unable to recover their efficient wholesale costs for Q1 2019, which is contrary to s.1(6)(d) of the Act
b) Customers will experience a far sharper – around £50 higher – increase in prices once the cap is adjusted from 1 April 2019, when the enduring (cost-reflective) methodology for wholesale costs is introduced. Our current estimate for the wholesale element of the cap from 1 April 2019 is £525 per dual fuel customer on an annualised basis, contributing to an overall price increase of around £150 per dual fuel customer.

37. To explain the impact in more detail:

a) In its May consultation, Ofgem proposed an April-Sept 2018 observation period. This would have led to an allowed wholesale cost level of £485 per dual fuel customer on an annualised basis.
b) In its statutory consultation, Ofgem is proposing a Feb-July 2018 observation period. This proposal would lead to an allowed wholesale cost level of £433 per dual fuel customer on an annualised basis.
c) The difference between the May proposals and statutory consultation on an annualised basis (£485 - £433 = £52) equates to a shortfall in the cap for an efficient supplier of around £19 per dual fuel customer in Q1 2019.
d) ✂[9][10].

38. It would be incorrect to suggest that an efficient supplier unwinding previous hedges to match Ofgem's proposed May index would have benefitted by an amount equivalent to the £19 per customer shortfall. ✂ An efficient supplier would also have followed Ofgem's May transition proposal, even if commodity costs for Q1 had fallen since then.

39. Our concerns regarding Ofgem's proposed approach to setting the transition index are sufficiently material that we have obtained an opinion from Counsel (provided alongside

[6] ✂
[7] Appendix 4, paragraph 4.17
[8] See for example SSE's response to Question A6.7 of the May Consultation: https://www.ofgem.gov.uk/system/files/docs/2018/09/sse_response_0.pdf, page 39
[9] ✂
[10] ✂

this response) which sets out that Ofgem's proposed approach would be unlawful. Clearly, these concerns would be alleviated were Ofgem to revert to the transition index proposal as set out in the May consultation, and this would be our strong preference. However, were Ofgem to advance any alternative ways of ensuring that these costs can be recovered over the lifetime of the price cap – consistent with the requirement of s.1(6) of the Act – we would welcome the opportunity to discuss these further.

## *Other shortfalls in bottom-up cost allowances*

40. There are a number of other areas in which Ofgem's proposals result in a material shortfall in Ofgem's cost allowances. These relate to:

a) Variations in customer mix;
b) Treatment of uncertainty; and
c) Unidentified gas.

41. In order for the cap to be consistent with the Act, it should be adjusted to accommodate for the shortfalls outlined below, and set out in more detail in the appendices to this response. More specifically (and as set out in the legal opinion shared alongside this response), we believe it would be contrary to the Act and unlawful for some efficient suppliers to be unable to finance their activities.

### *Variations in customer mix*

42. We support Ofgem's proposal to not use the frontier supplier as the operational cost benchmark. We agree with Ofgem that the frontier "would be unlikely to be sufficient to cover the costs of an efficient supplier with a normal customer base"[11].

43. In practice, however, no supplier has a perfectly representative customer mix, and no other supplier will have the same customer mix as the benchmark supplier (i.e. ScottishPower). Therefore, Ofgem's proposals will have different impacts on different *efficient* suppliers, to the extent that their customer mix differs from that of ScottishPower. Under Ofgem's proposals, some *efficient* suppliers will be unable to finance their activities, even after taking headroom into account. We do not consider that such an outcome is compatible with s.1(6)(d) of the Act[12] and it raises questions as to the potential impact on suppliers with customers who exhibit different preferences and needs from those of the benchmark supplier.

44. There are some suppliers who will have higher *efficient* costs than Ofgem assumes in its construction of the cap, owing to one or more of a number of differences in customer mix. Some examples of what those differences are, and the adjustment that Ofgem should make to the price cap to enable efficient suppliers to finance their activities include:

[11] Appendix 6, paragraph 3.53.
[12] Our view is supported by Counsel's opinion, which states that the "statutorily-identified needs apply (a) to all of the holders of supply licences, and (b) to all of the (non-exempt) customers paying standard variable and default rates for the supply of gas or electricity by those holders of supply licences".

a) Up to £3 to accommodate suppliers with Warm Home Discount customers paying by Standard Credit;
b) At least £2 to accommodate suppliers with higher proportions of Priority Services Register (PSR) or single-fuel accounts than the benchmark supplier;
c) At least £2 to accommodate suppliers with a higher proportion of standard credit customers than Ofgem has assumed; and
d) Up to £4 to accommodate the additional costs faced by obligated suppliers with reducing customer bases.

45. Taken cumulatively these adjustments would have a material and positive impact on the ability of such suppliers to compete. As explained in our more detailed response, a balanced assessment of the evidence indicates that an additional allowance of at least £15 should be built into the cap to accommodate legitimate variations in cost.

***Treatment of cost uncertainty***

46. A balanced assessment shows that the "uncertainty" headroom that Ofgem has proposed for the cap will not compensate for the shortfall in efficient costs described above. Ofgem has stated that the uncertainty headroom is required to cover other "uncertain" costs instead, including:

a) Wholesale cost uncertainty resulting from uncertainty around basis risk and unmodelled volatility in demand (e.g. weather patterns, commodity shocks, error in forecasts of expected customer numbers, or uncertainty around volatile unidentified gas costs); and
b) A "number of factors" which could increase or decrease suppliers' operating costs, including the introduction of the faster switching programme or mandatory half-hourly settlement.

47. Ofgem has not attempted to quantify the likelihood or magnitude of these costs. As stated in our detailed response a balanced assessment of the evidence indicates that an additional allowance of at least £15 should be built into the cap over and above the combined £13 allowances that Ofgem has proposed to accommodate: (a) the inherent uncertainty in wholesale and other supplier costs; and (b) wholesale backwardation costs, which – contrary to Ofgem's apparent assumption – can be directly modelled and calculated (rather than being treated as an inherently uncertain cost).

***Consequences of the failure to address the shortfall in allowances***

48. Ofgem has not assessed fully the nature and level of service provided to specific groups of customers with particular characteristics or needs (i.e. with a higher cost to serve), such as customers on the PSR. The failure to make appropriate provision for the requirements of these customers in the cap may well have adverse consequences ✂, which will affect the intensity of retail competition to the detriment of energy customers.

49. Absent appropriate provision for these customers under the cap, we do not believe that it is open to Ofgem simply to rely upon other licence conditions relating to customer service to ensure that existing service levels are unchanged (as it asserts in the consultation document). Instead, these licence conditions and the way in which suppliers serve certain groups of customers will, going forwards, necessarily be constrained by and subject to the decisions that Ofgem has chosen to adopt in relation

to the funding provided under the cap to meet the preferences and requirements of groups of customers who have a higher cost to serve.

### *Unidentified Gas*

50. Ofgem has made an incorrect estimate of the absolute costs of Unidentified Gas (UIG). Ofgem's analysis suggests that an allowance of 0.96% would be appropriate for the costs of UIG, despite the fact that publicly available data from Xoserve suggests that the current costs are around 5%. As we explain in our more detailed response, Ofgem's justifications for the 0.96% are incorrect.

51. In particular, suppliers individually are not able to effectively reduce costs of UIG by tackling theft and submitting more regular meter readings. It is unreasonable for Ofgem to impose an expectation on suppliers that is in whole or in part outside of their control.

52. Instead of the current proposal, we suggest a more appropriate approach would be for Ofgem to use the latest Xoserve view of UIG to set the allowance, for a period where reconciliations have occurred for the majority of sites.

## *Competitive headroom and the removal of the cap*

53. Two significant consequences of the cap are that: (a) some efficient suppliers are likely to be unable to compete effectively; and (b) on Ofgem's own admission, levels of switching will be likely to reduce by 50%. As is explained more fully in the appendix, Ofgem's proposals are likely to lead to switching reducing to record low levels. There is no qualification in s.1(6)(b) or s.1(6)(c) of the Act which suggests that a reduction in consumer engagement and competition of the order of magnitude such as 50% are intended. Indeed, the opposite is the case. Sections 1(6)(b) and (c) refer to the "need" to "enable" and "maintain" respectively, which are strong words indicating Parliament's intentions. Competition and engagement are also means to protecting and enhancing the welfare of consumers. Overall, we consider that Ofgem's proposed approach cannot be reconciled with the Act.

54. We encourage Ofgem to reconsider its interpretation of the Act and provide competitive headroom at a level that enables *all efficient* suppliers to compete, not just some, and to be designed in a way that maintains incentives for *all customers* to switch.

55. It is difficult to reconcile Ofgem's expected effect of the cap on switching (reduction of 50%), with achieving effective competition. We agree that if the cap is to dampen switching and customer engagement, then such measures should not be used to judge whether the cap should be allowed to lapse. Instead, we welcome Ofgem's recognition that it should focus on realistic conditions for competition, rather than outcomes. In these circumstances, the need to establish a clear path to the removal of the cap by the end of 2020 is critical to mitigate the risk of the cap becoming a more established feature of the regulatory landscape. We encourage Ofgem to publish and consult on its view of the conditions for effective competition by the end of Q1 2019, and look forward to engaging in that process.