

Centrica's response to Ofgem's statutory consultation on the Default Tariff Cap: Appendices

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In addition to (i) the Executive Summary, (ii) Disclosure Room reports from Frontier Economics, (iii) legal annexes from Towerhouse LLP, and (iv) legal opinions from external Counsel, these Appendices contain Centrica's response to Ofgem's statutory consultation on the Default Trice Cap. In this document, our Appendices are structured with each Appendix corresponding to Ofgem's of the same number, in the following order:

- Appendix 2: Cap level analysis and headroom
- Appendix 3: Updating the cap
- Appendix 4: Wholesale costs
- Appendix 5: Policy and network costs
- Appendices 6 and 1: Operating costs and benchmarking
- Appendix 8: Payment method uplift
- Appendix 9: EBIT
- Appendix 10: Exemptions

Our response to Appendix 7 on smart metering costs is not listed above because it is not contained in this document. We are submitting our Appendix on smart metering costs separately to Ofgem on 8 October 2018, in order to help ensure that information from the Disclosure Room is kept separate.

Appendix 2: Cap level analysis and headroom

1. In Appendix 2 of its statutory consultation document, Ofgem recognises that it may need to set the cap higher than the “efficient benchmark” for three reasons:
 - a) To maintain incentives for customers to switch;
 - b) To accommodate variation in efficient costs from supplier to supplier (as a result of differences in the size and mix of different suppliers’ customer bases); and
 - c) To allow for any uncertain costs that are not accounted for in the benchmark.
2. Ofgem proposes to allow £10 of headroom to account for “residual” cost uncertainties on top of its 2017 baseline for the efficient benchmark. In support of this, Ofgem also suggests that it has already built additional headroom into the individual cost components of the baseline cap, which – taken in conjunction with the additional £10 of headroom – brings the total headroom allowance to £36.
3. The table below provides a breakdown of these proposed headroom allowances and the functions that Ofgem appears to envisage each component performing.

Headroom allowances within the cap (as characterised by Ofgem)	What functions is the allowance designed to perform (according to Ofgem)?		
	Accommodates variation in efficient costs across suppliers?	Accommodates supplier cost uncertainty?	Maintains incentives to switch?
£23 “allowance” over the efficient frontier – after subtracting a £5 “efficiency factor”	Yes	No	No
£3 wholesale “allowance”	No	Yes	No
£10 “residual uncertainty headroom”	No	Yes	No
Other ¹	No	No	No

4. We have three significant concerns about the proposals.
 - a) First, it is wholly misleading to characterise the cap as including “£23 allowance” for

¹Table A2.1 of Appendix 2 of Ofgem’s September consultation reports that in addition to the allowances listed in the table above, allowances of £1 and £2 are added for EBIT and VAT respectively. However, we understand that these allowances only result from applying a 1.9% EBIT margin and 5% VAT to the other headroom allowances. These EBIT and VAT allowances should not, therefore, be understood as wholly separate additional allowances to incentivise switching, allow for variation in efficient costs or accommodate uncertainty about the appropriate EBIT % or VAT % in their own right.

variation in efficient supplier costs. Ofgem is not proposing to grant any allowance for variation in supplier costs over and above those that it regards would be its efficient large supplier benchmark. 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.

- d) Second, the level of headroom that Ofgem proposes to allow for “cost uncertainty” is inconsistent with the requirements of the Act. A balanced assessment of the evidence indicates that an additional allowance of at least £15² should be built into the cap over and above the combined £13 allowances that Ofgem has proposed to accommodate the inherent uncertainty in wholesale and other supplier costs. In addition to this Ofgem must include a separate variable allowance for wholesale backwardation costs, which – contrary to Ofgem’s assumptions – can be modelled directly rather than being incorporated into the allowance for cost uncertainty.
- b) Third, as shown in the table, Ofgem is not proposing to leave any headroom specifically to incentivise customers to switch. Ofgem’s justification for this is not consistent with the requirements of the Act. It is essential that a separate headroom component is built into the cap (in addition to any headroom to accommodate cost uncertainty and variation) to satisfy the requirement in the Act to maintain customers’ incentives to switch.

5. We explain each of these concerns in turn.

The allowances that Ofgem proposes to make for variation in efficient costs across suppliers will not be sufficient to meet the requirements of the Act

- 6. Ofgem asserts that it has permitted a £23 allowance for variation in supplier costs over and above the “efficient cost frontier”. Ofgem’s characterisation of this £23 as an “allowance” for variation in costs is wholly misleading, since the “efficient cost frontier” is based on the operating costs of two suppliers with a completely different mix of customers to the large energy suppliers. A more accurate way of characterising the proposed allowance for differences in suppliers’ efficient operating costs would be to compare the operating cost allowance to the operating costs of the efficient large supplier that Ofgem proposes to use as its benchmark for the purposes of setting cap. On this basis, the allowance for variation in efficient costs across large suppliers is £0.
- 7. An allowance of £0 to accommodate differences in suppliers’ efficient costs compared to Ofgem’s benchmark for an “efficient supplier of scale” will be insufficient to allow the cap to accommodate variations in suppliers’ costs in the way that the Act requires. We explain the reasons for this in detail in Appendices 4, 5, 6, 8 and 10 below. To summarise:
 - a) Ofgem provides no evidence to demonstrate that it has undertaken a systematic evidence-based assessment to gauge the scope for costs to vary across efficient suppliers.
 - b) The £5 “efficiency factor” that Ofgem proposes to strip off the operating cost of the lower-quartile benchmark has no evidential justification and further removes any

²The £15 reference in this paragraph is not the same £15 in the previous paragraph. The requirements are additive.

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ability to believe the baseline includes headroom for variation in efficient costs. For further information, please refer to Appendix 6 below.

- c) Furthermore, additional allowances must be made over and above the lower quartile benchmark to account for variation in efficient costs across suppliers, and thereby allow efficient suppliers to cover their costs. These include:
- Up to £✕ to accommodate suppliers with Warm Home Discount customers paying by Standard Credit - for a detailed explanation of this requirement, please refer to Appendix 10 below;
 - At least £✕ to accommodate suppliers with higher proportions of Priority Services Register (PSR) or single-fuel accounts than the benchmark supplier for a detailed explanation of this requirement, please refer to Appendix 6 below;
 - At least £✕ to accommodate suppliers with a higher proportion of standard credit customers than Ofgem has assumed – for a detailed explanation of this requirement, please refer to Appendix 8 below; and
 - Up to £✕ to accommodate the additional costs faced by obligated suppliers with reducing customer bases – for a detailed explanation of this requirement, please refer to Appendices 4 and 5 below.
8. As can be seen from the chart below, taking these factors together implies a total shortfall of £15 in Ofgem’s proposed cost allowance to accommodate legitimate variation in efficient costs.³ Failure to build this additional £15 into the cap will prevent efficient suppliers from being able to recover their costs, and will therefore be inconsistent with the requirements of the Act. The requirement for an allowance to accommodate inherent uncertainty in wholesale and other supplier costs is a separate and additional requirement.

³ In practice the shortfall may be even higher than £15. This is because – given limitations in the data available to Centrica – some of the components of the £15 shortfall estimate have been calculated by identifying the cost differences that arise from differences in British Gas’s customer mix and the customer mix assumed by the price cap. In practice some third-party suppliers may have an even higher cost base than British Gas as a result of their customer mix. If so, an even larger allowance would need to be incorporated into the cap to accommodate these suppliers’ costs.

Figure 1. Decomposition of shortfall in allowance for variation in efficient supplier costs proposed by Ofgem

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Source: Centrica analysis.

Note: the £✂ allowance shown in the diagram for higher costs faced by obligated suppliers with shrinking customer bases is the mid-point of the range of £✂-✂ we have calculated. For further information please refer to Appendices 4 and 5 below

The level of headroom that Ofgem proposes to allow for “uncertainty” in wholesale and other costs is inconsistent with the requirements of the Act

9. Ofgem proposes to include two allowances for cost uncertainty:
 - a) An allowance 1% of direct fuel cost in the efficient benchmark to help suppliers manage the uncertainty around basis risk and “unmodelled volatility in demand” – (Ofgem reports that this amounts to £3 allowance per dual fuel customer on the basis of 2017-18 figures⁴); and
 - b) An additional £10 of headroom to account for “residual” cost uncertainties.
10. We agree that Ofgem is right to make allowances for cost uncertainty and that the most sensible and transparent way of doing this is – where possible – to build explicit allowances into each of the individual cost components of the tariff cap to account for this. However, Ofgem’s has not taken sufficient account of cost uncertainty to fulfil the requirements of the Act:
 - a) The combined £13 of allowances that Ofgem has proposed to account for cost uncertainty is not supported by an assessment of available market data;
 - b) A balanced and evidence-based assessment of these risks indicates that – for a TDCV dual fuel customer – a combined allowance of at least £18 should be added to cover wholesale and operating cost uncertainty alone (i.e. at least £5 higher than Ofgem’s proposal);
 - c) Ofgem should additionally include a separate variable allowance for backwardation costs which (contrary to its assumptions) can be modelled directly rather than being included in the allowance for cost uncertainty; and
11. Failure to make allowance for these cost uncertainties and backwardation costs will infringe the requirement of the Act to ensure that efficient suppliers are able to finance their domestic retail supply activities.
12. We explain each of these concerns below.

⁴ September consultation, Appendix 4, Table A4.1

The allowance that Ofgem proposes to make for wholesale basis risk in the cap has no evidential justification

13. The £3 allowance that Ofgem claims it has made specifically to account for wholesale cost uncertainty appears to relate to basis risk. In paragraph 3.53 of Appendix 4, Ofgem acknowledges that:
 - a) Suppliers are exposed to change in the summer-winter spread for the first default tariff cap;
 - b) After that, there is a range of options to manage exposure from locking in the profit and loss impact, to managing the cash flow; and
 - c) Both of these considerations will “incur some cost”.
14. Ofgem states that it has “considered this in providing additional the specific wholesale cost allowances and headroom”⁵. However, Ofgem has not explained why it considers its proposed allowance (amounting to 1% of the core direct fuel costs for both gas and electricity) should be sufficient for this purpose. This decision appears to be made without any evidential basis and without Ofgem having undertaken any of the necessary inquiries to give the decision a lawful basis.

The allowance that Ofgem proposes to make for “residual cost uncertainty” in the cap has no evidential justification

15. Ofgem acknowledges that the individual cost components of the tariff cap will not make allowances for all forms of cost uncertainty. It cites the following categories of residual cost uncertainty that will need to be built into the cap:
 - a) Residual wholesale cost uncertainty resulting from weather patterns, commodity shocks, error in forecasts of expected customer numbers, or uncertainty around volatile unidentified gas costs;
 - b) The costs of taking on the bad debts of failed suppliers (Ofgem recognises that in some circumstances some may not be covered by the Last Resort Supply Payments that are managed through network charges);
 - c) The potential impact that unexpected trends in demand or wholesale prices could have on policy and network costs; and
 - d) “a number of factors” which could increase or decrease suppliers’ operating costs, such as the introduction of half-hourly settlement and the faster switching programme.⁶
16. Ofgem is right to acknowledge such sources of cost uncertainty. However, it has provided no justification to support its proposition that a £10 allowance per dual fuel customer would be sufficient to compensate suppliers for taking on these risks.
17. Ofgem’s reasoning for not providing any justification appears to be that the potential costs listed above are difficult to quantify with a high degree of accuracy. However, this does not remove Ofgem’s obligation to assess the potential order of magnitude of these costs (or, if necessary, to collect data from suppliers for these purposes as part of its

⁵ September consultation, Appendix 4, para 3.53.

⁶ September consultation, Appendix 2, para 4.64.

consultation) with a view to demonstrating that its proposed headroom allowance has empirical grounding.

18. Ofgem also contends that the allowance is not intended to take account of all possible risks of a divergence in costs above the levels identified in the cap on the basis that “such an approach would lead to an unfeasibly high cap that would not reflect how suppliers manage risks”.⁷ We acknowledge that the cap should take account of the costs that suppliers could reasonably be expected to incur. However, this does not obviate the need for Ofgem to undertake a systematic analysis of these risks. At the very least it should consider:
 - a) What the costs could potentially be in the event that they materialise;
 - b) The probability of these costs materialising;
 - c) The probability of more than one of these costs materialising at the same time; and
 - d) An appropriate probability-weighted cost off the back of this.
19. Ofgem has provided no evidence in its statutory consultation document to suggest that it has undertaken any such analysis.
20. Given that it has not undertaken or presented any such analysis, Ofgem cannot claim that the £10 allowance provides “reassurance” that it has “appropriately taken account of the financeability matter in the Act” or that “efficient suppliers with unusually large numbers of expensive-to-serve customer types are able to finance their activities under the cap”.⁸ This aspect of the decision currently has been made without evidence and without Ofgem having undertaken any of the necessary inquiries to give the decision an economically sound and lawful basis.

An evidence-based assessment of these risks indicates that headroom of at least £18 should be provided to accommodate cost uncertainty, with a separate variable allowance over and above this for wholesale backwardation costs

21. In the absence of Ofgem providing evidence to support its proposed allowances for cost uncertainty, we have conducted our own assessment of the available evidence. This assessment points to the following conclusions:
 - a) The £3 (or 1% direct fuel cost allowance) that Ofgem proposes to allow for wholesale cost uncertainty is sensible, given the wide range of factors that can make wholesale costs inherently difficult to predict (e.g. weather patterns, commodity shocks, error in forecasts of expected customer numbers, or uncertainty around volatile unidentified gas costs). However, contrary to Ofgem’s assumptions, backwardation costs can be directly modelled and calculated (rather than being treated as an inherently uncertain cost). An additional explicit variable allowance for these backwardation costs should be built into the wholesale component of the cap – over and above the £3 wholesale uncertainty cost allowance that Ofgem is proposing. This cost allowance can, and should, be recalculated with each iteration of the cap. For further information, please refer to Appendix 4 below.
 - b) An allowance of at least £15 is needed to accommodate uncertainty in other costs

⁷ September consultation, Appendix 2, para 4.66.

⁸ September consultation, Appendix 2, para 4.67.

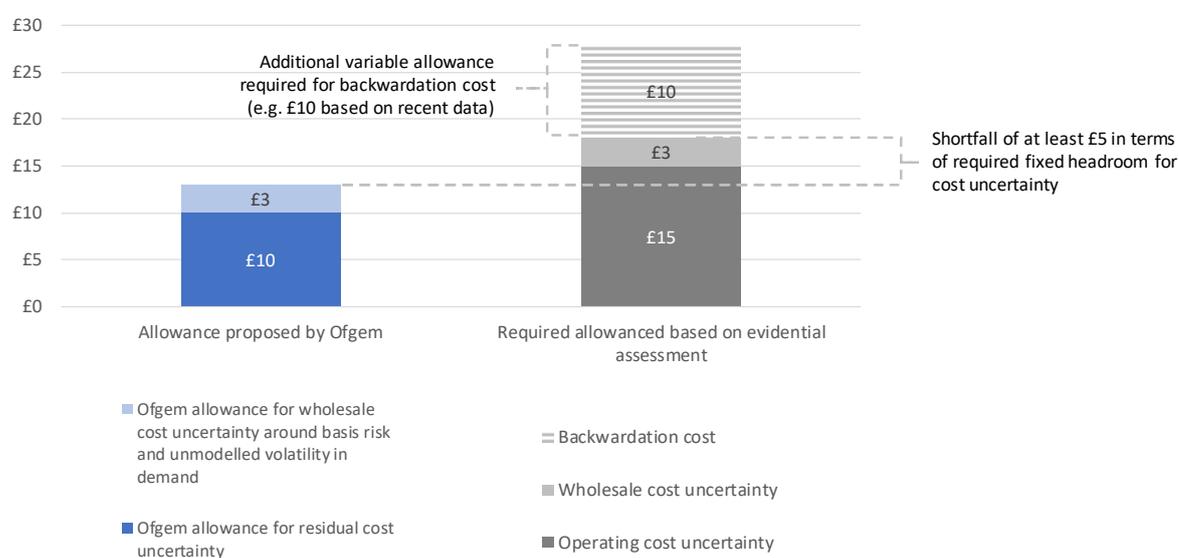
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(for further information, please refer to Appendix 6 below).

22. This adds up to a fixed allowance for wholesale and operating cost uncertainty of at least £18 plus an additional variable allowance for backwardation costs. As the chart below shows there is therefore a material shortfall in the allowances that Ofgem is currently proposing to build into the cap for these components – namely:

- a) A shortfall of at least £5 in Ofgem’s allowance for cost uncertainty, and
- b) An additional potential shortfall in relation to backwardation costs – the scale of the adjustment required will vary over time, and could in principle reduce bills if the market is in contango, but if the market is in backwardation this cost could be significant (for example In May we evaluated the cost to be £7/DF customer in 2019 and since then the cost has increased to £10/DF).

Figure 2. – allowances required to accommodate cost uncertainty and backwardation costs



Source: Ofgem proposals in Appendices 2 of the statutory consultation document; Centrica analysis.

23. Furthermore, a £18 allowance for cost uncertainty is itself a conservative estimate, since – as Ofgem has recognised – in practice there are other sources of cost uncertainty over and above those relating to wholesale costs and operating costs. These include unexpected changes in the network charges and policy cost that companies incur, as a result of demand patterns departing from those assumed in Ofgem’s modelling.⁹ The £18 requirement we have calculated does not take account of these additional factors, and should therefore be interpreted as a lower bound of the allowance that needs to be built into the cap to account for sources of inherent cost uncertainty.

Ofgem’s proposals for headroom for uncertainty in wholesale and other costs will fail to ensure that efficient suppliers can finance their activities

24. In light of these considerations, Ofgem cannot claim that its proposed allowance for cost uncertainty provides “reassurance” that it has “appropriately taken account of the financeability matter in the Act.”¹⁰

⁹ September consultation, Appendix 2, para 4.64.

¹⁰ September consultation, Appendix 2, para 4.67.

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25. To address this, Ofgem must:
- a) Reflect the concerns we have identified above and in Appendices 4 and 6 about the inadequacy of the allowances made for cost uncertainty in the individual cost components of the cap; and
 - b) Undertake the necessary inquiries and gather appropriate evidence to determine an allowance to cover “residual” sources of cost uncertainty which is based on evidence and analysis, rather than the current figure which is unjustified and likely unlawful.
26. This is critical because the evidence presented above indicates that an allowance of at least £18 for cost uncertainty should be built into the cap, *plus* an additional variable allowance for backwardation costs. The combined allowance of £13 that Ofgem is currently proposing for these components of the price cap is clearly not sufficient for this purpose.

Ofgem’s justification for leaving no headroom for competition is not consistent with the requirements of the Act

27. Ofgem is currently proposing not to include any headroom to support competition over and above the amount allowed for the efficient costs of supplying customers. It argues that – even in the absence of such headroom – the design of the cap will ensure that there is “sufficient competition in the market as whole” and that there are “incentives for customers to switch”.¹¹ This, Ofgem argues, will ensure that the cap is consistent with the requirements of the Act to have regard to these considerations.
28. This is not consistent with the requirements of the Act. For the reasons we explain below, the Act requires an explicit headroom allowance for competition to be built into the proposed cap. Failure to do this will infringe the requirements of the Act in at least three respects – namely the obligation to have regard to:
- a) The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
 - b) The need to maintain incentives for domestic customers to switch to different domestic supply contracts; and
 - c) The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.
29. We explain each of these three concerns in turn below.

The proposal not to include headroom for competition will not meet the ‘need’ to enable suppliers to compete effectively for domestic contracts

30. In the absence of any headroom for competition, the cap will in effect dictate the prices that large and mid-tier suppliers charge customers, even if they have exhausted all options to reduce their costs and improve their efficiency. This would be the case even if the tariff allowed such suppliers to cover their efficiently incurred costs in serving these customers. This is because:
- a) The cap would not leave any room for an efficient supplier with a typical mix of

¹¹ Ofgem (September 2018) Appendix 2 para 6.7.

- customers to set its default tariff at any level below the level of the cap without making an economic loss on this tariff; and
- b) The cap will also eliminate the ability of such a supplier to offer discounted acquisition tariffs below the level of the cap on a sustainable basis, since:
- This supplier would not be able to cover its efficiently-incurred costs from these acquisition tariffs alone; and
 - There would be no prospect of the supplier recovering these losses over the lifetime of the customer (because even if the customer subsequently migrated to the default tariff, the supplier would not make any profit from these charges over and above its cost of capital).
31. This will eliminate the ability of many suppliers to compete effectively for customers, even if they are fully efficient: indeed, Ofgem acknowledges that the level of the cap will only allow “some suppliers to compete”.¹²
32. Ofgem appears to present different justifications for its proposed approach at different points in the statutory consultation document. None of these justifications stand up to scrutiny.
33. First, Ofgem suggests that the cap will leave space for competition “at a market level” in the absence of any headroom because “some small and medium-sized suppliers have costs below those allowed for the tariff cap”.¹³ Some suppliers might have lower costs than are permitted under the cap (even if they are no more efficient than other suppliers) because:
- a) They are exempt from certain policy obligations and their associated costs; and/or
 - b) They have an atypically low-cost base because they have a mix of customers with a lower average cost-to-serve.
34. Such suppliers may have some scope to set prices at a level below the cap without making losses. However, it would be wrong to conclude this would deliver benefits for customers and meet the requirements of the Act. On the contrary:
- a) Competition can only deliver value for customers if it rewards suppliers who are able to offer a better service at a lower cost.
 - b) This will not be the case under the cap that is currently being proposed. Instead, a cap with no headroom for competition will give rise to a market in which any price dispersion and switching will not reflect effective competition. The underlying reality will be a system in which the prices that efficient suppliers can charge are effectively pre-determined by the level of the price cap, with the only suppliers who can afford to charge below the cap being suppliers who benefit from structural cost advantages from policy cost exemptions or their customer mix. Such a regime will be incapable of sustaining a system of effective competition that delivers genuine value for customers for two reasons.
 - First, it is not clear that whatever competition remains in this system will be sustainable. There are widespread calls to reform the policy cost exemption thresholds that would allow smaller suppliers to undercut the cap. Even if

¹² September consultation, Appendix 11, page 4 (emphasis added).

¹³ September consultation, Appendix 2, para 6.42.

these exemptions remain in place, one would expect small and medium-sized suppliers to cross these customer number thresholds as they continue to attract business at least in part because of their systemic cost advantage. This means that competition would need to be sustained by a continual supply of new entrants into the market. However, it is unlikely that recent rates of market entry will be sustained in an environment where – on the basis of Ofgem’s own predictions¹⁴ – customer switching rates are set to decline dramatically and where any new entrant’s ability to compete for new business will in any event reduce once it has passed the policy cost exemption threshold.

- Secondly – and more fundamentally – in contrast with a well-functioning competitive market, the suppliers that succeed in growing their business under the proposed price cap will do so because they have been handed a structural cost advantage by the system, and not because of their relative efficiency or quality of service. This will not deliver benefits to customers in the way the Act envisages, not least because customers that have higher costs to serve are less attractive to acquire.
35. In other words, the ability of some suppliers to undercut the tariff cap for reasons unrelated to cost efficiency will exacerbate the distortion to effective competition that the cap will bring about. Competition cannot be said to be “effective”, nor switching incentives “maintained” if options to customers with higher costs to serve are reduced or closed-off because these efficient costs are not allowed-for in the cap.
36. Second, Ofgem appears to suggest that in practice allowing headroom for competition will only support inefficient suppliers, and that efficient suppliers will be able to compete effectively even in the absence of any headroom. In paragraph 4.31, Ofgem recognises that that “larger, inefficient suppliers currently operating in the market may face more challenges than before to compete”, but suggests that it would be “inconsistent with the Act’s objective” to address this by building more headroom into cap because they are inefficient. In making this argument, Ofgem appears to be conflating “large” suppliers with “inefficient” suppliers. For the reasons set out in Appendices 3 to 10 below, this is wrong. Nonetheless, regardless of Ofgem’s views on the efficiency of existing suppliers, it must recognise that:
- a) To support competition that is capable of protecting customers in the way the Act envisages, the price cap must allow space for any efficient supplier – irrespective of its size or customer mix – to compete effectively for customers; and
 - b) It is entirely possible for large suppliers to be just as efficient as smaller suppliers, after controlling for differences in pass-through costs, policy costs and costs reflecting differences in customer mix that are beyond their control.
37. Ofgem cannot ignore the requirement for all efficient suppliers to be able to compete on the basis that it does not believe that all existing suppliers have exhausted their opportunities to make efficiency gains. However, on the basis of the statutory consultation, this appears to be what Ofgem is proposing to do. In its Draft Impact Assessment, Ofgem explicitly recognises that suppliers that are “operating efficiently but

¹⁴ September consultation, Appendix 2, para 7.43.

which face higher efficient costs compared to those used to set the cap... may not [be] able to make normal profit”.¹⁵ However, it does not appear to be proposing to take any steps to avoid such an outcome.

38. Third, Ofgem appears to suggest in paragraph 6.9 of Appendix 2 of the consultation document that the headroom it proposes to build into the cap to allow for “cost uncertainty” could, in practice, simultaneously create space for competition.¹⁶ The only circumstances in which an allowance for cost uncertainty could simultaneously support competition would be if the uncertain costs in question did not materialise at the level of the allowance. However, since these costs are – by their very nature – uncertain, there is no way that this allowance can be reliably earmarked for the purposes of supporting competition in this way. It is essential that two separate sources of headroom are built into the cap – one to account for residual cost uncertainty and the other to support competition.
39. Fourth, Ofgem suggests that it is not consistent with the objective of the Act to provide any additional headroom “so that suppliers with higher costs can offer cheap fixed tariffs by charging SVT customers”.¹⁷ In making this statement, Ofgem appears to be indicating that discounted acquisition tariffs (with the foregone revenues being recovered over the lifetime of the customer so as to enable the supplier to break even) should have no place in the energy retail market going forwards. This outcome is not consistent with Ofgem’s duty to take into account the need to “maintain incentives” for switching under section 1(6)(c).
40. A move that would effectively remove or seriously limit the ability of suppliers to offer discounted acquisition tariffs would be a significant policy development that – as the CMA recognised in the Energy Market Investigation¹⁸ – would place the energy sector at odds with a wide range of retail industries in the UK where these types of introductory offer are commonplace. It is highly unlikely that such an outcome should be implied into the Act without express words in the legislation. Nor can precluding discounted acquisition tariffs be expected when the Act requires Ofgem to take into account the need to enable suppliers to “compete effectively for domestic supply contracts” (section 1(6)(b)). Section 1(6)(b) is *not limited* to existing default tariff customers, and therefore recognises that competition in retail energy markets occurs through the offer of non-default fixed-term tariffs, which are often discounted acquisition tariffs. Ofgem’s suggestion that it has no choice but to prevent customers on default tariffs being charged more for the purposes of allowing competition and switching is an incorrect interpretation of the Act.
41. We are very concerned that Ofgem’s proposal to effectively prohibit discounted acquisition tariffs has not been subject to a rigorous impact assessment that considers the impact on competition and protection of consumers in the short and longer term. Precedent suggests that the costs of such a proposal outweigh the benefits. Two previous regulatory interventions that have limited the scope for suppliers to offer

¹⁵ September consultation, Appendix 11 (Draft Impact Assessment), para 6.53.

¹⁶ In paragraph 6.9, Ofgem states that it does not agree the uncertainty and competition headroom requirements should necessarily be “summed to calculate an overall headroom allowance”. This, Ofgem contends, is because “[s]etting separate additional allowances for uncertainty and for switching and competition would systematically allow some companies to over-recover their costs.”

¹⁷ Appendix 2, para 2.5.

¹⁸ See, for example, para 9.329 in the CMA’s Energy Market Investigation Final Report.

targeted acquisition tariffs aimed at attracting new customers – the prohibition on regional price discrimination in 2009 and the simpler choices component of the Retail Market Review (RMR) reforms in 2013 – were subsequently found to have caused detriment to competition and customers and have now been withdrawn. In its Energy Market Investigation Final Report, the CMA explicitly identified the restrictive impact of the RMR rules on the number of discounted acquisition tariffs that suppliers could offer as a factor that was harming competition and causing detriment to customers.¹⁹ On the basis of Ofgem’s analysis in the consultation document, a price cap that eliminates the ability of large and medium-sized suppliers to offer discounted acquisition tariffs would have a more harmful effect on switching and competition than either of these well-intentioned, but counterproductive initiatives.²⁰

42. Even if Ofgem were to take the view that discounted acquisition tariffs were inconsistent with the requirements of the Act, it would then be imperative that Ofgem simultaneously took steps to ensure that all efficient suppliers could compete on level terms if the cap were introduced. For the reasons explained above, this would – at the very least – require removing or offsetting the impact of the small supplier exemptions that currently distort competition and also ensuring that all suppliers actively seek to acquire customers that come with a higher cost to serve.

The proposal not to include headroom for competition will not meet the ‘need’ to ensure that efficient suppliers can finance their activities

43. By not enabling efficient suppliers with higher costs that are beyond their control (such as having a higher-cost-to-serve customer base) to compete effectively for customers, the proposed cap will simultaneously prevent efficient suppliers from being able to finance their activities, in contravention of s.1(6)(d) of the Act. This is because the cap will trap efficient suppliers with higher costs in a negative circle of:
 - a) Customer losses that they cannot stem; and
 - b) Increasing average costs and further declines in profitability, since these suppliers’ policy costs will be spread over a smaller and smaller customer base.
44. As noted above, Ofgem has itself explicitly recognised that efficient suppliers with higher costs will not be able to cover their costs under the default tariff cap regime: in its Draft Impact Assessment Ofgem notes that, under the proposed cap, suppliers that are “operating efficiently but which face higher efficient costs compared to those used to set the cap... may not [be] able to make normal profit”.²¹
45. Suppliers that are structurally prevented from being able to make a normal rate of return in this way will be unable to finance their activities, since investors and creditors will be unwilling to support a business that will be systematically loss-making even if it exhausts all options for increasing its efficiency.

¹⁹ See, for example, para 9.394 in the CMA’s Energy Market Investigation Final Report.

²⁰ Ofgem has estimated that the default tariff cap could reduce tariff differentials to £150 even in the absence of any impact on fixed-term tariffs, and that this in turn could reduce switching rates by up to 50%. This alone is a more significant reduction in switching than followed either the rollout of SLC 25A in 2009 or the simpler choices component of the RMR reforms in 2013. If the default tariff cap additionally makes it unprofitable for large and mid-tier suppliers from being able to offer cheap fixed term deals, then then tariff dispersion will – on Ofgem’s logic – likely contract to even less than £150, and switching rates will fall by more than 50%.

²¹ September consultation, Appendix 11 (Draft Impact Assessment), para6.53.

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46. This directly contravenes what the Act describes as a “need” to ensure that efficient suppliers can finance their activities. This must mean that efficient suppliers are able to use their revenues from default tariff customers to finance the costs of supplying to those customers. Ofgem must address this issue in two ways:
- a) First, it must ensure that the cost allowances built into the cap are sufficient to allow all suppliers to cover their efficiently incurred costs of supplying to their default tariff customers, irrespective of their customer profile.
 - b) Second, it must ensure that there is sufficient headroom for efficient suppliers with higher costs that are beyond their control to compete effectively. As noted above, this means leaving sufficient headroom for efficient suppliers to be able to offer discounted acquisition tariffs in order to attract new customers. The current proposal for the cap would make it affordable for *some* suppliers to compete while making it impossible for others to do the same. This latter group of suppliers will struggle to finance their domestic supply activities, because shareholders will be unwilling to put capital into a business that is incapable of competing effectively for customers.

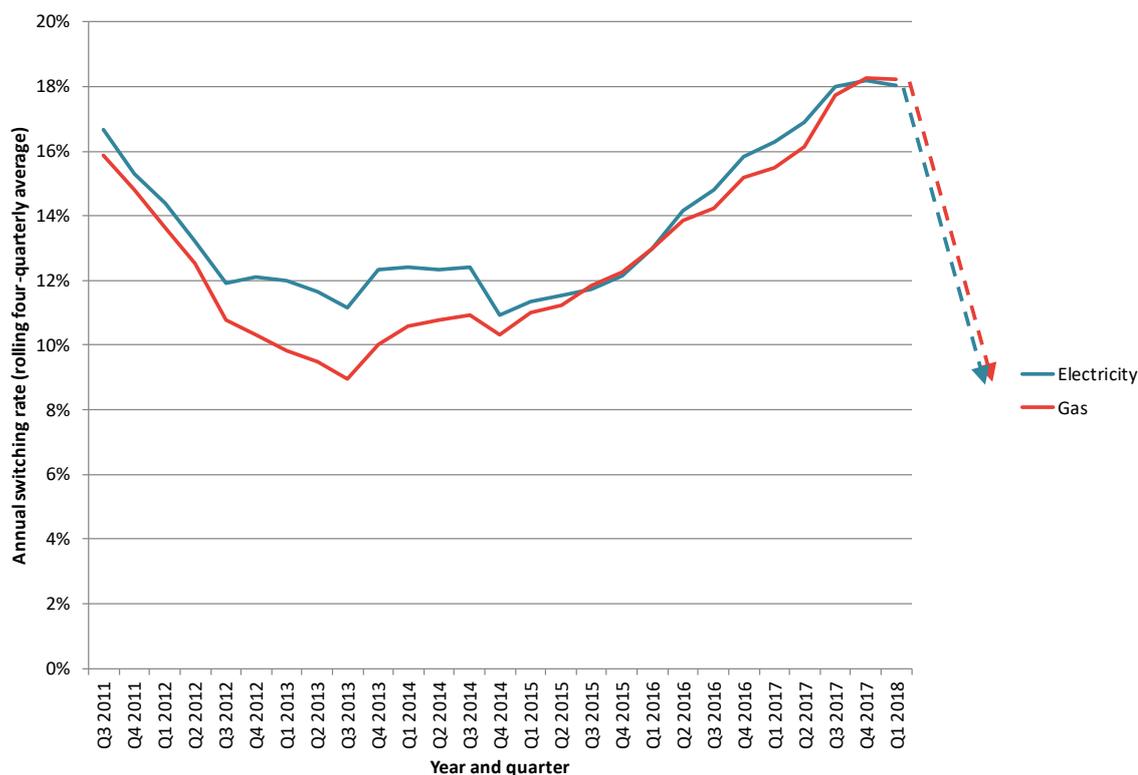
The proposal not to include headroom for competition will fail to meet the ‘need’ to maintain incentives for customers to switch

47. Ofgem itself recognises that the proposed level of the cap will lead to a reduction in price dispersion to £100-150. It estimates that this in turn could reduce switching rates by as much as 50%.²²
48. Ofgem argues that this is consistent with the requirements of the Act, since:
- c) “there will continue to be incentives for engaged customers to switch to cheaper fixed tariffs, even with the proposed cap in place”; and
 - d) “the cap is temporary, and [Ofgem] would expect that any reduction in engagement during the life of the cap would reverse when the cap is lifted”.²³
49. On the basis of Ofgem’s own analysis, such an outcome would be highly detrimental for the energy retail market. A 50% reduction in switching rates will not only reverse the progress that the industry has made in increasing switching rates in recent years, but reduce switching rates to unprecedentedly low levels, as can be seen from the chart below.

²² September consultation, Appendix 11 (Draft Impact Assessment) para 5.78 and Appendix 2 paragraph 7.43 (“There is substantial uncertainty, but our view is it is likely that, other things being equal, switching rates will fall following the introduction of the price cap. *Our best estimate is that, by reducing price dispersion, the proposed level of the cap could reduce switching rates by as much as 50%.*” [Emphasis added])

²³ September consultation, Appendix 2, para 4.16.

Figure 3. – historical domestic switching rates in gas and electricity and projected impact of the cap on the basis of Ofgem’s analysis



Source: BEIS Transfer statistics in the domestic gas and electricity markets in Great Britain, June 2019; Ofgem analysis of the impact of the cap.

50. As the chart above shows, a 50% reduction in domestic switching rates would bring both gas and electricity switching rates below 10%. For electricity, switching rates have never fallen below 10% (even in the aftermath of the ban on doorstep selling) since the market was fully liberalised. Gas switching rates have only fallen below 10% on one occasion since the market was fully liberalised. Furthermore, as explained above, there are reasons to believe that switching rates could fall even more than the 50% that Ofgem has suggested.
51. Ofgem therefore appears to suggest that even if the cap brings about an unprecedented reduction in switching rates, whatever switching remains after the reduction is still consistent with “the need to maintain incentives for customers to switch”.
52. This is not a correct interpretation of the Act. s.1(6)(c) states that Ofgem must have regard to the need to “maintain incentives” for customers to switch. The word “maintain” does not imply that a reduction in switching of 50% (or even 30%) is acceptable. Nor could a reduction in switching of this magnitude be acceptable because it is traded-off against “protection”. Consumers are protected through effective competition, not in spite of it.
53. Furthermore, Ofgem has provided no evidence to support its assertion that the reduction in customer engagement during the life of the cap will quickly or easily reverse when the cap is lifted. Since no measures that have been introduced in the past have brought about such a rapid and dramatic decline in switching rates, there is no precedent that Ofgem could point to in order to justify such an assumption. On the contrary, as a wide range of industry stakeholders have emphasised in their submissions to Ofgem, there

are reasons to fear that a price cap could permanently damage customer engagement in the market, by sending out a message that Ofgem will intervene on behalf of customers – meaning that customers perceive less need to engage in the market themselves. This was one of the primary concerns that the CMA cited during the Energy Market Investigation to support its conclusion that a wider price cap (over and above the tariff cap it introduced for PPM customers) would be detrimental to customer engagement and customer welfare on a long-term ongoing basis.²⁴ While it is, of course, to be hoped that industry initiatives – such as faster switching and the roll out of smart meters – will offset this damage by facilitating further customer engagement in the domestic energy retail market in future years, the net impact of these competing influences on customer behaviour is not possible to predict with confidence. The temporary nature of the cap does not diminish the duty in s.1(6)(c) of the Act.

54. In addition, a balanced assessment of the evidence that Ofgem has presented would suggest that switching rates could fall even further than the 50% that Ofgem has suggested. Ofgem appears to have based its conclusion that up to £150 of price dispersion would be achievable under the cap on a “top-down” assessment of the impact of the cap, which it describes in Section 5 and the Annex to Appendix 2 of the statutory consultation document. We have three concerns about this analysis.
- a) First, the description that Ofgem has provided of this top-down analysis does not include any figures on the grounds that the input data is “highly confidential”.²⁵ However, despite Ofgem setting up a Disclosure Room to enable interested stakeholders to assess other types of confidential information, it has not included this material in the Disclosure Room. Moreover, Ofgem has not reported the results of this analysis in the Annex to Appendix 2, making it impossible to understand exactly how the results it has reported elsewhere link back to this assessment.
 - b) Second, Ofgem states that it has used its top-down analysis to assess the impact of three “stylised” scenarios, which it claims involve “extreme reactions” to the cap.²⁶ It states that for this reason “we have not used [the analysis] as a predictor of any one outcome”. It is not clear why Ofgem believes weight can be placed on its predictions with regard to the impact of the price cap on price dispersion in light of this.
 - c) Third, Ofgem’s finding that the market could support price dispersion of £150 under the cap appears to be based on a scenario that assumes that discounted acquisition tariffs will remain constant.²⁷ This is an implausible outcome, since it implicitly assumes that in practice the price cap will neither soften the intensity of competition at the bottom of the market, nor render any of the discounted acquisition that are currently available on the market unprofitable on the basis of an assessment of expected customer lifetime value.
55. In light of these considerations it would seem likely that – on the basis of Ofgem’s assessment – price dispersion of £150 constitutes an upper limit, and that it would be

²⁴ See, for example, paragraph 11.88 of the CMA’s Final Report, where the CMA expressed concern that that “once the principle of such a highly interventionist remedy [i.e. a wider price cap] to deal with weak customer engagement is established, it inevitably increases the risk of further such interventions in the future, with *ongoing harmful effects* on engagement and supplier incentives” (emphasis added).

²⁵ September consultation, Appendix 2, para 7.4.

²⁶ September consultation, Appendix 2, para 5.19.

²⁷ September consultation, Appendix 2, para 4.42.

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more realistic to expect that price dispersion will narrow much further than this. On this basis, switching rates could fall by more than 50%.

56. There is no reason to believe that the £10 headroom allowed for cost uncertainty (as well as the other allowances for uncertainty that Ofgem states it has built into the individual cost components of the cap) will support any price dispersion in the industry in the way that Ofgem assumes. As explained above, this is because the only circumstances in which this allowance for cost uncertainty could simultaneously support competition would be if the uncertain costs in question did not materialise at the level of the allowance. However, since these costs are – by their very nature – uncertain, there is no way that this £10 allowance could be factored into a prudent supplier's pricing decisions that would in turn enable a greater level of price dispersion. In any event, as explained above, there are clear reasons to believe that the £10 allowance proposed by Ofgem will not be sufficient to allow the cap to accommodate the cost uncertainty faced by suppliers, let alone simultaneously provide headroom for competition.
57. The only remaining factors that could support price dispersion under the cap are allowances built into the cap to reflect differences in costs that are beyond the control of suppliers (i.e. cost differences resulting from policy cost exemptions or differences in cost to serve resulting from differences in customer mix). It would not be acceptable under the Act for Ofgem to use these cost differences to support price dispersion – and therefore incentives to switch – for the reasons we have explained above. These sources of price dispersion would be inherently unsustainable, since they will force suppliers with legitimately higher costs into a position where they can no longer finance their domestic energy supply activities.
58. We therefore disagree with Ofgem's assertion that the price cap could sustainably support levels of price dispersion of up to £150 in the absence of any headroom for competition.

Appendix 3: Updating the cap

59. This section deals with the two types of updates which we understand Ofgem to be planning, namely:
- a) Routine updates which occur by virtue of the ongoing operation of the conditions, e.g. to wholesale costs (likely to be April / October);
 - b) Methodological updates which will be given effect through licence modifications.
60. Note that this section does not cover specific concerns raised in relation to updating for wholesale costs, smart meter costs, operating costs and payment differentials, which are dealt with elsewhere in the Appendices.

Routine updates to the cap

61. We agree with the underlying need for updates during the life of the cap to reflect changes in underlying costs, and we further agree the need for different updates for different components. We also note that changes in underlying wholesale costs alone are likely to necessitate actual revisions on a six-month cycle. We broadly support the proposal to synchronise the cycle for revision with April/October PPM changes, confirmed in February and August respectively.
62. We note the following excerpts from the consultation (from Appendix 5):
- 2.32. Under the existing safeguard tariffs, where the inputs that will be used to update the cap are available in advance, we send suppliers provisional details of these around two weeks prior to the cap being set, so as to reduce uncertainty. We intend to continue this practice where possible with the default tariff cap, including providing confirmation of those inputs which are and are not expected to change in advance of the level of the cap being formally published. [emphasis added]
63. This is a very important confirmation which we strongly welcome and on which we are placing reliance. We need as much advance notice of the likely update as we can have, to enable us to plan our business properly.

Broader non-routine changes to the cap including methodological changes

64. Beyond the need for periodic routine updates – for which we accept that disproportionate procedural requirements are unnecessary – there may also be a need for more profound changes to the tariff cap, including to the methodology, for example as a result of Ofgem’s intended review of smart metering costs.
65. Parliament has made specific provisions for modifications to tariff cap conditions. These are set out in section 1(2) of the Act. The requirements of that section are engaged for such modifications – including the need to have regard to the matters in section 1(6).
66. Ofgem is also required to conduct such consultation as is necessary in the circumstances and, in any event, a statutory consultation pursuant to section 4 of the Act.

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67. This modification regime is specific to tariff cap licence conditions set under the Act. Unlike the Gas and Electricity Acts, there is no provision entitling Ofgem to include modification provisions with conditions themselves. There is thus no way of Ofgem to avoid consultation in accordance with the Act, whether by including provisions in the licence conditions that enable modification or by ‘sub-delegating’ important parts of the licence to notices that Ofgem can issue. This matches the normal rules for sub-delegation.²⁸
68. Section 2(3) also explicitly sets out that Ofgem ‘may’ consult on the methodological aspects of any modifications subsequent to the introduction of tariff cap conditions. We take this explicit mention – which is not strictly necessary – to be a clear indication that there should be a presumption in favour of such a consultation.
69. Given the above, it follows that any proposed changes to the level or methodology of the cap once implemented must be treated by Ofgem as full licence modifications, requiring a full process of consultation on such proposed changes, rather than introduced through some internal mechanism.²⁹
70. Finally, we would stress that the extent of any consultation will vary depending on the importance and complexity of the issues involved. Even where the requirement for statutory consultation is engaged, this need not be onerous where the issues are simple and uncontentious. Conversely, in more complex cases the statutory consultation on its own is unlikely to be sufficient. We would strongly welcome the opportunity to engage early with Ofgem where it intends to make changes, to help it identify any areas which would benefit more or less consultation, in order to avoid any misunderstandings which may otherwise arise.

Other points including accounting for unforeseen trends in efficient costs

71. It is not clear what the status is of Table A3.1 in Ofgem’s statutory consultation. It is not clear whether these are examples of issues where Ofgem would consider ex post adjustment to the cap would be warranted. Or, possibly, they are examples of cost uncertainties that are supposed to be covered by the level of cost headroom. We address in our response to other Appendices our view that the proposed methodology already introduces systematic features that will cause the cap to be too low for any given price cap period. For the avoidance of doubt, these need to be addressed in advance of the cap being set rather than through the way in which it is updated.
72. As described in our response to Appendix 2, we do not consider allowances sufficiently reflect the uncertainty affecting estimates of efficient costs.

²⁸See, for example, the OPSI statutory Instrument Practice guide (para 1.2.2) says that: “If the enabling Act so provides, an instrument made under it may itself confer power to make further instruments, generally in the form of rules, regulations or licences. The exercise of such a power is known as sub-delegated legislation” ... “that “Unless there is specific statutory authority to the contrary ... a reference must be to an existing publication ... otherwise, if the authors of the publication alter it, the effect of the instrument will be altered, which will constitute unauthorised sub-delegation.”

²⁹For example, proposed licence condition 28AD.16 would allow Ofgem to amend the methodology by issuing a statement in writing in certain cases. While Ofgem does state that there must be consultation, it is silent on whether such consultation must meet the full requirements of consultation to changes to the methodology under the Act.

Extension of the cap

73. The cap is intended to be in force until the end of 2020. It may be extended to the end of 2021, 2022 or 2023 if the Secretary of State issues a notice under section 7 of the Act during that year, following a review and recommendation by Ofgem.
74. For the reasons set out in Appendix 4, it is essential that suppliers are able to match the way Ofgem assesses wholesale costs in their buying strategy. This means that supplies must have sufficient advance notice to apply that strategy.
75. It is therefore essential that there is clear guidance from Ofgem at as an early a stage as possible. A material guide from Ofgem (at the very least, a “minded to” decision) will be required by February prior to the end of the year in question, to allow suppliers to ensure they are appropriately hedged for Q1 period of the following year in the event the cap is extended.
76. We therefore request that Ofgem provide a commitment to industry that it will respect the desirability for suppliers to match Ofgem’s assumed hedging strategy when preparing its reviews of whether the cap should be extended. In the event this is not possible, then we request that Ofgem provide a commitment to industry to revise the level of the cap to ensure that suppliers are nevertheless able to recover their wholesale costs.

Appendix 4: Wholesale costs

Overview

77. Whilst some aspects of Ofgem's approach to wholesale costs are reasonable and have taken on board feedback from industry, there are three key areas on wholesale costs where Ofgem has taken an approach that is unjustified and has resulted in a substantive understating of wholesale costs: the Q1 2019 wholesale allowance; the allowance for unidentified gas (UIG); and accounting for basis risk and backwardation. We also have concerns about the approach that Ofgem is taking to Capacity Market costs, which in line with Ofgem's categorisation, we address within this section of our response.

Q1 2019 wholesale allowance

78. Counsel's opinion (attached to this submission) sets out why Ofgem's proposal for assessing wholesale costs for the initial cap period cap lacks supporting justification. This section of Centrica's response should be read in conjunction with that opinion.

79. The opinion concludes that Ofgem's proposed approach is unjustified and, without proper justification, a decision by Ofgem to progress as it now proposes would be unlawful.

80. Ofgem's justification for using an index is that suppliers can match the way Ofgem assesses wholesale costs in their buying strategy,³⁰ which clearly requires that suppliers have sufficient advance notice to apply that strategy. And Ofgem's clear objective, in setting an observation period for its wholesale cost index, is to reflect the actual wholesale energy costs incurred by suppliers. Against these objectives, Ofgem's current proposed approach is entirely unjustified: Ofgem has pointed to no evidence to show that its proposed observation period better reflects the actual costs of suppliers in Q1 2019 than its May proposal, and has failed to seek any such evidence from suppliers other than through this consultation.

- a) Furthermore, Ofgem's new proposal now lacks the virtue of being a period to which it could point to as being clearly signalled so that suppliers could react and align their hedging strategies. ✕ suppliers will have placed weight on and acted on the clear signals that Ofgem issued into the market in May by having the transition Q1 2019 index, as the only option put forward in the policy consultation.
- b) Ofgem's previous proposal reflects the reality of what suppliers have done. This reflects what Ofgem envisaged, what suppliers have told Ofgem, and what Ofgem has expressly acknowledged.
- c) Ofgem has not explained how it is justifiable to ignore the costs of suppliers who have contracted in August or September 2019 within the index features for Q1 2019.

³⁰ September consultation, Appendix 4, para 2.41.

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81. Ofgem claims that its new proposal for Q1 2019 “reflects underlying costs more closely”³¹ and that “large suppliers have most likely already bought much of the energy SVT customers will use in early 2019”³², and will therefore have secured forward contracts at better rates than those which have since eventuated in August and September.
82. Ofgem has not undertaken any of the basic inquiries of suppliers that would be needed to establish whether this is correct, and it has no evidence to justify its conclusion:
- a) We have not been asked by Ofgem to provide data on our forward purchasing or the composition of our current hedging position for 2019. The only data Ofgem references relate to suppliers’ strategies in 2016. Data from two years ago is not relevant because the market was at that stage not anticipating a price cap being introduced and it cannot have taken into account that suppliers will have moved to match the index Ofgem indicated that it intended to apply in its May Consultation.
 - b) ✕.
83. 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.
84. 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) ✕✕^{33 34}
85. 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.
86. Given the late timing of Ofgem’s announcement of its new approach, it is now impossible for any supplier to match the proposed index on a prospective basis because the time

³¹ September consultation, Appendix 4, para 4.13.

³² September consultation, overview document, para 2.22.

³³ ✕

³⁴ ✕

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period for suppliers to adjust their purchasing behaviour to match Ofgem's observation period of February 2018 to July 2018 has passed.

87. Counsel's opinion concludes that Ofgem's currently proposed approach would be unlawful. ✕.
88. In accordance with its duties in the Tariff Cap Act (i.e. to ensure that efficient suppliers can recover their costs) Ofgem must adopt an index that allows suppliers to recover their costs. Consistent with the very reason Ofgem gave for setting an index in the first place, it is essential Ofgem's proposal can be replicated by suppliers, or at the very least it must revert to the transition proposal outlined in the May consultation. 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.

Unidentified Gas (UIG)

89. We do not agree with the proposal for only a 0.96% uplift in the wholesale gas allowance to cover the costs of UIG.
90. We consider the calculation in the statutory consultation to be based on an inappropriate combination of the pre-Nexus gas statement and post-Nexus product type splits. It is inappropriate to use the Allocation of Unidentified Gas Expert's (AUGE) view because the level of unidentified gas is not something that the AUGE is formally required to make a determination on. The AUGE's focus is on how unidentified gas is allocated rather than its total value. Further, the AUGE's view is inappropriately low for the current period. This is in part because it is influenced by 2014/15 data where UIG was close to zero. Indeed, the AUGE data on historic level of unidentified gas (2009/10 to 2015/6) shows that the proposed allowance would have been insufficient for 5 out of the 7 years.
91. In our response to the May consultation we referred to publicly available data on the Xoserve website that shows that the cost of UIG for the industry as a whole is 5%. Xoserve is an independent and neutral expert. Instead of its current proposals Ofgem should use the latest Xoserve view of UIG, for a period where reconciliations have occurred for the majority of sites. This would be a more reliable way to assess the current level of UIG. If the allowance is not changed to reflect this an efficient supplier will not be able to cover UIG costs. Even using this approach will be a conservative estimate of UIG costs for residential customers as the cost for supplying residential customers is higher than the industry average due to the way UIG is allocated.
92. Ofgem justifies its UIG allowance that is lower than reality on the basis that it considers that suppliers are able to control UIG, and specifically that suppliers are able to reduce costs of UIG by tackling theft and submitting more regular meter readings. However, Ofgem has not justified its assertion, which is incorrect; 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.
93. Actions by any individual supplier to reduce theft from their own customers will require a supplier to incur costs and be exposed to risks, and yet under the current schemes they are not able to fully capture the benefit of such efforts. This means that an efficient

supplier acting individually cannot efficiently reduce its own UIG costs by seeking to improve theft detection.

94. Whilst suppliers can submit more regular meter readings, this does not affect the underlying level of UIG. Recent evidence as cited above shows that the level of UIG remains considerably above the proposed allowance even after meter readings have been processed. Therefore, even if suppliers were to submit more regular meter readings this would not allow them to achieve a UIG cost as low as that which Ofgem is proposing to allow.
95. Overall, Ofgem should provide an allowance for UIG that reflects its actual costs and suppliers' ability to control those costs on an individual basis. The solution is 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. UIG could be subject to review over time. It would not be acceptable under the Act for UIG to be set at a level below costs that an efficient supplier would be unable to achieve individually. Even efficient suppliers cannot control the activities of other suppliers and other parties which can affect the outcome of UIG costs and allocation, and neither can Ofgem guarantee the actions of these parties.

Basis risk and backwardation

96. In Centrica's response to the May consultation, we made the case that the current backwardation of the market represents a cost to suppliers that cannot be recovered under the 6-2-12 index updated six-monthly. In May we evaluated the cost to be £7/DF customer in 2019 and since then the cost has increased to £10/DF as outlined in Appendix 2.
97. In the statutory consultation³⁵, Ofgem makes the assertion that the basis risk exposures net out, with over-recovery in one period being offset when the spread moves back again the next season. This is not the case when the market is structurally in backwardation, as it is at present, and it is not reasonable to expect suppliers to absorb this under-recovery in the expectation of potential over-recovery in the future.
98. It is a feature of wholesale energy markets that they are more often in backwardation than contango (since 2015 the market has been in backwardation about 2/3 of the time), so it is possible that the under-recovery would not be reversed during the period of the price cap.
99. There is a difference between the PPM cap devised by the CMA and Ofgem's proposed methodology. In the PPM cap it could be argued that the structure of the forward curve at the time the cap was set was already captured in the benchmark (notwithstanding all the other issues we have with the benchmark methodology). It was therefore possible to hedge to capture that existing spread. Ofgem's proposed methodology does not reflect the current structure of the market so this is purely a cost to which suppliers are exposed.
100. The impact on wholesale costs of market structure (additional costs for backwardation and lower costs for contango) relative to the 6-2-12 index can be fully calculated at the

³⁵ Paragraph 2.36

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time that the cap is set. This means that, by the time that the cap is set, market structure impacts on costs are no longer a risk; rather, they are a known cost. Such calculation only requires the information that Ofgem is already using to set the wholesale allowance. Therefore, Ofgem should include as part of wholesale costs an allowance for market structure that is calculated and updated for each cap period to accurately reflect costs.

Other commodity risks

101. The cap leaves suppliers exposed to short-term weather risk, and this is exacerbated by the low Q1 2019 cap. In March 2018 day-ahead prices rose to an all-time high of 230p/th against a prevailing price range of 50-60p/th, costing £4/customer on a single day, which could not have been recovered under the cap. At current market prices of 76p/th for Q1-19 against a marginal selling price of 100p/th under the proposed cap, prices only have to rise 25p/th to leave suppliers making a loss on all extra units their customers consume in cold weather. Long-term changes in price can be captured in the wholesale index, but these short term spikes cannot be recovered.
102. Further to the normal weather risk that suppliers are facing, there is the additional risk of a no-deal Brexit. ✕
103. At current prices, we forecast the proposed cap to increase by c. £150/customer in April, with Ofgem announcing the levels in early February. We have highlighted to Ofgem and the CMA the risk of volatility in the 6-2-12 index. It is very difficult for suppliers to forecast customer response due to the very large increase, and this potentially leaves suppliers exposed to holding risk on the commodity that they are purchasing, particularly those with large numbers of customers on default tariffs. ✕

Annex 2 – Issues with the wholesale cost allowance spreadsheet

104. The UIG uplift allowance link is incorrect – in the cell ‘1a Direct Fuel Cost Component’!H56, and then copied across delivery periods, there is an absolute cell reference missing to ‘3a Allowances’!\$B25 which means that all periods beyond the first year do not reflect the UIG uplift.
105. Bank holidays, i.e. non-trading days, need to be removed from the price data tabs ‘3d Price data, elec’ and ‘3e Price data, gas’. It is difficult to tell without the full price data and formulas working in the sheet, but we have identified small differences between our calculation of the index and Ofgem’s hard coded numbers and consider this to be the source of the error.
106. In the tab ‘2a Elec’ there is an error copying down values from cell K1518. This does not currently affect the calculation but will do as more of the sheet is populated.

Capacity Market

107. We do not understand the rationale for setting Capacity Market cost allowances with reference to costs for a given fiscal year (Apr - Mar). Capacity Market costs are already annualised, but the vast majority (c. 99%) relate to the costs of paying capacity providers and are recovered on a Delivery Year basis (running Oct-Sep). Therefore, the principle

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of cost reflectivity would suggest allowances should be based on a delivery year basis rather than a fiscal year basis. Converting these costs to fiscal years systematically creates a difference between the timing of costs incurred by suppliers and the recouping of those costs via the cap, potentially distorting competition in the wider market given the range of clearing prices for different delivery years observed to date.

108. The current proposal also creates unnecessary uncertainty and risk for the level of the cap in the summer price cap periods. For instance, for the 2017/18 delivery year, the Early Auction concluded on 3rd February 2017 and the Transitional Auction concluded on 22nd March 2017. For the 2018/19 delivery year, the T-1 auction concluded on 1st February 2018, whilst the T-1 auction for the 2019/20 delivery year is scheduled to conclude on 30th Jan 2019. It seems clear that Ofgem may not always be able to capture the impact of the T-1 auction in the summer price cap and may need to forecast the outcome of the auction. Even when the auction concludes in time, the short turnaround is undesirable and could lead to errors due to insufficient time for validation. For the summer cap Ofgem will always need to estimate the inflation uplift to be applied to the next delivery year for previously procured T-4 auction capacities.
109. All of this uncertainty, risk and estimation is unnecessary given that the impacts of both the T-1 auction result and the inflation uplift to be applied to T-4 clearing prices do not affect suppliers' costs during the summer price cap period at all – they only impact costs from the following October. Therefore, for the reasons given above, we believe it to be appropriate to align Capacity Market costs allowances with delivery years rather than fiscal years.
110. The approach to Capacity Market allowances does not cater for the additional costs borne by suppliers with reducing market shares. Because a suppliers' Capacity Market liability for a delivery year (Oct-Sep) is based on its' Nov-Feb market share, a supplier that loses customers after February will not be able to recover the outstanding Capacity Market liabilities in respect of those customers which it has lost. For Centrica, whose market share has been reducing, this lag effect has meant that over the last two years our Capacity Market costs have been recovered over a customer base ✕ lower than the customer base that has driven the annual liability. This effect would add ✕ to annual costs per customer in future price cap periods and again, these incremental costs simply reflect policy design rather than supplier inefficiency.

Findings from the disclosure room

111. Please refer to our confidential annex to this section for our response on wholesale matters related to the information that our Authorised Advisors have reviewed in the data room.

Appendix 5: Policy and network costs

Policy costs: Overview

112. With regards to policy costs, we agree with the proposed approach to estimate costs using publicly available administration data wherever possible. We also agree with the proposal to set the cap to reflect forecast policy costs in the given six-month cap period.
113. However, there are some areas where we do not agree with the suggested approach, and where we believe the proposed methodology, contrary to Ofgem’s statutory obligations, will not allow an efficient supplier to recover its costs. These concern the lag in calculation of obligation share, and the new supplier allowance in ECO.

Policy costs: Lag in calculation of obligation share & ECO supplier allowance

114. Because lagged supply volumes are used to calculate the size of obligations for ECO, there is a risk that suppliers with reducing market shares will not be able to recover their costs. For Centrica, whose market share has declined over the past few years, this lag effect has created additional annual costs - c.£✕-✕ per Dual Fuel customer in each of the last three years. These costs simply reflect a disproportionate distribution of policy costs due to an artefact of the policy design, and bear no relation to supplier efficiency.
115. Ofgem states that the converse effect exists for a growing supplier, in that this methodology may overstate the cost of the scheme. Ofgem further states that “basing the allowance on a supplier in steady state (neither growing nor shrinking) best balances these risks.”³⁶ However, it is incumbent on Ofgem to ensure that suppliers are able to recover their efficient costs. Providing a policy allowance that is generous for some suppliers under this methodology does not “balance” the fact that efficiently incurred costs for others are not properly allowed for. This further illustrates how Ofgem’s approach to the cap is contrary to its statutory obligation to ensure that efficient suppliers are able to finance their activities.
116. The proposed change to the tapering of the ECO obligation to a ‘supplier allowance’ approach will further increase the share of ECO costs borne by large suppliers and break the linear link between supplier size and obligation size. This creates a penalty to scale. ✕ Again, these incremental costs reflect intrinsic policy design rather than supplier inefficiency.
117. We recognise that adjusting the level of the policy cost allowance to account for the effect of timing lags and the supplier allowance may not be straightforward. However, given that the historic effect can be quantified, we propose that the overall headroom allowed under the cap is increased. An increase of £✕ would allow all suppliers to fairly cover their costs, as would be consistent with the need to ensure that efficient suppliers are able to finance their activities.

³⁶ September consultation, Appendix 5, para 2.12.

Forecasting and annualising of policy costs

118. We support the principle of generally setting the cap to reflect forecast policy costs in the given six-month price cap period, to ensure the cap is cost reflective and reduce the risk of distorting competition in the wider market. We are also comfortable with the rationale for the exception being proposed for CfD costs. The proposal to annualise these on an Apr-Mar basis, to avoid the risk of the cap systematically varying between winter and summer as a result of seasonal trends in wholesale prices is sensible.
119. However, we do have concerns about the forecasting and annualisation of Capacity Market costs, which in line with Ofgem’s categorisation of costs we address in our response on wholesale costs.

Network costs

120. No Comment.

Appendices 6 and 1 – Operating costs and benchmarking

Overview

121. Ofgem has proposed to set the operating cost element of the price cap at TDCV by using a “bottom-up” efficiency benchmarking exercise. While this was suggested as an option in the May consultation, it was one of a number of methodologies, and was discussed in very general terms. It is therefore incorrect of Ofgem to claim that “in most respects, our proposals are similar to those we described in our May consultation”³⁷, as much of what is now proposed is new.
122. As we have previously submitted, this general methodology is in principle a reasonable basis on which to estimate a price cap. We welcome the fact that Ofgem has chosen to undertake the benchmark analysis on a dual fuel basis, given the inaccuracies that benchmarking on a single fuel basis would lead to. We also strongly 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 a benchmark.
123. Given the limitations of the data available to Ofgem, we agree that carrying out benchmarking based on all customers (rather than just those on SVTs) is a reasonable course of action. However, we disagree with Ofgem’s statement that SVT customers are “...likely to have significantly lower sales and marketing costs”.³⁸ Ofgem has presented no evidence on this point. In addition to new customer acquisitions, sales-related spend also includes engagement towards internal switching. Indeed, for British Gas the number of SVT customers moving internally onto more ✕ Furthermore, British Gas’s marketing also includes spend on our brand, reinforcing the benefits of being with British Gas, for example our British Gas rewards offer, which supports retention of existing customers on default tariffs.
124. Ofgem has made a number of significant errors in its application of the bottom-up methodology for setting the operational costs allowance. As such, the bottom-up cap that has been proposed has been set at a level that is too low to satisfy the requirements of s.1(6)(d) of the Act.
125. It has not been possible to ascertain all of the reasons for this, given that Ofgem has prevented stakeholders from being able to properly assess and evaluate the proposals. A “bottom-up” calculation, by its nature, is entirely reliant on the information provided to Ofgem by suppliers. Ofgem has not released all operational cost used to determine the allowance to Centrica’s advisers, even in the controlled environment of a Disclosure Room. The CMA took a very different approach from Ofgem and released similar data when setting the PPM cap. This significant error of process means that it has not been possible for Centrica to respond properly to the proposal or verify the robustness of Ofgem’s calculations. This materially increases the risk of error in Ofgem’s ultimate conclusions.

³⁷ Ofgem (September 2018), Appendix 6, para 1.6.

³⁸ Ofgem (September 2018), Appendix 6, para 2.15.

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126. Below, we have set out the main flaws that we have been able to identify based on Ofgem’s proposed approach and the information that Ofgem has chosen to release, and potential ways in which Ofgem could correct for them.

- a) Ofgem has made legal errors in its interpretation of the requirements of the Act. S.1(6)(d) of the Act requires that that Ofgem *must* have regard to “the *need* to ensure that holders of supply licenses who operate efficiently are able to finance activities authorised by the license” (our emphasis).³⁹ This means that a cap which does not permit suppliers to recover their efficiently incurred costs is unlikely to comply with the Act. As currently designed, the cap will prevent a significant proportion of the market from recovering efficiently incurred costs to serve. Ofgem should ensure that efficient suppliers with higher cost-to-serve customer bases are able to finance their operations. We discuss in Appendix 2 how this could be done through an increase in the headroom allowance.
- b) Ofgem’s £5 reduction per dual fuel customer has no reasonable justification. Ofgem should remove this reduction.
- c) Ofgem’s interpretation of the cost data ignores the effect the smart meter rollout. Ofgem should amend the SMNCC to take account of the lower smart meter rollout of the benchmark company in 2017, as described in Appendix 7 of our response.
- d) Ofgem has made errors in the calculations it uses to set the operational cost benchmark at nil consumption. These errors mean that – contrary to what Ofgem states – the standing charge at nil consumption is above standing charges prevalent in the market in 2017. Ofgem should correct these errors, which would not affect the headline level of the cap at TDCV.
- e) Ofgem has failed to account for the increased costs of the Faster Switching programme – and its reasons for not doing so are incorrect. Ofgem should ensure that an allowance is included, for example through an increase in the operational cost allowance.
- f) Ofgem’s choice of index for the opex component (CPI-H) has consistently understated the increase in Ofgem’s measure of “efficient” costs over time. Ofgem should ensure that the headroom allowance is sufficient to cover such deviations in efficient cost from the allowance.

127. We discuss the implications of these errors (in both process and methodology) in more detail below.

Process errors

128. In our response to Ofgem’s May consultation, we stated that “...*the robustness of the analysis will ultimately depend on the data provided by suppliers, which we have not been able to see ... This is a procedural error and it has substantive consequences: it*

³⁹ Section 1(6)(d).

means that Ofgem will not benefit from proper, informed responses and its decision-making will, accordingly, be compromised.”⁴⁰

129. Ofgem has not changed its approach, and has not put the necessary data into the Disclosure Room. We cannot see any valid reason why Ofgem would not want to disclose this information. Not doing so has meant that Centrica and its advisors have been unable to respond properly to a number of areas of Ofgem’s proposals. For example:
- a) Had Ofgem provided data on all suppliers’ costs and its proposed adjustments, it would have been possible to verify Ofgem’s statement that observable differences in vulnerable and single fuel customer numbers accounted for £2 – £4 of the variation on costs between Ofgem’s lower quartile and frontier estimate of costs.
 - b) Had Ofgem provided data on all suppliers’ costs and its adjustments, it would have been possible to verify Ofgem’s statement that some suppliers’ operating costs had increased by more than CPI-H and others by less.
 - c) Had Ofgem provided the adjustments it had made to all suppliers’ data (rather than just Centrica’s) we could have been able to comment on the appropriateness of these.
 - d) Had Ofgem provided the spreadsheets underlying its calculations, we would have been able to check for errors. It is notable that Centrica and its advisors have found such errors in some of the few models that are available to them (including the nil consumption calculation, described below). This suggest that similar errors may exist in other calculations carried out by Ofgem which we have not been permitted to review.
130. We have similar concerns in respect to other areas of the price cap calculation – for example, payment method differentials.
131. This inadequate approach to transparency is in marked contrast to the CMA’s conduct during its Energy Market Investigation where it shared data provided by suppliers in a confidentiality ring including:
- a) Disaggregated data on the cost of new meters;
 - b) Meter maintenance cost data from suppliers;
 - c) Unit indirect costs for the Six Large Energy Firms;
 - d) Historical financial accounts and accounting data of the mid-tier suppliers; and
 - e) Payment method differentials by supplier.
132. Ofgem’s approach is particularly problematic given the opex benchmark is taken from the adjusted RFI response of a single supplier. It is therefore only this supplier that will have the opportunity to judge whether Ofgem has interpreted and adjusted its financial data in an appropriate way, or whether it is likely to be an appropriate company to set benchmarked costs for the industry.
133. The situation in terms of benchmarking and adjustments is somewhat similar to RIIO network price controls, where companies may be aware which firms are contributing

⁴⁰ Centrica response to Policy Consultation (June 2018) para 186, p.44.

towards the efficient frontier. However, in the case of network price controls, there is a considerable level of transparency regarding the data used for benchmarking. Ofgem will be aware of cases where one firm has noticed errors in the data provided by another firm. This default price cap consultation process has provided no such opportunity.

134. Given these issues, it is extremely difficult for us to make any judgement as to the validity of the data underlying Ofgem’s operating cost calculations. What follows is our attempt to identify the main sources of error in the estimate of benchmarked operating costs, based on the information that Ofgem has chosen to release.

Ofgem’s proposed approach would prevent efficient suppliers from recovering their costs, in contravention of the Act

135. S.1(6)(d) of the Act requires that that Ofgem must have regard to “the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence”. A cap which does not permit suppliers to recover their efficiently incurred costs is unlikely to comply with the Act. However, there are a number of ways in which the current proposals mean that many suppliers will be unable to cover their efficiently incurred costs. These include:

- a) Suppliers with higher proportions of PSR or single-fuel accounts than the benchmark supplier;
- b) Suppliers with a higher proportion of standard credit customers than Ofgem’s assumption;
- c) Suppliers with Warm Home Discount customers paying by Standard Credit
- d) Suppliers with a higher number of gas-first smart meter installs; and
- e) Obligated suppliers with a reducing customer base.

136. These are only some of the known drivers of cost differences between suppliers. We recognise that Ofgem will not be able to quantify all such cost drivers – as discussed in the following section, this is part of the rationale for using a lower quartile (rather than frontier) benchmark.

137. The Act does not permit Ofgem to pick which suppliers are allowed to finance their activities; it simply refers to “suppliers”. All suppliers are covered by this: if a company is a supplier, it falls within the protection offered by the Act. No reasonable reading of this requirement would suggest it is compatible with such a large proportion of the market being unable to recover efficiently incurred costs.

138. Below, we discuss the implications of the first of these areas. The others are covered in other Appendices.

Suppliers with a higher proportion of vulnerable customers

139. Ofgem states that it has set the operating cost benchmark at a level it considers will permit an efficient supplier with an *average* customer base to cover its costs.⁴¹ Ofgem also states that companies will have a higher cost-to-serve if their customer base contains a greater proportion of higher cost-to-serve customers, such as those that are

⁴¹ September consultation, Appendix 6 para 3.66.

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vulnerable (e.g. those on the PSR), or single-fuel customers.⁴² This implies that any supplier with a customer base containing higher-than-average proportions of vulnerable customers, single-fuel customers or offline customers will be unable to finance its activities.

140. Given that ScottishPower is the supplier setting the benchmark (as can be ascertained from published Consolidated Segmental Statements), it is possible to compare the customer mix that it supplies to the customer mix of other firms, to see to what extent they are unable to cover their cost-to-serve.
141. The most complete information exists regarding customer vulnerability, since Ofgem collects and publishes this as part of its annual social obligation reporting. Based on this data for 2017, and using estimates of customer numbers derived from Cornwall Energy, we have determined that ScottishPower had around 17% of its customers on the PSR at the end of 2017.
142. As shown in the table below, ten suppliers had a higher proportion of customers on the PSR. These suppliers accounted for 36 million accounts – or 79% of the total market (excluding ScottishPower itself).

Supplier	Proportion of accounts on PSR	Total number of accounts
E.ON	34%	✕
British Gas	28%	✕
Scottish and Southern	25%	✕
Bristol Energy	23%	✕
Zog Energy	23%	✕
EDF Energy	21%	✕
ENGIE power Limited	20%	✕
economyenergy	19%	✕
Tonik Energy	18%	✕
npower	18%	✕
TOTAL		✕[c. 36 million]

143. The same issue exists for single-fuel customers, which Ofgem indicates cost more to serve. Using market share data from Cornwall Energy (which only covers 14 of the largest suppliers) we estimate that 23% of ScottishPower's accounts were single fuel in 2017.
144. As shown in the table below, four suppliers had a higher proportion of customers with single fuel accounts than ScottishPower. These suppliers accounted for 22 million accounts – or 53% of the total market (excluding ScottishPower itself).

⁴² September consultation, Appendix 6 paras 3.44, 3.46.

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Supplier	Proportion of single fuel accounts	Total number of accounts
EDF Energy	31%	✕
E.ON	26%	✕
Scottish and Southern	25%	✕
npower	23%	✕
TOTAL		✕[c. 22million]

BG

145. These results show that the majority of GB customers are with suppliers that have a higher cost-to-serve than the benchmark. Those suppliers would be unable to finance their efficient activities under the proposed cap, even had Ofgem not gone on to remove the £5 “efficiency factor” discussed below.
146. Ofgem estimates that the median additional cost to serve a dual fuel PSR customer in 2017 was £10 per dual fuel customer account, while the median additional cost to serve a single fuel customer was £9 per account.⁴³ It is therefore possible to calculate the amount by which each supplier is unable to recover efficiently incurred costs due to these two customer mix effects. This is £✕ per dual fuel account for British Gas, and £✕ per dual fuel account for E.ON (the supplier that is most affected out of those 14 we hold data on).
147. At the very least, sufficient headroom needs to be included to allow for these sorts of cost differentials (in addition to headroom for other cost differentials and uncertainties), which reflect the exogenous customer mix of suppliers rather than any inefficiencies.
148. These figures may be significant underestimates given the level of uncertainty in Ofgem’s estimates of the additional costs to serve. We have carried out a further calculation based on Ofgem’s values of the range of responses given to it, and in doing so assumed these ranges are equally spread around the median (except for PSR, where this would imply a negative cost-to-serve differential). This would imply additional costs of £46 per DF PSR customer, and £27.50 per pair of single fuel accounts (compared to a dual fuel account). This would imply that, purely as a result of the cap not controlling for these two factors, British Gas would be unable to recover £✕ of efficiently incurred costs per dual fuel customer. The worst hit supplier (E.ON) would be unable to recover £✕ of efficiently incurred costs.
149. While we do not expect Ofgem to use these upper-bound estimates, it is crucial that the price cap takes account of these significant uncertainties. We discuss this in further detail in the following section.
150. This is still likely to be a significant underestimate of the extent of non-recovery, since it does not take into account other factors (such as the take-up of online accounts) which may increase specific suppliers’ costs to serve, and for which no data is available to quantify.

⁴³September consultation Appendix 6 para 3.37

The £5 “efficiency factor” is unjustified

151. Ofgem proposes to subtract a £5 “efficiency factor” from the value of the cap for a dual fuel customer. As far as we can determine from the consultation document, the main justification for this is that Ofgem believes that its lower quartile benchmark would “...likely lie above an efficient level of costs for an efficient supplier with a normal customer base.”⁴⁴
152. Ofgem also refers to the CMA’s price cap as a precedent supporting the use of a lower benchmark. Finally, the name “efficiency factor” itself suggests another ground upon which the £5 may have been deducted (albeit one which Ofgem has not explicitly articulated).
153. None of these justify the removal of the £5.

It is incorrect to choose a benchmark below the lower quartile on the grounds this reflects efficient costs

154. Ofgem proposes a benchmark below the lower quartile on the basis of analysis comparing the operating costs of the company closest to the lower quartile to the supplier with the lowest proportion of single fuel and PSR customers in the sample. Ofgem considers that the differences in cost implied by these two factors accounts for only £2 - £4 per account, compared to the £13 difference between the lower quartile and frontier.⁴⁵ Since Ofgem has permitted neither Centrica nor its advisors to view the data underlying its benchmarking analysis, we are unable to verify this figure.
155. Ofgem’s analysis ignores the rationale for using a lower quartile estimate rather than the frontier, which is to account for *unobserved* factors which may make the frontier company’s costs unobtainable by other participants in the market. Ofgem takes account of the need to account for unobserved cost differences when setting price controls for the regulated network companies.
156. For example, in RIIO-ED1, Ofgem chose to use the upper quartile of efficiency (i.e. the lower quartile of costs) rather the frontier to “...allow for other factors that may influence the DNOs’ costs”.⁴⁶ This was despite the efficiency scores already using regression modelling to control for a variety of observable factors affecting cost.
157. Similarly, in RIIO-GD1 Ofgem chose the upper quartile of Gas Distribution Network (GDN) performance rather than the frontier.⁴⁷ Again, this was done in addition to benchmarking that used econometric techniques to control for various observable cost drivers.
158. In the statutory consultation, Ofgem has stated that it does not believe that there is greater uncertainty in the supply market than in a network price control because energy suppliers operate across the whole of GB, supply the same market, and doing so provides greater consistency in their outputs.⁴⁸ We disagree for a number of reasons.

⁴⁴September consultation, Appendix 6 para 3.5.

⁴⁵September consultation, Appendix 6 para 3.74.

⁴⁶Ofgem (2014) RIIO-ED1: Final determinations for the slow-track electricity distribution companies, para 4.12

⁴⁷Ofgem (2012) RIIO-GD1: Final Proposals – Overview, para 4.4.

⁴⁸ September consultation, Appendix 6 para 3.71.

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159. First, energy suppliers differ in many ways that network companies do not. For example, as customer-facing businesses, energy suppliers have a much greater scope to vary parts of their business model (e.g. whether or not to focus on offering services online, and what kind of service to offer consumers). Energy suppliers also have much more scope to target specific customer groups, unlike network companies which must supply all customers in their area.
160. Second, when considering how much cost uncertainty exists, it is uncertainty *after* any attempts to control for exogenous cost drivers that is relevant. Ofgem’s approach to controlling for exogenous drivers of cost in the supply market (two pieces of ad-hoc analysis examining the impact of two factors – PSR and single fuel customers) falls short of the complex analysis taken to control for cost drivers for network companies. Ofgem has not controlled for factors such as:
- a) The proportion of online customers each firm has.
 - b) The position within the cycle of investment (e.g. for IT assets or marketing) each supplier was at in 2017.
 - c) Other features of the customer mix of each supplier – for example whether some suppliers have a customer base that is disproportionately less likely to fall into debt.
 - d) The quality of service offered by each firm.
161. This final point also has implications for the effects of the cap. If Ofgem set the benchmark at the frontier of efficient costs for a supplier which met the statutory minimum quality of service and no more, it would imply that no supplier would be able to offer more than this bare minimum. In our response to the May consultation, we provided examples of what this might mean in practice. For example, a £15m shortfall in cost allowance compared to what the Act requires could result in ✕, leading to a significant increase in abandoned calls ✕.
162. Third, the data presented by Ofgem indicates the significant extent to which some elements of its analysis are uncertain. For example, the estimate of the additional cost to serve a PSR customer had a range of £46, while the estimate of the additional cost to serve a single fuel customer had a range of around £10. These ranges are larger than the median cost differentials themselves, and indicative of significant uncertainties regarding the drivers of costs. It is also possible that the observed differentials in the customer base could account for the difference between the lower quartile and frontier costs.
163. There is therefore no justification to moving away from the precedent of lower quartile benchmark, which is what the £5 “efficiency factor” does.
164. Ofgem does acknowledge that “There may be other factors in addition to proportion of vulnerable and single fuel customers which could drive differences in suppliers’ costs that are not related to efficiency”, but states that the “impact is likely to be relatively small.”⁴⁹ There is no justification of this position – Ofgem refers to legacy pension costs and the extra costs of supplying offline customers, but does not (and by definition cannot) quantify the impact of unobserved variations between suppliers. It is the

⁴⁹ September consultation, Appendix 6 para 3.76.

existence of such factors that means that the lower quartile benchmark should be used rather than the frontier.

The CMA's cap is not a relevant precedent

165. Ofgem also justifies the use of a lower benchmark with reference to the CMA's PPM cap, which was based on two smaller suppliers with lower costs. However, Ofgem has not adopted the CMA's precedent in many other areas – notably in headroom, where the CMA's price cap provides almost £20 more headroom per dual fuel customer than is being proposed by Ofgem. More importantly, the PPM cap covers a much lower proportion of the market than the default cap, meaning that the impact of setting the default cap too low creates much greater risks for customers.

The £5 reduction is not justified as an efficiency incentive

166. Although not explicitly stated, the naming of the £5 reduction as an “efficiency incentive” may suggest it is intended to help Ofgem meet the requirements of s. 1(6)(a) of the Act, which provides that Ofgem must have regard to the need to create incentives for holders of supply licences to improve their efficiency.
167. This would be incorrect. In imposing a price control set at a level required for *efficient* suppliers to finance their activities, Ofgem would incentivise efficiency.⁵⁰ The obligation to incentivise efficiency does not warrant setting a price below the level which is necessary to ensure that efficient suppliers can finance their activities.
168. Further, the present situation is quite different from a typical price control where it is expected that the price control will (repeatedly) be set by reference to a regulated firm's own costs. In such a situation there is a concern that firms will have an incentive to allow costs to rise and accordingly there is a specific reason to set the control at a level which maintains incentives to efficiency.
169. By contrast, the present cap is intended to be a safeguard cap against excessive prices, imposed on a temporary basis, and with no mechanism by which suppliers' incurred costs in one period could feed back to the price cap in a subsequent period. Suppliers remain subject to incentives towards efficiency both through the need to compete with each other for customers (many of whom are acutely price-conscious) and in order to maximise profits.

Ofgem has failed to take into account the differing stages of the smart meter rollout suppliers will have been at

170. Through its inclusion of the SMNCC, Ofgem has acknowledged the impact that the smart metering programme has on suppliers' operating costs. Some (perhaps all) suppliers will have been more or less advanced in their smart metering programmes in 2017 than the average, and this will therefore have driven material differences in costs between suppliers. Ofgem's policy consultation listed “Stage of the smart meter rollout” as a possible factor that might drive variation in operating costs, that is not related to relative efficiency or inefficiency.⁵¹

⁵⁰ Joint Regulators Group (JRG) Cost of Capital and Financeability March 2013.

⁵¹ Policy consultation table A8.2.

171. However, when interpreting the spread of operating costs in the statutory consultation, Ofgem entirely omits the smart meter rollout as an explanation for the different costs it observes. Instead, Ofgem states that “Our expectation – drawing on the conclusions of the CMA – is that much of the variation in operating costs that we observe is likely to reflect differences in suppliers’ relative efficiency.” Ofgem’s adjustments to the operating cost figures make an adjustment for the direct costs of the rollout, but not the indirect costs (e.g. the costs of smart meters themselves, traditional meter termination costs, and all the costs and benefits in Ofgem’s non pass-through SMNCC model).⁵²
172. Ofgem should not rely on the CMA’s analysis (which is now around three years old and was produced in support of a considerably narrower cap) when it has the data and tools available to carry out its own analysis. And, in this case, the state of the market is very different to when the CMA carried out its analysis. According to BEIS, in 2015 large suppliers installed 1.2m smart meters, and operated 1.9m smart meters by the end of the year. While, in 2017, large suppliers installed 4.6m smart meters and ended the year with 8.8m in operation.⁵³ Even if the CMA had considered (and rejected) the notion that the smart meter rollout may at least in part be affecting the distribution of costs it observed, it is not possible for Ofgem to make the same statement now.
173. By not taking into account suppliers’ different stages of smart rollout and different associated costs, there is a risk that the benchmark will be unattainably low since it reflects a company with a smart meter rollout profile that was below the average in 2017.
174. Ofgem must therefore ensure that the price cap as a whole allows for the costs of the smart meter rollout to be fully covered. As discussed in Appendix 7, which also quantifies this issue, Ofgem could do this by amending its SMNCC model so the 2017 “baseline” is based on the rollout profile of the benchmark supplier and not the industry average.

The opex allowance at nil consumption is miscalculated, leading to an underestimate of unit costs

175. As described in chapter 4 of Appendix 1, Ofgem has benchmarked the cap (and therefore the operating cost component) at nil consumption in line with market prices in 2017.
176. Ofgem’s calculations (as set out in the “OC - nil.xlsx” file provided by Ofgem) contain at least two errors. Both of these errors result in the nil consumption benchmark being overstated. Given the way in which the cap is fixed at TDCV, this results in a unit rate which is too low.
177. Ofgem’s method for calculating the operating cost component of the cap at nil consumption involves two steps. First, Ofgem calculates the average direct debit standing charge offered in the market. Ofgem then “reverses” the cap calculation, removing all other components (network charges, policy costs, EBIT, and headroom) to obtain an operating cost component that should be consistent with this average standing charge.

⁵² “Operating cost disclosure” model.

⁵³ BEIS smart meter statistics.

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178. If performed correctly, the resulting operating cost allowance should, when fed back through the price cap model, result in a standing charge equal to the market rate.⁵⁴ However, as shown in the tables below, this is not the case. These tables show, from left to right:

- a) The average 2017 standing charge (excluding network charges) reported in Ofgem’s nil consumption cap model, broken down by cap component;
- b) The average 2017 standing charge taken from Ofgem’s “default cap level” model; and
- c) The difference between the two.

Table 1A. Nil consumption benchmark – Electricity Single

	Average 2017 standing charge	Average 2017 cap level	Difference
PC	6.68	6.68	-
OC	43.19	43.20	+0.01
PAAC	0	4.50	+4.50
PAP	0	0.97	+0.97
E	1.27	1.37	+0.10
H	0.99	0.82	-0.17
TOTAL	52.13	57.54	+5.41

Table 2A. Nil consumption benchmark – Electricity Economy 7

	Average 2017 standing charge	Average 2017 cap level	Difference
PC	6.68	6.68	-
OC	43.45	43.47	+0.01
PAAC	0	4.50	+4.50
PAP	0	0.96	+0.96
E	1.28	1.38	+0.10
H	0.99	0.82	-0.17
TOTAL	52.40	57.81	+5.41

Table 3A. Nil consumption benchmark – Gas

	Average 2017 standing charge	Average 2017 cap level	Difference
PC	6.68	6.68	-

⁵⁴ Should Ofgem make further changes to the cap methodology, the nil consumption calculation will need to be updated accordingly to ensure that this holds.

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OC	68.47	68.48	+0.02
PAAC	0	4.47	+4.47
PAP	0	0.85	+0.85
E	1.43	1.53	+0.10
H	1.11	1.19	+0.08
TOTAL	77.68	83.20	+5.51

179. After the operating cost that is calculated is put “back through the cap”, the resulting standing charge for a dual fuel customer is almost £11 higher than Ofgem’s calculation of the market average. It is therefore factually incorrect to say that the cap, as currently presented, “...set[s] the initial level of the benchmark at nil consumption in line with market prices in 2017.”⁵⁵
180. This overstatement of the standing charge results in the unit rate being understated. There are two main drivers of this error that we have been able to identify.
181. First, when Ofgem “reverses the cap calculations”, it fails to subtract a payment method differential. This is not apparent from the consultation document, but is explicitly stated in Ofgem’s model, which says: “We do not attempt to subtract a payment method value. This would require an assumption about the extent to which direct debit prices at nil consumption included an allowance for the costs of serving standard credit customers.”⁵⁶
182. If Ofgem is to include a socialised element of the payment differential, as is its current intent, this must be taken account in this calculation. If not, the resulting standing charge benchmark will not reflect the market average, as demonstrated above.
183. Ofgem’s justification for not doing so (that this would require an additional assumption) creates a serious internal inconsistency in Ofgem’s methodology. By “reversing the cap calculation”, Ofgem is assuming in every other respect that suppliers’ pricing methodology follows the assumptions built into the cap. For example, Ofgem has assumed:
- Suppliers have an EBIT percentage of 1.9%, which is applied to their cost base (but not headroom);
 - An additional headroom is added on, at a value of 1.45%; and
 - Policy costs, operating costs, and network costs are passed through to customers as per the price cap model.
184. This is an internal inconsistency which has not been properly explained. As noted above, Ofgem has not explicitly consulted on it.
185. The second error we have identified concerns the calculation of EBIT. Ofgem’s price cap model applies EBIT to all components of the cap except headroom and network costs. However, the nil consumption model assumes that headroom *does* apply to network costs. The headroom figure component at nil consumption is thus overstated

⁵⁵ September consultation, Appendix 1, para 4.1.

⁵⁶ “OC – nil.xlsx”, tab “Components”.

compared to what Ofgem intended it to be (for electricity – gas has no network charges at nil consumption). This error results in a much smaller change than the issue identified above, though, so the net effect is still a unit rate that is too low.

The cap does not cover the costs of the Faster Switching programme

186. Our previous response provided the example of the Faster Switching programme which for British Gas corresponds to a c£Xm incremental increase in operating cost each year,⁵⁷ as well as capex of £Xm - £Xm. Ofgem is proposing not to make allowance for predictable increases in costs driven by regulatory requirements. The two justifications that Ofgem has made for this proposal are incorrect.
187. First, Ofgem states regulatory change is part of “business as usual” and would affect suppliers’ costs in the benchmark period. However, Ofgem has not provided examples of any programmes which would have had a one-off impact on 2017 costs of a similar scale. Centrica is not aware of any such programme:
- a) While Project Nexus resulted in significant costs (c£Xm for Centrica) most of these costs were incurred in 2016 and before. To the extent any of these costs were capitalised, they will continue to flow through to our P&L for 2019 and future years.
 - b) While there were other regulatory changes (for example, the implementation of the PPM cap, CMOL trial, and the implementation of new principles on informed choices and sales) these did not require significant infrastructural spend of the type required for the Faster Switching Programme.
188. Second, Ofgem states that there may be offsetting impacts from general productivity improvements, such as those from increased digitalisation and automation. Ofgem does not provide evidence to support this assertion.
189. Ofgem asserts that Faster Switching would not have a large effect on the cap. However, the costs of Faster Switching are significant, and can be quantified – and were quantified by Ofgem for the purpose of its Impact Analysis on the programme. It is also incorrect for Ofgem to disregard individual proposals for changes to the cap on the grounds that they are immaterial; when put together they are large.
190. Ofgem’s Impact Analysis for Faster Switching provides estimates of two types of cost.⁵⁸ Transitional costs are estimated at £111.7m across the industry. Ofgem assumes that the scheme will take three years to implement and will run for fifteen years. However, under Centrica’s accounting policies, computer software is depreciated over a period of five years, and we have no reason to assume that other companies will have different policies. The rest of the opex allowance is designed on the basis of the costs that flow through suppliers’ P&Ls into their CSSs, and so it is consistent to assess the costs of future opex on the same basis. The depreciation of these costs would therefore add around £0.88 per dual fuel customer to suppliers’ costs.
191. Annual on-going costs are estimated at £6.3m, which would equate to a further £0.25 per dual fuel customer per year.

⁵⁷ Main response para 250.

⁵⁸ Ofgem (2018), Delivering Faster and More Reliable Switching: decision on new switching arrangements table 3.2.

192. In addition to the costs directly faced by suppliers, the DCC and Xoserve will incur costs as part of the implementation of Faster Switching, which will be passed through to suppliers. While the pass-through component of the SMNCC will allow for recovery of these costs, the cap only allows Xoserve costs (recovered as part of the operating cost allowance) to rise at CPIH. This will lead to a material under-recovery of these costs. Based on Xoserve's business plan, we estimate that this will amount to £0.67 per gas customer in 2019/20.
193. Ofgem must therefore ensure that its opex allowance for 2019 and going forward includes an additional £1.80 allowance to cover these costs.
194. Further costs will be incurred by suppliers (both directly and passed through from other organisations) as a result of electricity settlement reform, with implementation due to start from 2020. Ofgem has started to calculate these costs as part of its business case for these reforms, and will need to add an appropriate allowance to the cap once in due course.

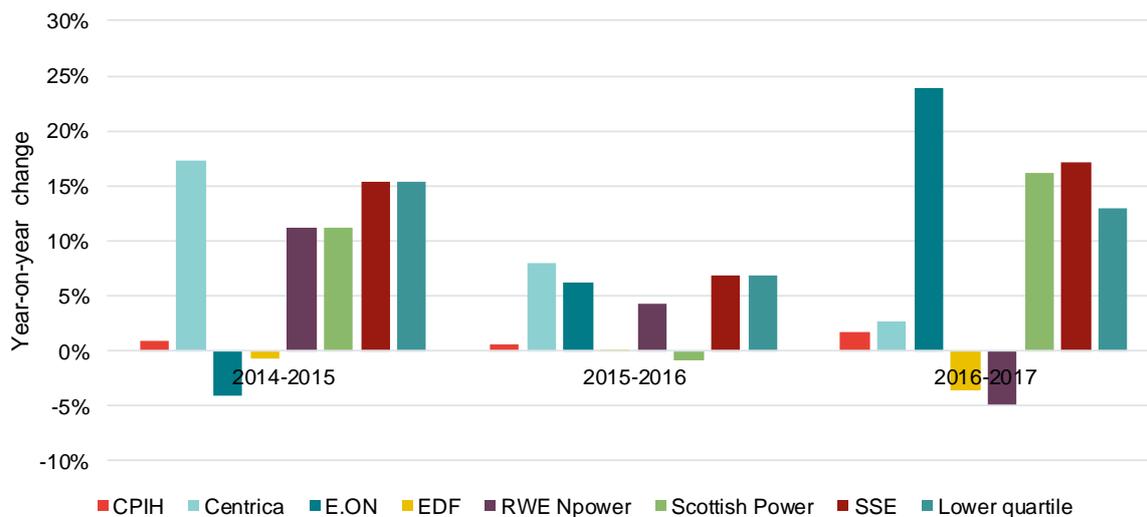
CPIH is not an appropriate index to update the allowance for operating costs

195. In response to Ofgem's May consultation, we agreed that the CPIH was a reasonable index to use for the non-smart operating costs of suppliers, providing that it was shown to be a good proxy for changes in suppliers' non-smart operating costs.⁵⁹ We expected Ofgem to confirm whether or not this was the case based on its analysis of suppliers' historic costs.
196. Ofgem has stated that among the benchmarked sample, some suppliers' operating costs had increased by more than CPIH while others had increased by less than CPIH.⁶⁰ While Centrica does not have access to Ofgem's benchmarking dataset, we have replicated this analysis using the publicly available CSSs, and it is shown below for electricity. The bars indicate the increase in indirect costs per account each year. It can be seen that in the vast majority of cases, indirect costs rose faster than the CPI-H. Crucially, the lower quartile (which Ofgem is using as its efficiency benchmark) rose considerably faster than CPI-H.

⁵⁹ Main response, para 249.

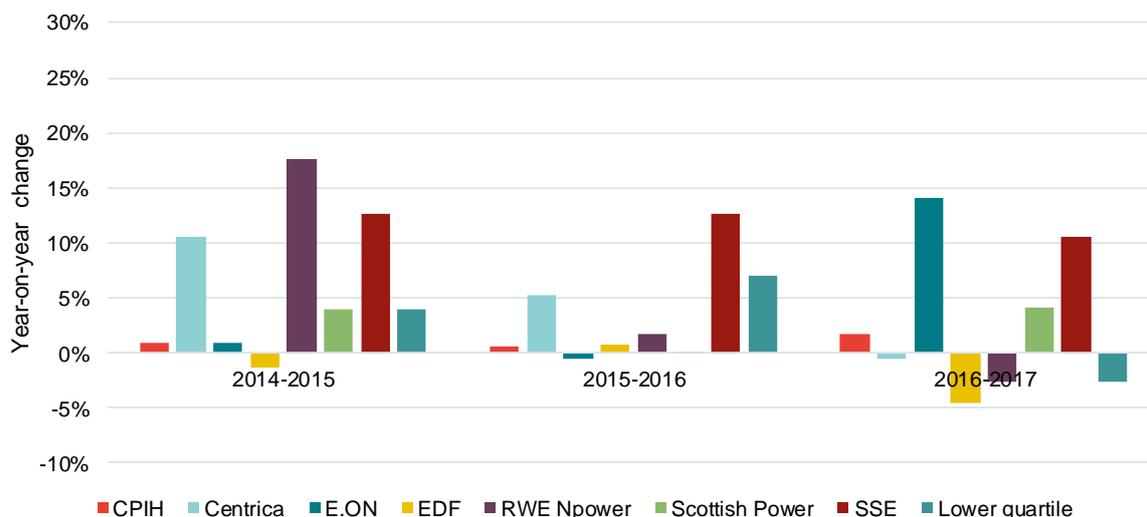
⁶⁰ September consultation, Appendix 6, para 4.16.

Figure 4. Year-on-year changes in opex (electricity, no smart adjustment)



197. Similar results can be seen for gas:

Figure 5. Year-on-year changes in opex (gas, no smart adjustment)



198. We do not have access to financial information on the wider set of companies available to Ofgem. However, figure A6.1 in the Statutory Consultation shows the lower quartile of operating costs across this wider sample increasing from around £82 per customer to £94 per customer. This increase of around 15% substantially outpaced the increase in the CPI-H during this period.

199. Some of the increases may be driven by the smart metering programme. As the SMNCC model does not produce SMNCCs going back to 2014 (and even if it did, Centrica does not have direct access to this model), we have estimated an approximate SMNCC. This has been calculated by using the 2019 SMNCC and then assuming that the SMNCC in a given year is proportionate to the difference in the smart installed base in that year and in 2017. The results after subtracting this figure (which will be negative for the years shown) are indicated below.

Figure 6. Year-on-year changes in opex (electricity, with smart adjustment)

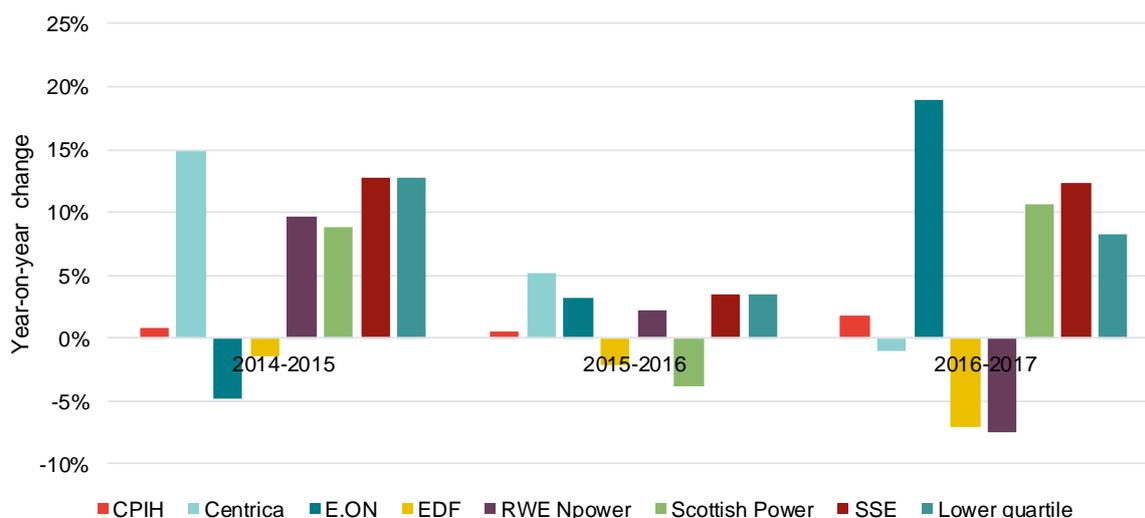
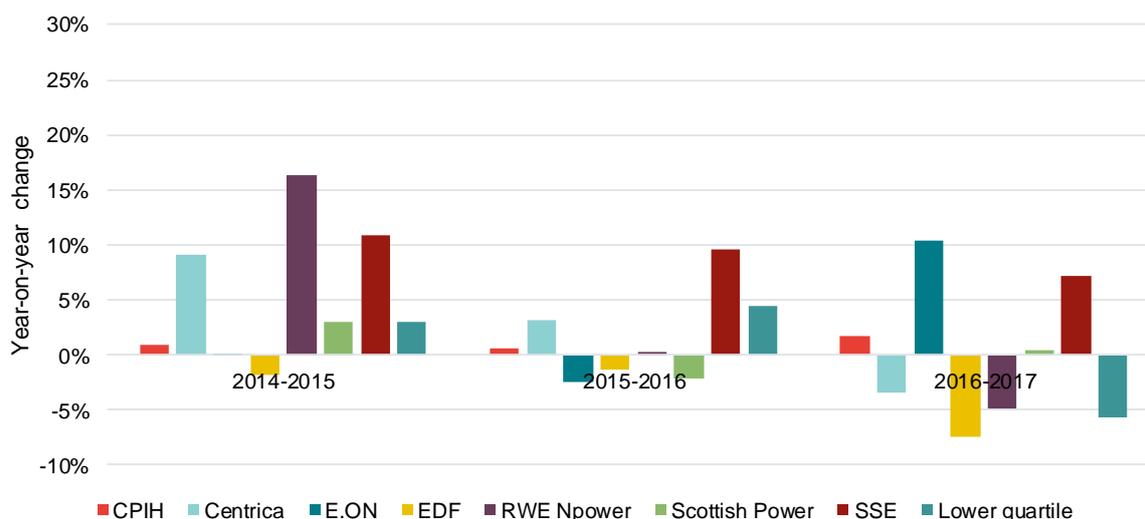


Figure 7. Year-on-year changes in opex (gas, with smart adjustment)



200. It is therefore clear that, historically, CPIH has failed to capture changes in suppliers' opex, even after the smart metering programme is accounted for.
201. We have carried out additional analysis to quantify the potential impact of such changes in cost on the proposed price cap. This has involved simulating the outturn of a price cap if one were to have been set in the past, along the lines now proposed by Ofgem.
202. First, we have adjusted the CSS figures to subtract the estimation of the SMNCC, as described above. For 2014 (the first year where the CSSs included customers numbers), we have calculated average indirect costs per customer for each of the six suppliers. We have benchmarked the lower quartile (i.e. second-lowest cost) supplier on a dual fuel basis, and then extracted the gas and electricity costs of this supplier (which happens to be ScottishPower in 2014).

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203. For each subsequent year, we have then calculated:

- a) The price cap as it would have been set, by scaling this benchmark in line with CPI-H; and
- b) The actual “efficient” costs, generated by repeating the analysis described above for the new year.

204. We present the results of our analysis for both fuel types below. The green line in each figure represents the indirect costs per customer derived from carrying out the benchmarking afresh each year. The light blue line shows the allowance for operating costs which would have been calculated had the cap been set in 2014 (on the basis of the lower quartile) and updated using CPIH.

Figure 8. Simulation of a 2014 cap (electricity)

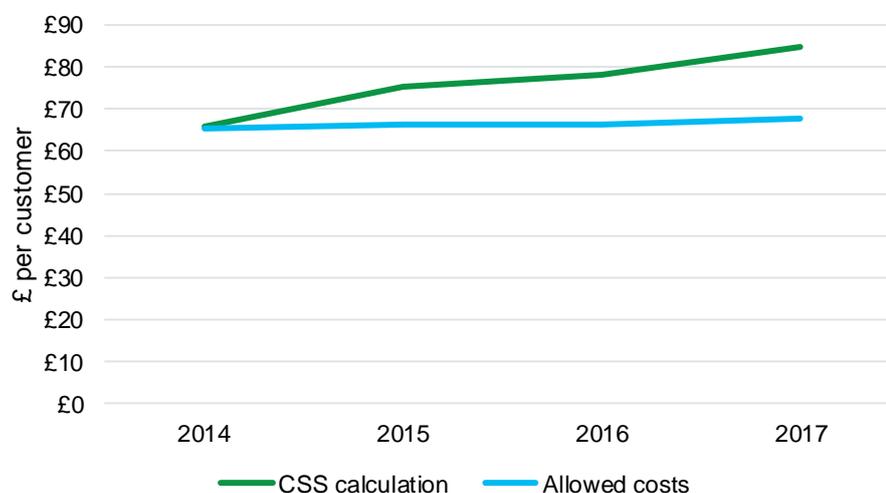
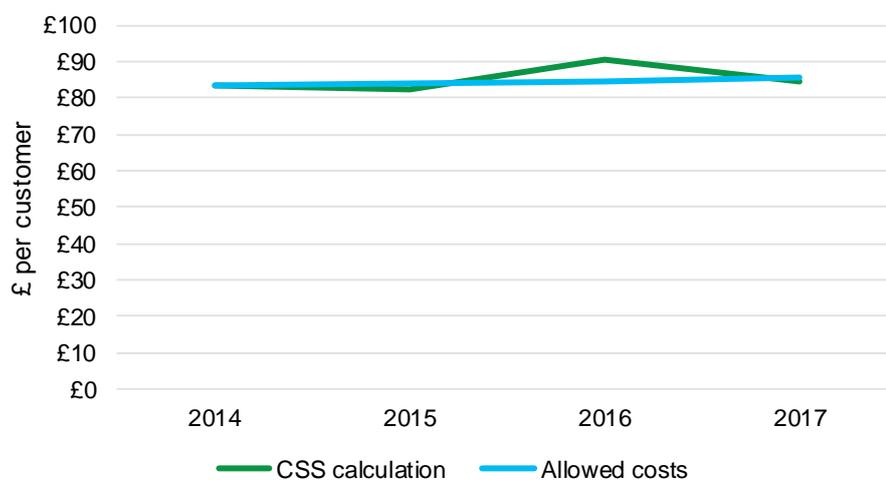


Figure 9. Simulation of a 2014 cap (gas)



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205. Had the cap been set in 2014 on the basis that Ofgem is now proposing, the dual fuel allowance in every year (from 2015 to 2017) would have been below the actual “efficient” benchmark. By 2016, this gap would have been almost £18 for a dual fuel customer.
206. This analysis shows the significant risk that a cap indexing indirect costs in line with CPI-H could lead to efficient suppliers unable to finance their operations. Unless Ofgem is able to suggest a more suitable index, it will need to account for this risk as part of its headroom.

Appendix 8: Payment method uplift

Overview

207. We agree with the principle of including a payment method differential as part of the price cap. Customers paying by standard credit (SC) incur greater costs for suppliers than customers paying by direct debit (DD), and the cap needs to reflect this.
208. However, the cap that Ofgem is proposing does not properly account for these differential costs impacting on efficient suppliers' ability to recover their costs. Ofgem's proposed approach is therefore at odds with the obligations of the Act. There are a number of particular aspects of Ofgem's proposals that need to be revisited.
209. First, 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.
210. Second, we strongly disagree 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.
211. Third, we 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.
212. 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

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fuels - i.e. applying it equally between them - would also have no effect on the overall level of the price cap.

213. We explain these points in more detail below.

214. At the end of this section we also address two important operational implementation issues, which risk causing significant customer confusion and detriment if not addressed. One concerns the different treatment of PPM customers, the other concerns the application of some of the SC uplift as a percentage.

Ofgem must reduce the extent to which the payment method uplift is socialised, to reflect current market practice

215. We support Ofgem's movement away from the pure socialisation of bad debt and administrative costs it suggested as part of the May consultation. However, Ofgem is still proposing to socialise the majority (60%) of these additional costs.

216. In our response to the May consultation, we expressed our concerns that any amount of socialisation would:

- a) Reduce the incentive for standard credit customers to switch to direct debit, increasing costs for all customers and disproportionately for those suppliers with more standard credit customers;
- b) Give a competitive advantage to those suppliers with a greater proportion of DD customers than the split assumes; and
- c) Mean that those suppliers who are efficient but have a greater proportion of SC customers than the split assumes cannot finance their activities.

217. We continue to have reservations regarding Ofgem's proposed approach. Nevertheless, if Ofgem does require that some of the payment method uplift is socialised, this must be done in a way which is both consistent with its own logic, and compatible with the requirements of the Act.

The proposed level of socialisation leads to payment method differentials lower than those observed in the market

218. If Ofgem does continue to socialise the payment method differential, its own logic dictates that it should do so in a way which is consistent with the observed differentials in the market.

219. Ofgem has stated "*The market simple average dual fuel differential was £82 as of July 2018, which is in line with what the price differential of our proposed option would be in the first cap period.*"⁶¹ This is a misleading comparison for two reasons.

220. First, if Ofgem is carrying out this type of benchmarking, it should do so on the basis of the large supplier differential (£90)⁶² rather than the simple market average (£82). Ofgem's analysis of costs implies that the £82 is less cost-reflective than the £90.

221. Second, the benchmarking of the cap must be done for a time period consistent with when the differential was measured. According to Ofgem's analysis, the payment

⁶¹ September consultation, Appendix 8 para 3.27.

⁶² We note that the benchmark supplier, Scottish Power, has an even higher payment method differential than £90.

method differential that the cap would have allowed for the Summer 2018 would only be £79.77.⁶³

222. Ofgem should therefore – at a minimum – decrease the extent of socialisation to produce a cap level for Summer 2018 that would be consistent with the £90 figure. We have calculated that this would require the socialisation percentage to be reduced from 60% to approximately 51%. This figure (and the calculations below) are based on Ofgem’s calculation of “efficient” costs, but would need to be adjusted if those costs were amended as a result of updating the benchmarking methodology.

The cap needs to ensure that suppliers with a higher proportion of standard credit customers than assumed in the socialisation can cover efficiency incurred costs

223. Under the cap, suppliers with a proportion of SC customers above that assumed by Ofgem’s socialisation calculation will still be unable to finance their efficient costs of supply. As discussed in our response to Ofgem’s proposal on headroom, the Act requires that all suppliers are able to finance their efficient costs.
224. We have calculated the extent to which a socialisation of 51% would leave British Gas unable to cover the costs of its standard credit customers on default tariffs. This shortfall is equal to £✕ per dual fuel account.
225. This calculation has been carried out based on the both the 51% socialisation, and assuming that Ofgem adopts our proposal (set out below) to equalise the payment method differential across fuels. Should Ofgem not adopt these changes, the resulting shortfall would be greater (£✕ per dual fuel account).
226. This shortfall is a conservative estimate of the amount that Ofgem would need to add to headroom, since:
- a) It takes as given the payment method costs calculated by Ofgem. As discussed below, we have serious reservations regarding the benchmarking exercise that Ofgem has carried out. Should Ofgem correct its benchmarking, it is likely that the shortfall calculated above would increase. However, Ofgem has not provided access to the supplier-level data that we need to carry out this correction.
 - b) There are likely to be suppliers with a greater proportion of standard credit customers. To meet the requirements of the Act, Ofgem must ensure that *all* suppliers are able to finance their efficient costs of supply.

The payment method uplift should be allocated equally across fuels

227. Ofgem’s methodology has been designed in a way that “*broadly reflects the payment method differentials currently in the market*”. We explained above how the dual fuel payment method differential Ofgem is allowing is lower than those seen in the market.
228. However, focussing on dual fuel figures hides another clear discrepancy between the level of the cap and the tariffs in the market. The table below shows the payment method differentials observed in the market, and allowed by the cap. The payment method uplift allowed by the cap for gas customers is around two-thirds of the uplift allowed for electricity customers. This is manifestly different to the average payment method differentials in the market, which are almost identical across fuels.

⁶³ Results based on Ofgem’s supplementary model – default tariff cap level.

	Average large supplier payment differential (at TDCV, inc VAT) as of July 2018	Payment differential implied by the cap methodology for Summer 2018
Electricity	£45	£45.21
Gas	£45	£30.76

Ofgem must equalise the “socialised” element of the uplift across fuels

229. The most glaring inconsistency in Ofgem’s approach is the way in which the socialised element of the payment method uplift is different across fuels. **There is no justification – economic or otherwise – for unequal distribution of the socialised SC costs across electricity and gas DD customers.** At the very least, Ofgem must equalise this element of the uplift. We have calculated (based on the 51% socialisation outlined above) that this would result in the following 2017 payment method uplifts.

	Before equalisation	After equalisation
Elec SC uplift	56.80	55.99
Elec DD uplift	9.63	8.83
Differential	47.17	47.17
Gas SC uplift	42.22	43.03
Gas DD uplift	8.02	8.83
Differential	34.20	34.20

Ofgem must further equalise the “non-socialised” element of the uplift across fuels

230. Although equalising the “socialised” portion of the differential is essential, the cap would still (as shown above) lead to payment differentials that are different for gas and electricity – contrary to what is observed in the market and therefore contrary to Ofgem’s rationale for socialisation.

231. In order to ensure full consistency with its own logic, Ofgem should equalise the entire payment method differential (both the “socialised” and “non-socialised” elements)

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between fuels. In the table below, we have calculated a set of headroom parameters (PAACo and PAP) which allow this.⁶⁴

	Ofgem's proposal	Amended figures
Gas SC PAACo	13.32	14.73
Gas SC PAP	5.71%	8.10%
Gas DD PAACo	4.47	3.87
Gas DD PAP	1.13%	1.15%
Elec SC PAACo	12.84	14.73
Elec SC PAP	8.24%	7.18%
Elec DD PAACo	4.50	3.87
Elec DD PAP	1.44%	1.02%

232. It is important to note that these changes result in shifting the uplift between fuels, rather than increasing the cap. Indeed, the reduced socialisation of the differential would both allow the headline dual fuel cap for DD customers to fall, and means that less needs to be added to headroom to ensure that all suppliers are able to finance their efficient costs.

Ofgem's benchmarking methodology is flawed

233. Ofgem has chosen to benchmark the payment method differential:

- a) Separately from all other operating costs;
- b) Separately by gas and electricity; and
- c) Separately for each of the three cost categories within the payment method differential.

234. Such an approach is entirely inconsistent with how Ofgem has carried out benchmarking for the main opex allowance. It leads to a risk that the uplifts will be based on a set of results that do not reflect what is obtainable by an actual supplier. Moreover, given Ofgem's refusal to make available the data underlying its approach, it is impossible for Centrica to properly judge the extent of any errors that this approach may have produced.

It makes little sense to benchmark a differential in this way

235. Ofgem is benchmarking the costs associated with SC customers separately to its benchmarking of all other operating costs. However, a firm may have a low payment method differential between DD and SC as a result of incurring relatively high DD costs, rather than low SC costs. It would be more consistent for Ofgem to use the payment method differentials of the benchmark company chosen in its opex analysis.

Separately benchmarking values for gas and electricity leads is incorrect as it is possible for suppliers to allocate costs between fuels in different ways

236. We understand that Ofgem has separately benchmarked the lower quartile differential for both gas and electricity, and for each component of the cost differential. By picking

⁶⁴ These figures are subject to the rounding in Ofgem's published figures.

the most efficient supplier for each *reported* cost category, Ofgem's new proposal implies the existence of an efficient supplier that does not exist in reality. There is significant risk of error in Ofgem's proposal because suppliers may not have a consistent approach to cost allocation across fuels. Ofgem's approach to benchmarking is one factor which may have led to the unrealistic split of the payment method uplift between fuels described above.

237. Ofgem recognised this risk for the opex allowance and is proposing to use a dual fuel benchmark. In Appendix 6 para 2.32, Ofgem stated:

However, for some suppliers in our sample, costs per customer were very similar for both fuels. There was evidence to suggest that this was a result of how suppliers had allocated costs – simply pro-rating costs according to customer numbers - rather than these suppliers being relatively more efficient for gas, relatively less efficient for electricity. Given this, we concluded that carrying out our benchmarking exercise separately for gas and electricity created a risk that we might set the benchmark artificially low for gas.

For this reason, we propose to choose our benchmark by comparing suppliers' total operating costs per customer account, rather than benchmarking gas and electricity separately. That is, for each company, we propose to take total operating costs in £m, combined across gas and electricity, and divide by the total number of gas and electricity accounts. We propose to use this combined measure of operating costs per account in our benchmarking analysis.

238. As explained above, these very same issues are present for the benchmarking of payment method differentials. Ofgem should therefore adopt a consistent approach for SC uplift and use a single benchmark supplier for both fuels and allocate the extra SC costs across electricity and gas equally since this reflects market practice. It is irrational and unreasonable for Ofgem to accept these concerns in one context, and yet ignore them and take an entirely different approach in a different context without providing any reasons for the inconsistency.

Benchmarking separately for bad debt, working capital and other administrative costs ignores the trade-offs that may take place between these categories.

239. In its opex benchmarking, Ofgem acknowledged that there may be substitutability between different categories of expenditure. As a result, it carried out its benchmarking at the level of total operating costs, rather than individual cost lines.
240. Such issues exist equally when benchmarking the payment method differential. For example, one component of "other administrative costs" relates to debt recovery. A supplier may choose to spend more on debt recovery in the expectation that this will reduce levels of default (and therefore bad debt charge).
241. In the presence of such trade-offs, it is incorrect to benchmark individual aspects of the payment method differential. Doing so – as in the case of benchmarking fuels individually – may lead to an unachievable benchmark.

Ofgem has not permitted Centrica or its advisors to access the data on which the analysis is based

242. Ofgem’s analysis is based entirely upon the data which suppliers have provided to it. However, Ofgem has not let Centrica see this data and it has not been disclosed to Centrica’s advisors within the controlled environment of the Disclosure Room. This is in marked contrast to the CMA, which permitted the release of firm-specific payment method differential data as part of its confidentiality ring. Towerhouse LLP explains in the Legal Annex on procedure that Ofgem’s approach is unprecedented and seriously flawed.
243. Ofgem attributes some of the difference between these results and those in the May consultation to “...*corrections to the data after additional quality assurance*”.⁶⁵ This is a vague statement. Not allowing stakeholders to understand and see exactly what Ofgem has done is a breach of requirements for procedural fairness.

The percentage element of the uplift leads to significant operational issues

244. Ofgem has proposed to apply the working capital and bad debt components of the payment method uplift as a percentage.
245. Centrica has concerns regarding the operational impact this will have on suppliers’ systems, and the knock-on effect on customers. A change from a DD discount reflected solely in the standing charge, to a discount with both fixed and variable elements, adds complexity and potential confusion when communicating this to customers and makes tariff comparisons harder.

SMETS2 (and “fully interoperable” SMETS1) prepayment meters

246. We are very concerned about the unintended consequences of Ofgem’s proposal for PPM customers with traditional and SMETS2⁶⁶ 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).
247. 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.
248. 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,

⁶⁵ September consultation, Appendix 9 para 2.11.

⁶⁶ Or fully interoperable SMETS1

including those with SMETS2 meters to mitigate the risk to the rollout of smart prepay meters that we have identified.

249. We explain these concerns and our proposed interim solution further below.
250. Ofgem’s proposals for SMETS2 and “fully interoperable” SMETS1 prepayment meter customers are set out only briefly in Appendix 8⁶⁷ and summarised in Section 5 of the overview document as follows:
- “We do not propose to have a separate cap within the default tariff cap for customers with a SMETS2 meter in prepayment mode. There are very few SMETS2 smart meters rolled out to consumers, so we do not yet have reliable data on the actual costs of SMETS2 meters in prepayment mode. As such we are not able to make a reliable estimate of the separate cap level that would be appropriate. However, this is an area that we will keep under review”⁶⁸*
251. We understand that the Act requires Ofgem to make some provision for PPM SMETS2 meters insofar as they relate to default tariffs. This is because, unlike other prepayment meters within scope of the PPM cap, they are not exempted. However, we see very substantial difficulties with this proposed approach that Ofgem does not appear to have considered in both the supplier switching journey and the smart upgrade journey. These difficulties are entirely avoidable by specifying a separate set of rates within the default tariff cap for PPM SMETS2 meters which are identical to the PPM cap rather than identical to the proposed Direct Debit default cap.
252. The fundamental difficulty with applying different caps to different types of prepayment meter is that although the headline level of the cap is broadly the same at TDCV, the PPM cap and the proposed default cap have different standing charges and unit rates. To apply separate caps therefore requires separate tariffs, in turn requiring a capability to accurately and reliably identify customers’ meter asset type in advance, and an ability to migrate customers from one tariff to another if the designation of their meter changes (as will be the case when the CMA directs that SMETS1 meters are sufficiently interoperable to fall outside the PPM cap).
253. In the smart roll-out, a tariff change (requiring a consumption based personal projection) would have to be added to the journey increasing complexity for the customer and likely reducing uptake of smart meters. As the standing charge/unit rate mix is different for the PPM and Default Caps, some customers may have a higher quote and be deterred from taking a smart meter. This could arise either as a result of SMETS2 meter installation, or as a result of SMETS1 re-designation. Informing the customer of this possible price increase would make it more difficult for us to promote the Smart meter to a PPM customer.
254. When switching, in order for a customer to get a correct projection, they would need to know if they had a traditional/SMETS1/ SMETS2 meter when getting their quote to switch. This is likely only possible if they know their meter number. As most customers are unlikely to know where to look for their meter number, the additional effort is likely to further reduce switching among prepayment customers. For those customers who do

⁶⁷ September consultation, Appendix 8 paragraphs 2.2 and 2.3.

⁶⁸ September consultation, Overview document at 5.17.

make the effort, there is a risk that they get it wrong, creating a poorer experience when the supplier has to switch their tariff post-acquisition, possibly increasing what they pay.

255. These unintended consequences are entirely avoidable by ensuring that a single cap applies to all prepayment meters, which can be supported by a single tariff. In the short term, as a stop gap, Ofgem can achieve this by specifying that SMETS2/excluded smart meters are subject to the same cap rates (within the default tariff cap) as other prepayment meters. Separately, the methodology underpinning the existing prepayment meter cap requires review and we urge Ofgem to pursue such a review urgently with the CMA to ensure a cap that allows appropriate recovery of efficiently incurred costs in general and smart meters in particular.

Appendix 9: EBIT

Ofgem has not properly engaged with the concerns expressed by stakeholders with regard to its proposals for EBIT

256. Ofgem is proposing to use a 1.9% EBIT margin for the purposes of calculating the price cap, on the basis that this was the margin calculated by the CMA in the Energy Market Investigation for a supplier who is carrying out trading activities itself. We set out a number of concerns about this approach in response to Ofgem’s May consultation. The summary of stakeholder feedback that Ofgem has provided in Appendix 9 of its statutory consultation document confirms that we were not alone in voicing such concerns. Ofgem reports that only one consumer group and one supplier supported Ofgem’s overall approach, whereas “several” suppliers highlighted a range of issues.
257. Ofgem has not properly engaged with these concerns in the statutory consultation. Instead, it has used the CMA’s approach in the context of the PPM price cap to avoid engaging with the concerns that stakeholders have raised.
258. The table below illustrates the extent to which Ofgem has relied on CMA precedent (and specifically CMA precedent from the Energy Market Investigation rather than in more recent market investigations where the CMA has adopted a different approach to assessing economic profitability), rather than engaging with the substance of the concerns that Centrica and other stakeholders have raised.

Issues raised by Centrica / other stakeholders	Ofgem’s response
Adopting the CMA’s analysis would be inconsistent with Ofgem’s previous use of EBIT benchmarking as part of the Retail Market Review.	<ul style="list-style-type: none"> “We note the CMA’s expertise in this area, and are satisfied it was well placed to choose a robust approach.”⁶⁹
The CMA materially understated the working capital requirements of energy retail businesses, since they only allowed for average working capital requirements when suppliers must in reality hold sufficient working capital to allow them to cover their peak requirement. For a large supplier, this additional working capital can be highly material – by our calculations in excess of £300m.	<ul style="list-style-type: none"> “The CMA carried out an in-depth review of profitability as part of its market investigation. While we accept that judgements are inherent for this approach, we have no reason to believe that we would necessarily be able to develop a more robust answer for the amount of capital employed than the CMA.”⁷⁰
The CMA’s methodology did not make adequate allowance for the risk/contingent capital that a large stand-alone supplier would need to hold in order to be able to withstand short-term losses that suppliers will periodically face as a	<ul style="list-style-type: none"> [As above]

⁶⁹ September consultation, Appendix 9, para 3.6.

⁷⁰ September consultation, Appendix 9, para 3.32.

<p>result of unpredictable demand shocks that are beyond their control. These risks of short-term losses – and therefore the need to hold capital – arise irrespective of the supplier’s chosen hedging strategy. Since suppliers cannot immediately adjust their tariffs in response to these shocks, they must set capital aside to ensure that they can withstand periodic losses.</p>	
<p>The CMA’s assessment of capital requirements for regulatory collateral was based on errors in approach. The CMA assumed that suppliers could rely primarily on letters of credit rather than setting aside any capital for this purpose. However, it provided no evidence to substantiate its assumption that a large standalone supplier would have access to such facilities on the terms that its methodology assumed, particularly given the extremely thinly capitalised business model that the CMA was envisaging that such a supplier would operate.</p>	<ul style="list-style-type: none"> • [As above]
<p>In both of the market investigations that it has undertaken since the Energy Market Investigation, the CMA has avoided attempting to estimate firms’ capital costs for the purposes of informing its thinking about the competitive EBIT margin. In the case of the current investigation into investment consulting, the CMA cited the difficulties associated with “the identification and measurement of intangible assets” in an industry with comparatively few tangible assets as a major factor contributing to its decision not to pursue such an analysis.</p> <p>This suggests that the CMA may itself have changed its views of the value of attempting with estimating quantify capital costs in such industries in light of the difficulties it encountered during the Energy Market Investigation.</p>	<ul style="list-style-type: none"> • “We should be cautious about interpreting the CMA’s analytical choices in particular investigations ... as implying a general change in its views.”⁷¹ • “It is possible to make adjustments to firms’ balance sheets to include some intangible assets for the purpose of assessing profitability. While this is not straightforward, the long process and multiple rounds of consultation followed by the CMA in the energy market investigation enabled it to make these adjustments.”⁷²
<p>Ofgem should use the mid-point of the CMA’s WACC estimates (10.25%) rather than the 10% figure proposed by the CMA, which has no evidential basis.</p>	<ul style="list-style-type: none"> • “[The CMA] was aware of stakeholder feedback that it should use the mid-point at the time of its final report. We do not propose to make piecemeal changes to the CMA’s analysis.”⁷³

⁷¹ September consultation, Appendix 9, para 3.8.

⁷² Ibid.

⁷³ September consultation, Appendix 9, para 3.21.

Ofgem’s reasons for not engaging with stakeholders’ concerns do not stand up to scrutiny

259. Ofgem cites three reasons for relying on the CMA’s analysis rather than engaging with the substance of the concerns that have been raised. Ofgem has not considered these reasons in light of the obligations set out in the Act, and these reasons do not meet the requirements of the Act (e.g., the obligation to allow efficient suppliers to recover costs in order to finance their activities).
260. First, Ofgem suggests that it has relied on the CMA because the CMA has expertise in the field of assessing economic profitability. While the CMA does have experience in this area, its thinking may have evolved: the CMA has decided not to pursue an ROCE/WACC analysis of profitability in either of its two most recent investigations. Ofgem cautions against jumping to the conclusion that the CMA has changed its view on this basis. However – given the degree of faith Ofgem has placed in the CMA’s experience in this field compared to either its own limited experience or the views of industry stakeholders – it is incumbent on Ofgem to consult the CMA to confirm whether its thinking has evolved. Ofgem has provided no indication that it has consulted with the CMA to determine whether its views have changed. In any event, Ofgem – like any other decision maker subject to public law – is under an obligation not to surrender its independent judgment by insisting on following the CMA’s approach and adopting the CMA’s decision. There is a significant body of case law showing that decision makers are not entitled to refuse to engage with the merits of a concern raised in consultation on the basis that a third party has already made a decision which the decision maker wishes to follow.⁷⁴ Ofgem must engage with the merits. It cannot defer to the CMA’s expertise.
261. Secondly, Ofgem suggests that it would not be proportionate for it to develop its own estimate of suppliers’ capital requirements “and potentially delay protection to default tariff customers, given that this is a temporary cap”.⁷⁵ Ofgem appears to be making three points here:
- a) time and resource constraints would make it challenging for it to conduct a proper assessment of these issues itself;
 - b) given this, time constraints override some of the mandatory considerations of the Act; and
 - c) the cap is only temporary.
262. None of these statements provide an acceptable reason for not engaging with the concerns that stakeholders have raised about the inconsistency of a 1.9% EBIT allowance with the requirements of the Act:
- a) For the reasons we have explained above and is clear from the legal opinion from Counsel, the need to ensure financeability is a mandatory consideration which

⁷⁴ e.g. *R v Special Adjudicator, ex p Paulino* [1996] Imm AR 122; see generally Fordham, *Judicial Review Handbook: 6th Edition*, section 50.2.

⁷⁵ September consultation, Appendix 9, para 3.35.

Ofgem is required to have regard to, including by conducting a full and proper assessment of whether each element of its decision is consistent with that need. Ofgem is legally wrong to think it can dispense with the need to take this matter into account; and

- b) The temporary nature of the cap (which will in fact last for a number of years) does not provide any justification for introducing a price cap that does not meet the requirements of the Act.

263. Third, Ofgem repeatedly states that it would be wrong to make “piecemeal changes” to the CMA’s analysis, on the basis that it would not be “reliable” and “would not necessarily improve the accuracy of the end result.”⁷⁶ We agree that a full reassessment of the CMA’s assessment would be preferable to making small changes, but Ofgem is wrong to decide that making such changes (even where there is clear evidence to support them) would be worse than leaving the methodology completely unchanged. In any event, contrary its stated position, Ofgem is, in fact, proposing to make certain changes to the CMA’s approach to EBIT: following feedback from stakeholders, it is proposing to replace the CMA’s approach to updating EBIT over time (in line with CPIH) with a different approach (involving keeping the EBIT margin as a percentage).⁷⁷ Ofgem does not explain why it considers this change to the CMA’s methodology to be acceptable, while simultaneously arguing that “piecemeal changes” would be inappropriate. Ofgem’s approach is inconsistent, irrational, and without proper justification.

To satisfy the financeability requirement of the Act, Ofgem must either revisit the 1.9% EBIT allowance or provide additional cost uncertainty headroom to account for this

264. For these reasons, the concerns that Centrica and other stakeholders have expressed about the proposal to use a 1.9% EBIT margin still stand. A balanced assessment of the evidence provides clear reasons to believe that an efficient standalone supplier of scale will be unable to cover its cost of capital and therefore be unable to finance its activities. As we have explained and evidenced in previous submissions, we consider that an EBIT of 4-6% is required to allow a standalone supplier of scale to cover cost of capital.⁷⁸

265. The most effective solution would be to revisit and engage with the substance of the concerns that stakeholders have raised on EBIT. Failing this, however, Ofgem must at the very least adopt a prudent approach and – recognising that it has not carried out a systematic analysis of the issue – build additional headroom into the price cap to account for this source of cost uncertainty.

266. Ofgem’s failure even to make allowance for uncertainty around its estimate of the required level of EBIT in this way directly infringes the Act’s requirement to have regard to the need for suppliers to finance their activities authorised by the licence. In Appendix 9, Ofgem itself explicitly recognises – and indeed emphasises – that any assessment of the appropriate level of EBIT requires “inherent judgements” to be made

⁷⁶ September consultation, Appendix 9, paras 3.21, 3.23 and 4.9.

⁷⁷ September consultation, Appendix 9, para 4.8.

⁷⁸ See, for example, Centrica response to Ofgem’s May consultation, paras 258-264.

about costs that are difficult to measure with a high degree of certainty.⁷⁹ Ofgem has accepted the principle that headroom should be built into the cap to cover such sources of cost uncertainty. However, the current proposals make no such cost uncertainty headroom allowance for EBIT.⁸⁰ This approach will hinder efficient suppliers' ability to finance their activities, contrary to the Act. It is also inconsistent with Ofgem's own stated principles and approach to other elements of the price cap methodology.

⁷⁹ See, for example, September consultation Appendix 9, paras 3.28 and 3.32.

⁸⁰ Table A2.1 of Appendix 2 of the September consultation superficially suggests that Ofgem has allowed £1 of headroom for uncertainty around the level of EBIT. However, we understand this is only intended to cover uncertainty around the size of the cost base by which the 1.9% EBIT margin must be multiplied. It does not cover uncertainty around whether 1.9% is a sufficient percentage margin to cover suppliers' cost of capital, which is the issue at stake here.

Appendix 10: Exemptions

Exemption of renewable tariffs

267. We do not disagree with Ofgem's proposals regarding exemption for renewable electricity and/or gas SVTs.

Exemptions for vulnerable consumers on the existing safeguard tariff

268. Ofgem is proposing to apply the Direct Debit cap to Standard Credit customers receiving the Warm Home Discount. Ofgem is proposing to do this to avoid such customers facing an immediate increase in bills once the new price cap is introduced. In principle we do not disagree with this aim. However, it does mean that suppliers will not be able to recover the efficiently incurred costs associated with these customers.

269. We support the removal of the existing safeguard tariff given that it was only designed as a temporary stop gap and Ofgem has done no work since that time to update it and improve its accuracy. However, if Ofgem transfers all existing safeguard tariff consumers onto the Direct Debit level of the proposed default tariff cap, even if they are standard credit (SC) customers, an allowance for the extra cost needs to be provided for in order for efficient suppliers to be able to finance their activities.

270. This proposal, which Ofgem has not consulted on previously, is not provided for within the calculation of the cost allowance on which the cap is based. It is also not mentioned in the Impact Assessment.

271. We understand Ofgem's desire to protect customers it considers to be vulnerable from higher prices. These customers already benefit from the WHD, which is a £140 annual discount. In order to maintain compatibility with the Act, Ofgem must socialise the extra costs across other customers by increasing the level of the DD cap. The socialisation must be done in a way which does not mean efficient suppliers with a higher proportion of WHD customers on standard credit are unable to finance their activities authorised by the license.

272. We do not have data on other suppliers' customer base by payment method and WHD status. However, based on our own default tariff customer base (and using payment method uplifts consistent with those we set out in appendix 8), we have calculated the average loss per customer as follows:

- a) During 2017, British Gas had ✕ customer accounts on default tariffs who were both in receipt of Warm Home Discount and paid by standard credit.
- b) We have amended Ofgem's payment method uplift calculations to take account of a reduced rate of socialisation and to equalise the PM uplift across gas and electricity. These calculations indicate there would have been a £✕ standard credit uplift for both fuels in 2017 (this is pre-VAT).
- c) Multiplying this figure by the number of customer accounts above suggests that we would have been unable to recover around £✕m of costs.

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- d) Dividing this number by the total number of SVT credit customers (6.04m) gives an average unrecovered cost of £✕ per account
 - e) This equates to around £✕ per dual fuel account.
273. The loss of the standard credit uplift for each WHD customer would therefore cost on average £✕ per default tariff customer. This may be an understatement of the impact on the most affected supplier, other suppliers may have a higher proportion of their customers that are standard credit WHD customers than British Gas.
274. Unless this proposed exemption is dropped or adjusted for, through socialisation of the costs it imposes, this would add further to the issues of financeability, contrary to the obligations of the Act. Ofgem cannot ignore how the costs of the exemption it proposes will be recovered.
275. As well as the impact on suppliers, it will also have significant negative implications for customers. Acquiring a WHD SC customer would come with a very associated large loss (£✕) meaning that they have less choice in the market.
276. As far as we can tell, neither of these implications is properly assessed in Ofgem's Impact Assessment. This is contrary to Ofgem's obligations to properly consider and quantify the "net benefit or cost of options" as required by the Impact Assessment Guidance. Ofgem's counterfactual to the default tariff cap appears to be a continuation of safeguard tariff, past the date on which it is due to lapse. This is clearly contrary to good practice, and is clearly not the appropriate counterfactual for Ofgem to be considering in its assessment.