Making a positive difference
for energy consumers

All Stakeholders

Email: retailpriceregulation@ofgem.gov.uk

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Default tariff cap: Webinar materials and stakeholder questions

Dear Stakeholders,

The Domestic and Electricity (Tariff Cap) Act came into force in July 2018. On 6 September 2018 we published a statutory consultation on our proposals (as required by the Act) for the design and implementation of a default tariff cap.

To support stakeholders in understanding our proposals and answer any questions, we hosted two webinars on 27 September 2018.

We recognise that not all stakeholders may have been able to attend the webinars. Today, we have published the presentation[1] and in an annex to this letter, we have also included a list of the questions we received and our answers.

Yours faithfully

Anna Rossington

[1] The layout of the slides may differ from the presentation used during the webinar. This is to help stakeholders follow the content without the aid of a voiceover.

Annex 1: Webinar questions and answers by topic

Benchmark methodology

1. **Question: Where does the acquisition cost sit (either direct supplier cost or broker cost) in the bottom-up approach? Is it in the operating costs?**

   Answer: We account for acquisition costs in operating costs. We make adjustments to ensure consistency between the way suppliers recognise these costs (ie whether they are capitalised or not, and how long they are amortised for). Please see Appendix 6 in the consultation for further detail.

Potential impact of default tariff cap

2. **Question: How does Ofgem's comment that switching could be reduced by 33% to 50% reconcile with "maintain incentives to switch"?**

   Answer: The Act requires the Authority to exercise its functions with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must – amongst other requirements as set out in the Act - have regard to the need to maintain incentives for domestic customers to switch to different domestic supply contracts.

   We consider our proposed cap level satisfies the Act and discuss this in Appendix 2. There are over 70 suppliers in the market and the majority of these offer tariffs which, if the cap was introduced today, are below the cap level and maintain incentives for customers to switch to cheaper Fixed Term (FT) tariffs.

3. **Question: The presentation states on slide 10 that 96% would have saved. 96% of what? All UK customers or those on SVTs?**

   Answer: Slide 10 states that 96% of "customers" in 2017 would have seen a bill reduction. More precisely, this 96% is a proportion of all SVT accounts, treating gas and electricity separately. This means that the remaining 4% includes electricity accounts that may have seen no change or increases in their bills, however this may have been offset for a customer if their gas bill reduced to a greater extent. FT customers are not included in this figure.

4. **Question: What analysis has Ofgem undertaken on the impact on fixed tariff customers (potentially seeing higher prices)? If so, what is Ofgem's understanding of the net impact of this cap on customer bills across all customer types?**

   Answer: We present analysis on the impact of the cap on FT customers in the Draft Impact Assessment and discuss its significance in Appendix 2 of the consultation. The impact on customers on fixed tariffs is much more uncertain (than for SVT and default tariff customers) as supplier behaviour and customer behaviour is harder to predict. We state that we expect that some suppliers may increase their fixed tariffs to recover reduced SVT revenues, but this is uncertain as suppliers face greater competitive constraint on FT prices. If some suppliers do increase prices, their FT customers are more likely to be engaged and may choose to switch to maintain low prices, or choose to stay with their supplier as they see fit. As part of our decision making process we analysed scenarios where fixed prices remain largely unchanged and scenarios where many suppliers choose to increase fixed tariffs to offset revenue reductions from the default tariff cap.

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5. **Question: When looking at the cheapest prices in the markets are you including loss making deals?**

   Answer: We looked at the cheapest tariffs in the market in our analysis to understand the impact that the cap might have (for example, on price dispersion), but we have not used data on the cheapest prices in the market to set the cap.

   When assessing the impact that the cap might have, we considered the cheapest tariffs (which may include loss making tariffs), but our analysis is not limited to these tariffs. We considered the range of tariffs available in the market, and that could be available following the introduction of the default tariff cap; and the impact that these tariffs, when considered together, would have on customers' incentives.

6. **Question: What will Ofgem do if the price cap significantly reduces switching and competition?**

   Answer: In our consultation we explain that we expect a reduction in switching rates (Draft Impact Assessment and Appendix 2). We note that a number of other factors will have an impact on competition and switching. We will keep switching rates under review as part of our wider monitoring role, and consider the changes in the context of other indicators, to assess the impact on consumers and their interests.

Wholesale

7. **Question: The wholesale cost is a calculated figure. What period was used for the last calculation and what period will be used for the April update?**

   Answer: The wholesale cost that would be used for the first cap period (up to 31 March 2018) is a weighted average of contracts that would be delivered between October 2018 and September 2019. The allowance is set using an average of the prices of those contracts observed between February 2018 and July 2018.

   The wholesale cost for the second cap period (April 2019 to September 2019) would be a weighted average of contracts that would be delivered between April 2019 and March 2020. The allowance is set using an average of the prices of those contracts observed between August 2018 and January 2019.

   Please see Appendix 4 of the consultation for further detail.

8. **Question: Will Ofgem be considering making a one-off exception to the wholesale cost component of the model to account for recent surges in wholesale costs?**

   Answer: We will consider how effectively our proposed approach to setting the wholesale allowance provides for wholesale costs as part of the consultation process. We will also consider alternative approaches or adjustments as part of that process, and welcome stakeholders to submit their views.

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9. **Question: The impact of the proposed suspension of the Market Making Obligation has not been modelled. Impacts could be: wholesale reference price becomes a less reliable indicator of suppliers' wholesale costs; carries a greater risk of 'gaming' the wholesale price to impact the wholesale allowance under the cap; and has disproportionate impact on non-vertically integrated suppliers.**

   Answer: We are aware of recent developments around the Market Making Obligation (MMO), and are working with the relevant policy team during the review of the policy. We have separately considered the impact on liquidity in our September Consultation (please see Appendix 4). We welcome any further evidence on this issue and on its implications for suppliers. We will consider evidence provided in our final decision.

10. **Question: How do you source the wholesale price?**

    Answer: We propose that the wholesale price data is provided by ICIS. Details are provided in Appendix 4 of the consultation, alongside the full methodology.

11. **Question: Have Ofgem considered reviewing UIG costs in line with XOSERVE's analysis of industry costs post- Nexus? These seem to diverge as the most recent analysis shows UIG costs are at 4% instead of Ofgem's benchmark of 0.96%? We would suggest reviewing these in line with the Smart costs review in October 2019?**

    Answer: In Appendix 4 of our consultation we consider the impact of reforms to UIG and the volatility and uncertainty currently surrounding those costs. We anticipate that this will reduce over time, as incentives and processes are in place, and we have the ability to assess whether this is the case over time. In Appendix 3 we set out more broadly our approach to potentially unforeseen trends in underlying costs.

12. **Question: Could Ofgem provide some insight into why they have chosen to use fiscal and calendar years to benchmark Capacity Market costs? Our analysis shows this would mean the cap lags behind as outturn diverges from forecast?**

    Answer: The approach provides greater consistency with our treatment of other wholesale periods.

Updating the cap

13. **Question: Ofgem is [proposing to] set the cap every 6 months. What will Ofgem do if wholesale prices suddenly and sharply rise after Ofgem has set the cap? Suppliers may not be able to continue to operate at a loss. Are there emergency contingency plans to complete an emergency interim review and what would trigger this activity?**

    Answer: We discuss how we propose to address unforeseen trends in underlying costs in Appendix 3 of the consultation. We propose not to include any provision to modify the level of the default tariff cap mid-period. We do not consider this necessary given that we will be updating the cap at six monthly intervals, and noting that we have included some headroom in the cap to reflect the uncertainty affecting our estimates of efficient costs. We welcome any views on the mechanisms included in the cap to address unforeseen trends in costs in responses to the consultation.

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Policy and network costs

14. **Question:** **Do you foresee any impact on how the suppliers interact with networks? Will they have increased incentives to lower the initial reporting of AQ's for example?**

    Answer: Our proposals for the default tariff cap have been designed with the intention that suppliers are not able to influence the cap's level via their actions. Therefore we do not expect an impact on how suppliers interact with network companies. However, we would welcome any views on unintended consequences and how suppliers' behaviour could be affected in response to our consultation

15. **Question:** **How is the inter-dependency with SoLR treated? If there is no allowance for SoLR costs, there is presumably the possibility that suppliers will make full usage of the industry levy or result in higher tenders, both of which appear to be unintended consequences and against stated Ofgem preferences.**

    Answer: Last Resort Supply Payments are managed through network charges, and so would be included in the efficient cost allowance through the network allowance. However, to the extent that a failed supplier has bad debt (which exceeds credit requirements that are set out in industry codes), these may be spread across the industry through a variety of mechanisms and would not necessarily be included in the efficient benchmark allowance. The credit arrangements set out in industry codes are designed to reduce the risks of these costs being passed onto other industry parties.

16. **Question:** **Could Ofgem elaborate on their thinking regarding using OBR forecast data for FiT costs?**

    Answer: As a broad principle, we propose to set the level of the cap with reference to 'exogenous' cost data – information on trends in costs that is not produced by suppliers themselves, and cannot be influenced by suppliers' actions. We consider the OBR forecasts to be the most reliable publicly available official forecasts of the costs of the scheme that are available. Our comparison with the outturn costs suggest that our methodology would overstate the costs in some years and understate costs in others.

Smart meter costs

17. **Question:** **Can you explain in more detail what's assumed regarding smart meter costs in the baseline opex allowance?**

    Answer: We set the baseline operating costs by analysing 2017 total operating costs. This baseline is not broken down into different components, smart costs or otherwise. See Appendix 6 for more details. We have assessed whether the benchmark supplier had representative smart costs and rollout in 2017 and they were in the lower quartile. We increased their cost to the level of the average smart cost and rollout in the baseline years. From the baseline onwards we add the change in smart cost since 2017 as described in Appendix 7 of the consultation.

18. **Question:** **When are you starting the 2019 review of smart costs and how are you coordinating with the CMA who are conducting a mid-term review of the PPM price cap in January?**

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Answer: We will consider a range of information to review whether the assumptions around smart costs remain appropriate, or need to be updated from October 2019. We are aware that the CMA intends to review smart costs in the context of the PPM cap, and also that other reviews or data submission will be available to us. Our assessment will be separate, but take the views of others, not limited to the CMA, into account as appropriate.

Payment methods

19. **Question: Ofgem have [proposed to] introduce a fundamental change to the way in which direct debit discounts will be applied to customer accounts (which goes against the style of discounting that was previously abolished by Ofgem's RMR programme). Has Ofgem considered the ramifications on supplier deliverability of such a major shift in IT logic?**

    Answer: We are currently consulting on the proposals and are interested to hear any views suppliers or other stakeholders may have on how these proposals may be implemented. The potential effect on suppliers' operations will vary depending on individual company's circumstances, so we welcome stakeholders to specify their specific issues in their consultation responses.

Renewable tariffs

20. **Question: If a supplier only has one tariff and it is renewable can they be exempt from the price cap?**

    Answer: The tariff would not be automatically exempt under our current proposals, but a derogation could be applied for. We propose that derogations would only be granted to a qualifying tariff that customers actively choose. If a derogation is given, the supplier would still need to offer a default tariff (ie a second tariff) that was below the cap for customers who hadn't made an active choice.

21. **Question: Does that mean that if a renewable tariff is accorded a derogation then this cannot be the default tariff so if the supplier wanted to roll customers onto a green tariff this would absolutely not be able to be exempt under any circumstances?**

    Answer: We are proposing that suppliers can apply for a derogation for 'renewable' SVTs. However, to obtain a derogation, these tariffs, under the Act, should be actively chosen by the customer. If a supplier is granted a derogation for a 'renewable' tariff then a supplier still needs to offer a default tariff to its customers (for those who haven't made an active choice - ie those who roll off the end of fixed term contracts, or deemed customers who have moved into a property with the existing supplier). This default tariff must be equal to or below the level of the cap. The default tariff would not necessarily be a renewable tariff.

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22. **Question: If a supplier has a renewable variable tariff is this tariff exempt from the cap? If yes, will Ofgem publish exact criteria or will suppliers have to apply for exemption for each renewable tariff?**

Answer: See the answer above. If we proceed with our proposals, the renewable tariff would not be automatically exempt. Appendix 10 explains the outcomes we propose a supplier must meet for us to consider a derogation and we summarise them below. There is also a draft questionnaire included in this appendix explaining information that we would consider to assess a derogation.

23. **Question: How is a renewable tariff being defined? Is there a minimum percentage of renewable energy?**

Answer: We propose that a derogation from the default tariff cap rules could be granted if the supplier could demonstrate:

- the tariff is an SVT that consumers have chosen to be on;
- by consumers being on the tariff, support is given to renewables to an extent that is materially greater than that which is brought about as result of subsidies, obligations or other mandatory mechanisms; and,
- the cost to the licensee of supplying electricity/gas by virtue of the tariff is materially greater than the level of the default tariff cap for reasons that are directly attributable to the support that the tariff provides to renewables.

It would be up to the supplier to demonstrate in its derogation request that the tariff would meet these outcomes

24. **Question: Can you confirm whether REGO-backed actively chosen SVTs would be eligible for a derogation?**

Answer: As we have set out above, our proposals would require a supplier to demonstrate that the tariff supported renewables materially greater than that which is bought about as a result of existing subsidies, obligations or other mandatory mechanisms.

Conditions for effective competition

25. **Question: When will you consult on the conditions for removal of the cap?**

Answer: We outlined in our statutory consultation that we will continue to develop our approach to assessing conditions for effective competition, using feedback received to date. We will look to engage with stakeholders again in 2019 to support the development of the framework.

Communication and implementation

26. **Question: Do you imagine issuing guidance to suppliers about how they should communicate the cap to their customers?**

Answer: At the moment we do not have any plans to issue guidance on how suppliers should communicate the default tariff cap to their customers. We are currently consulting on changes to the rules around domestic supplier-customer

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communications[2] and welcome any stakeholder views on communication of the price cap to this consultation or our statutory consultation.

27. **Question: How will you monitor consumer understanding of the cap and any behaviour changes once it is in place?**

    Answer: We will develop our monitoring approach later this year.

28. **Question: When will the first cap come into force?**

    Answer: We aim to implement the cap at the end of the year. However, this decision is dependent on our assessment of the evidence that we receive in response to the statutory consultation. If we proceed with our proposals we will confirm the implementation date as part of our final decision.

29. **Question: What steps are Ofgem taking to ensure that suppliers do not make cuts to operating expenditure that undermine long term resilience in order to maintain a higher EBIT margin? For example, by driving down wages or pension benefits for staff, or cutting back on new investment?**

    Answer: Our compliance and enforcement role ensures that suppliers are accountable for the services they provide, and we are clear that suppliers will be expected to meet their licence requirements and service commitments. We will provide more detail on compliance alongside our decision and welcome views from stakeholders in their consultation responses.

30. **Question: Will Ofgem be conducting any specific cap compliance monitoring?**

    Answer: Yes. The statutory consultation does not include reporting requirements in the draft licence conditions. We will use our data gathering powers to assess compliance. We will provide information on this issue alongside our decision on the cap, after reviewing stakeholders' views.

31. **Question: Will Ofgem let suppliers know what type of evidence suppliers need to submit to support [compliance assessment of] assumed consumption splits?**

    Answer: Yes. As above. We will provide this information alongside our decision (if we decide to proceed).

32. **Question: Since you now have a view on a 'break even' cost for suppliers, have you considered excluding loss leading tariffs from Cheapest Market Offer Letter activity? It risks undermining consumer trust in energy suppliers if Cheapest Market Offer Letter are promoting tariffs which by Ofgem's own analysis are loss making and unsustainable.**

    Answer: We are in the process of reviewing our research activities in light of the price cap proposals. At the moment we do not have any plans to exclude these tariffs. As we have said in our earlier working papers, "loss leading" tariffs do not necessarily lead to poor outcomes for consumers and could be part of a legitimate business strategy for firms.

[2] Statutory consultation: Domestic supplier-customer communications rulebook reforms, Ofgem, 20 September, https://www.ofgem.gov.uk/system/files/docs/2018/09/statutory_consultation_-_domestic_supplier-customer_communications_rulebook_reforms.pdf

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33. **Question: Could Ofgem provide some further clarity on their expectation on how customers should be transferred from the Direct Debit cap to the Standard credit cap i.e. how many Direct Debits can a customer miss before we transfer them to the higher rate?**

    Answer: If we proceed with the proposals it will be up to the supplier to ensure all consumers are charged the correct rates respective to their payment method and comply with existing licence requirements.

34. **Question: How will a default fixed tariff be defined? For instance if a supplier auto-roll a customer onto a 1-year fix below the cap, Ofgem said that the default fix would also be subject to the cap.**

    Answer: Customer that are "auto-enrolled" onto a fixed tariff are considered to be default tariff customers, and that tariff would be subject to the default tariff cap. Any default tariff would have to be below the cap level.

35. **Question: Are Ofgem expecting suppliers to follow the 'dead tariff' process when transferring vulnerable Safeguard tariff customers from their existing tariff to the suppliers standard default tariff?**

    Answer: SLC 22D "Dead tariffs" sets out a general prohibition on suppliers creating new 'dead tariffs' (variable tariffs with no end date that are no longer open to new customers). If we proceed with the proposals, we will expect suppliers to comply with existing licence conditions.

36. **Question: In regards to suppliers that offer only standard variable tariffs, would these have any special consideration in regards to the cap. This is due to customers being aware of the charges when signing up, therefore customer overcharging would not apply?**

    Answer: The Act does not provide exemptions for SVTs in this circumstance – all SVTs will be subject to the default tariff cap.

Warm Home Discount consumers

37. **Question: How will Warm Home Discount customers who don't want to pay via Direct Debit be treated?**

    Answer: The cap will not affect how Warm Home Discount customers pay for their energy. The cap sets a maximum price they will pay, whatever payment method they choose. For Warm Home Discount customers this maximum will be set at the level of the Direct Debit cap, even if a customer actually uses Standard Credit. This ensures these vulnerable consumers receive the appropriate level of protection and prevents them from receiving a "step change" in their bills as a result of the default tariff cap.

38. **Question: How will Ofgem ensure that WHD recipients do not pay more in the medium term than they would have done if they continued to be protected by the safeguard tariff?**

    Answer: We consider the default tariff cap will provide a high level of protection for customers, including Warm Home Discount customers, as it ensures their bills reflect underlying costs for the period to time that the cap is in force (whether in the short, medium, or longer term).

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39. **Question:** **How will Ofgem work to ensure that WHD recipients continue to be protected once the default cap ends?**

Answer: We are focussed on ensuring that vulnerable customers – including but not limited to those receiving the Warm Home Discount – are appropriately protected during and after the cap. The form of that protection will depend on circumstances, and one of the conditions for removing the cap is that we expect a substantial change in how the market serves customers and enables them to engage. We will assess these developments and work with stakeholders to ensure that protection is in place and effective. This will include considering whether further price protection for a targeted group of vulnerable consumers is necessary.

40. **Question:** **Are customers on WHD automatically transferred to the default tariff cap? What if they wish to stay on a fixed term tariff?**

Answer: The Domestic Gas and Electricity (Tariff Cap) Act requires Ofgem to introduce a price cap for standard variable (SVT) and default tariff customers only. It does not apply to fixed term tariffs that a consumer has chosen (rather than defaulted on to). Under our current proposals, those SVT consumers in receipt of WHD and who are already protected by the WHD safeguard tariff would automatically be transferred onto the default tariff cap. We expect consumers, including vulnerable consumers, could still save money by switching (even if a price cap is in place) and we would encourage those consumers to continue to shop around for better deals.

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