

Default Tariff Cap – Statutory Consultation

Webinar



27/09/2018

- **Welcome and introduction**
- **Overview of statutory consultation**
- **Final questions to be submitted**
- **Break**
- **Question & Answer session**
- **Closing remarks**

Raise your hand:

At any point during the session you can raise your hand if you are experiencing difficulties. Please click the 'raise hand' icon and one of the facilitators will contact you directly.

Submit questions:

At any point during the session you can submit questions. This can be done by using the chat section. Questions will be answered at the Q&A session at the end of the slides.

Using responses:

As with our previous events, we use the views gathered to inform our decision making process. We still encourage you to express your views in a formal statutory consultation response which closes on 8 October 2018.

Any problems:

If you encounter any problems during the webinar please email stakeholders@ofgem.gov.uk

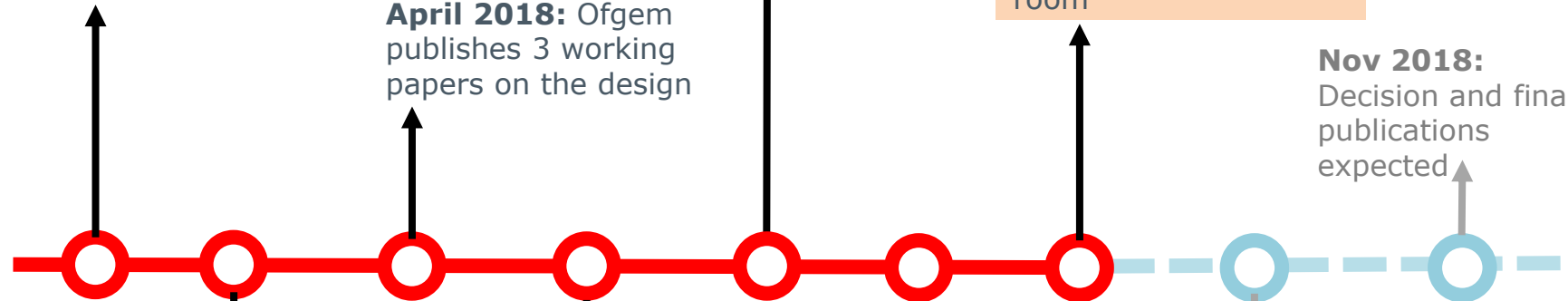
Feb 2018: Government proposes legislation to introduce a temporary tariff cap for customers on Standard Variable (SVT) and default tariffs

April 2018: Ofgem publishes 3 working papers on the design

June 2018: Ofgem hosts workshops and publishes early draft licence conditions

Sept 2018: Ofgem publishes its statutory consultation on the price cap design and launches a disclosure room

Nov 2018: Decision and final publications expected



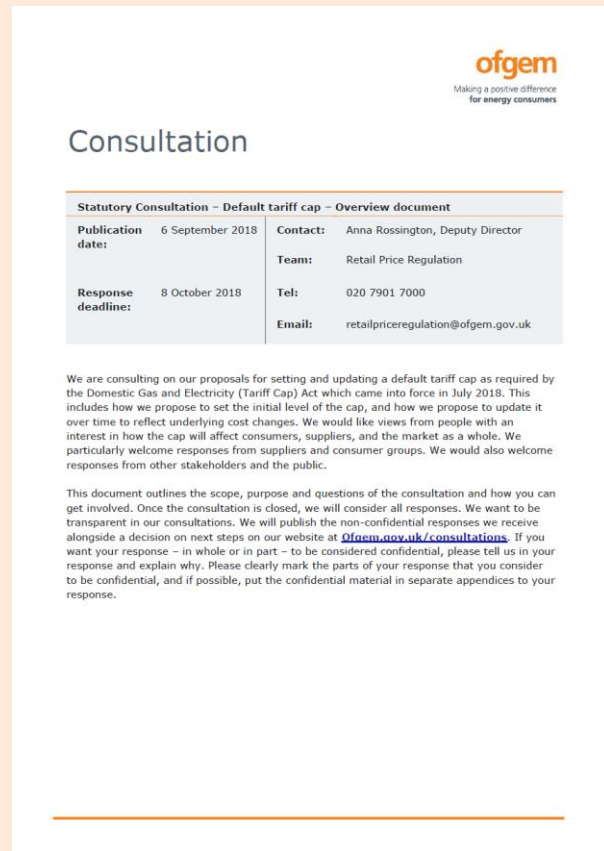
Mar 2018: Ofgem publishes an open letter providing an update of its plans and two working papers on the design

May 2018: Ofgem publishes the default tariff cap policy consultation

July 2018: The Act receives Royal Assent and Ofgem announces it's intention to not proceed with the vulnerable price cap

Oct 2018: Responses to the statutory consultation are due.

Our consultation sets out our proposed methodology for the Default Tariff Cap



- **The Act's** objective
- **Potential levels**, given the proposals
- **Potential impact**, considering the Act
- **Proposed methodology** for the cap
- **Scope of the cap**, including exemptions

On 19th July, Parliament passed the Domestic Gas and Electricity (Tariff Cap) Act

Purpose

- The Act requires Ofgem to introduce a temporary cap on standard variable and default fixed term tariffs as soon as reasonably practicable
- The **objective** of the Act is
 - to protect existing and future customers who pay standard variable and default rates.
- In designing the cap, **Ofgem has to have regard to:**
 - a) The need to create incentives for holders of supply licences to **improve their efficiency**;
 - b) The need to set the cap at a level that enables holders of supply licences **to compete effectively** for domestic supply contracts ;
 - c) The need to **maintain incentives for domestic customers to switch** to different domestic supply contracts; and,
 - d) The need to ensure that holders of supply licences who operate efficiently are able **to finance activities** authorised by the licence.

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Timing

- The price cap is a temporary measure until 2020 with possibility of extension until 2023. This means, as well as designing how the tariff cap works and implementing it, Ofgem will be required to:
 - **Review by 31/08/2020 whether the conditions are in place for effective competition, with recommendation to Secretary of State on whether the cap should be extended or not;** and,
 - Design the conditions for effective competition.
- These extensions would be for one year, with further reviews in 2021, and if required, 2022. The cap ceases to have effect at end 2023 at the latest.

Exemptions

- The Act gives the Authority some discretion to exempt SVTs that have been chosen by the consumer and that appear to the Authority to support the production of renewable gas or electricity.
- The Act stipulates that tariff cap conditions do not apply to consumers receiving protection from other tariffs caps in virtue of being deemed to be vulnerable due to their financial or other circumstances.
- **The Act requires Ofgem to consult on whether a renewable tariff exemption is appropriate, and if so, how to exempt the respective tariffs.**

The cap level differs depending on a customer's circumstances

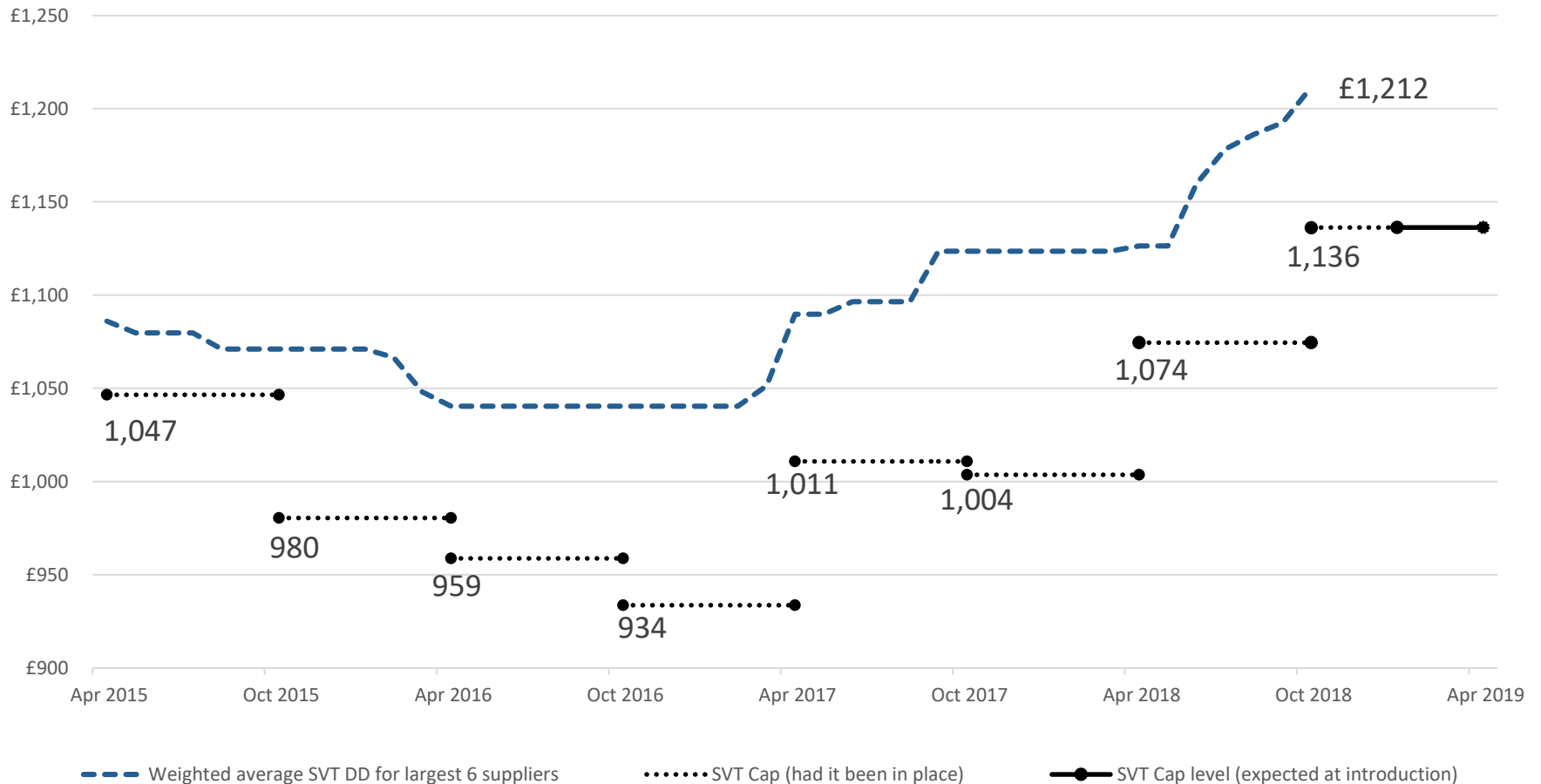
Table 1: potential cap levels in January 2019, including VAT, based on proposals

Cap	Fuel	Annualised standing charge	Annualised bill at typical consumption
Single rate, direct debit	Gas	£97	£539
	Electricity	£86	£597
	Dual fuel	£183	£1,136
Single rate, standard credit	Gas	£111	£573
	Electricity	£101	£646
	Dual fuel	£212	£1,219
Multi-register, direct debit	Electricity	£86	£734
Multi-register, standard credit	Electricity	£101	£792

Source: Ofgem

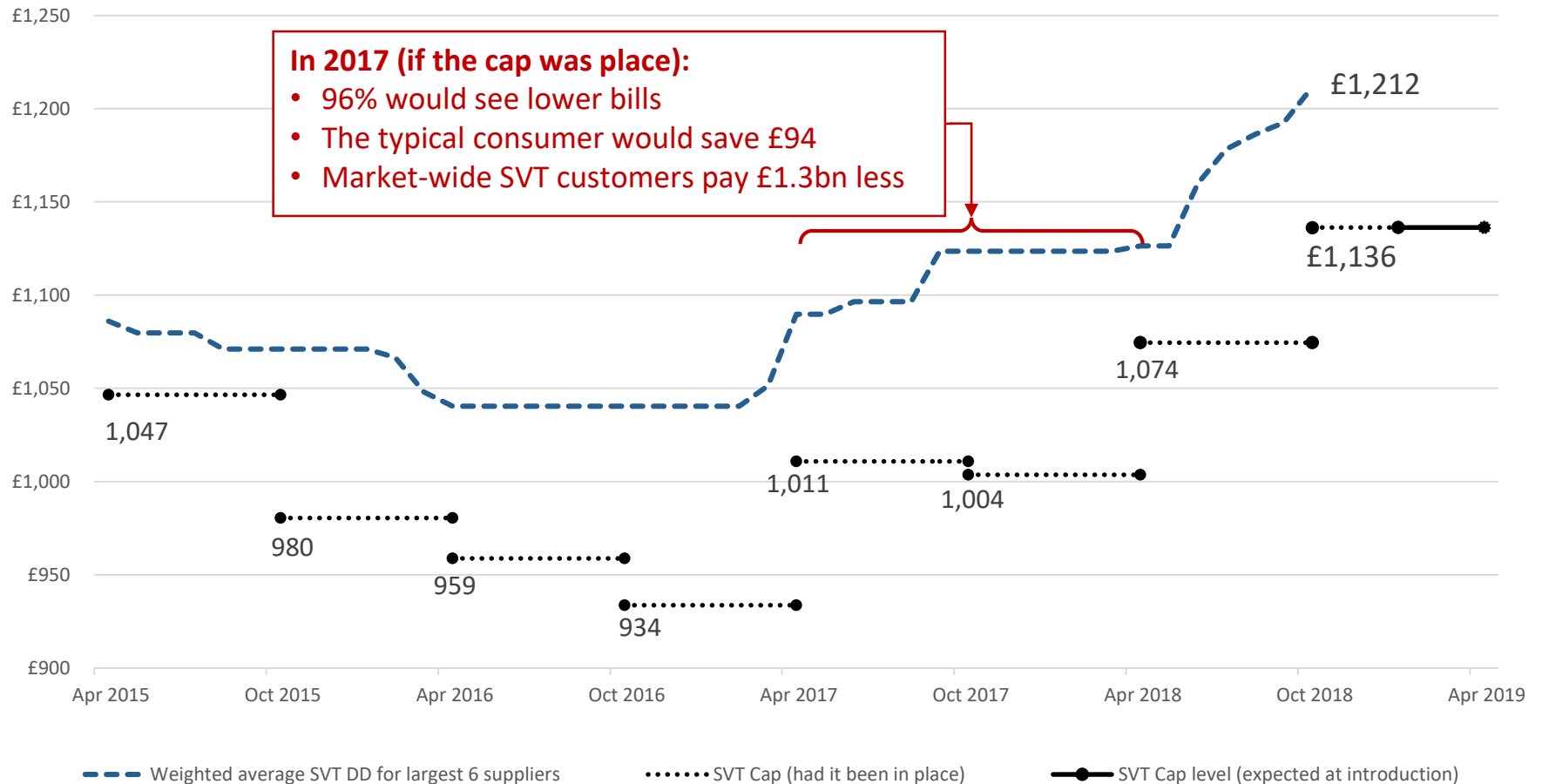
The cap would have reduced SVT prices by around £90 on average since April 2015

Direct debit annualised dual fuel bill (£ nominal)
For customers with typical consumption



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Direct debit annualised dual fuel bill (£ nominal)
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We propose to set the cap by estimating an efficient allowance for each cost component

	Dual fuel	
	Direct debit 2019 (£)	Standard credit 2019 (£)
Wholesale	444	444
Policy	137	137
Network	258	258
Operating costs	189	189
Payment method uplift	23	99
EBIT (profit margin)	20	21
VAT	54	58
"Efficient" Benchmark	1,124	1,149
Headroom	12	13
Cap	1,136	1,219

Setting allowances for each component

- **Wholesale, network and policy costs** - we propose to set allowances mostly based on external data (ie not from suppliers).
- **Operating costs** - we propose to base this on benchmarking analysis from suppliers' (with over 250,000 customers) historical expenditure. We are not proposing to break this down into more granular categories. As a result, the operating cost allowance includes the cost of smart metering.
- **Payment methods** - we propose to set a different cap for direct debit and standard credit. The payment differential is similar to the market average (£83 in 2019, but varies with underlying costs). We propose 60% of the bad debt and administrative cost will be spread across both payment methods. We plan to allocate all of working capital costs to standard credit.
- **EBIT (profits)** - we propose to allow a supplier to make a normal level of profit (an allowance of 1.9% before interest and tax).

We propose to set the cap by estimating an efficient allowance for each cost component

Table 7: Components of direct debit dual fuel benchmark 2017 – allowances for variation and uncertainty

Cost component	Efficient frontier	Additional allowances ¹	Total
Wholesale	364	3	367
Policy	117	0	117
Networks	258	0	258
Operating costs	146	23	169
SC costs allocated to all customers	21	0 ²	21
EBIT at 1.9%	17	1	18
VAT @ 5%	46	1	47
Benchmark	968	28	996
Headroom	0	10	10
VAT @ 5%	0	1	1
Total impact on DD customers	968	39	1007
Excluding VAT	922	36	959

Ofgem analysis, 2018

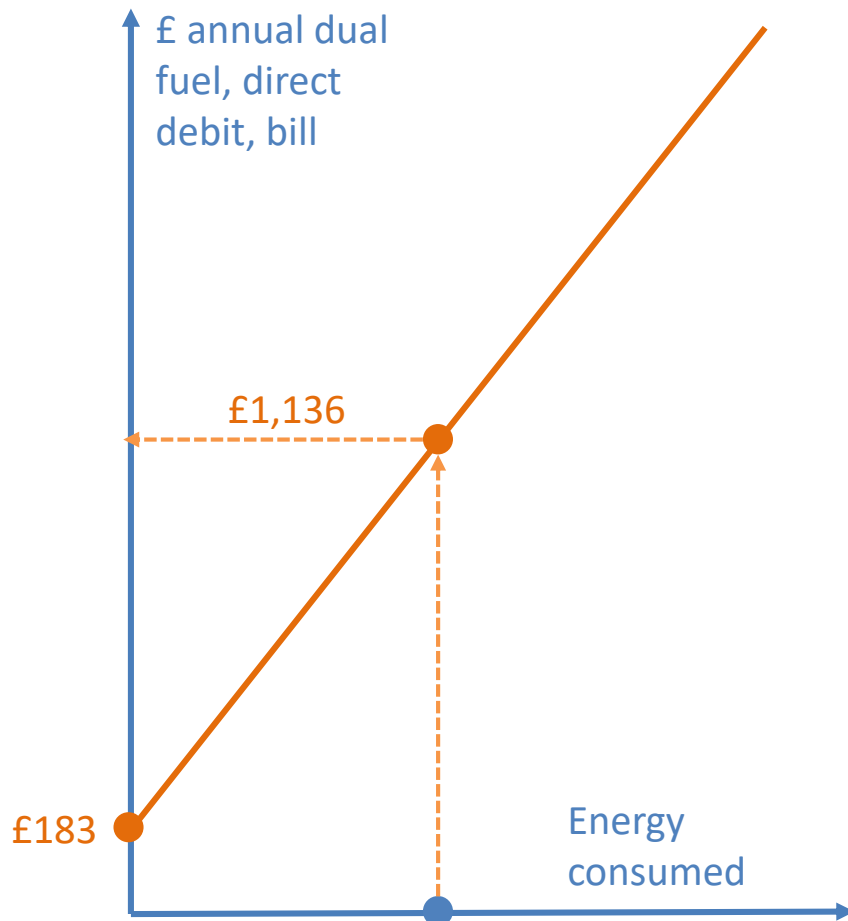
Notes:

1. The additional allowances only show specific allowances for uncertainty and the difference between the frontier and our benchmark costs. Other aspects of our methodology (including conservative assumptions) will reduce the impact of uncertainty, but they are not shown here. For instance, our analysis shows that policy cost forecasts in the three years between 2015 and 2017 tended to be higher than actual costs (see Appendix 5 (Policy and Network costs) and our approach for the standard credit cost is conservative (see note 2)
2. For standard credit we use the lower quartile to set efficient costs. For standard credit customers (not shown here) the uplift is £9 higher than had we used the frontier supplier (for each additional cost component). If we were to take the frontier cost for each additional cost component separately, then the frontier benchmark for both direct debit and standard credit caps would be lower.

Setting the overall level of the cap:

- We propose to include £10 headroom on top of our 2017 baseline for a dual fuel direct debit customer.
- We propose to apply this headroom as a percentage (1.45%) and apply it to all cost components except network costs. In 2019, headroom would be £12 for DD.
- Headroom covers uncertainty and variation in efficient costs that is **not** already included in the benchmark.
- Taking the benchmark and headroom together, the cap is £38 (incl. VAT) higher than it would be if we benchmarked to 'frontier' suppliers in our sample.
- Other ways we address uncertainty include:
 - Conservative assumptions
 - Flexibility in updating the cap

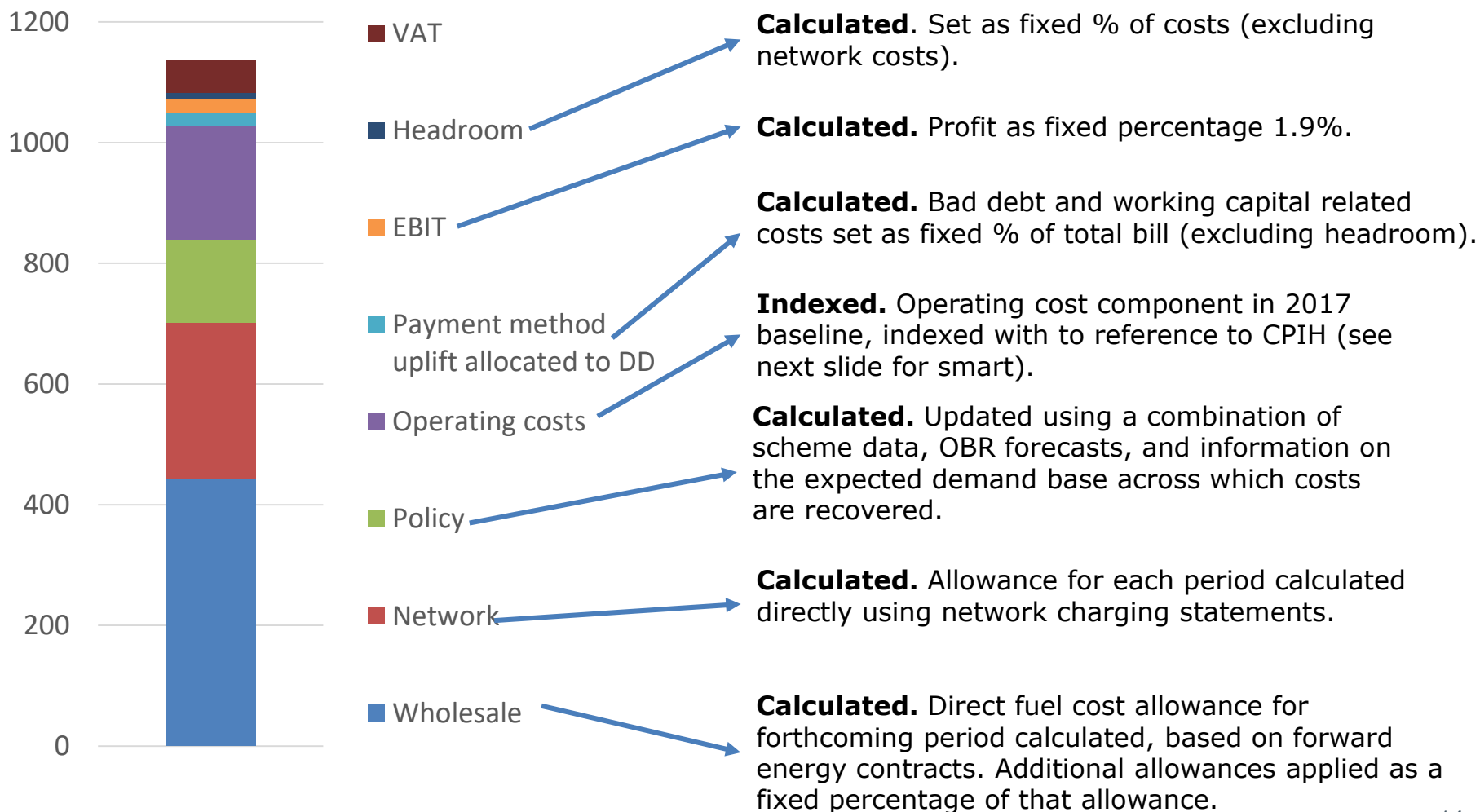
We propose to set the cap by estimating an efficient allowance for each cost component



Varying the cap with consumption:

- We propose to set the cap at nil consumption at £183 in 2019 (dual fuel).
- We set the cap at nil consumption in line with market prices.
- Cap levels for other levels of consumption are calculated on a straight line basis.
- We implement this using:
 - a maximum standing charge and
 - a maximum variable rate
- Suppliers can apply for a derogation for tariffs with low to no standing charges (and higher variable rates) that benefit low consumption customers.

We propose to update the cap every six months, on 1 April and 1 October



We increase the cap for changes in net smart costs, which we will review in 2019

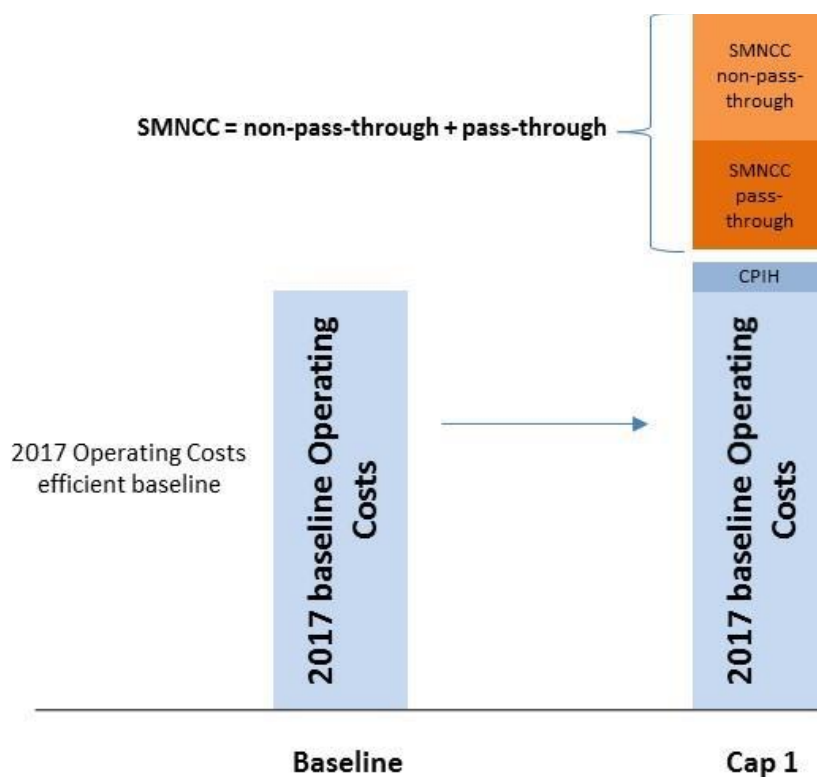


Figure is illustrative and not to scale

Approach

- We propose to include a separate smart metering increment (smart metering net cost change - SMNCC).
- This enables us, when initially setting and subsequently updating the cap, to vary smart metering costs in a different manner to the other elements of the cap.
- This is because suppliers are still rolling out smart meters and this is likely to increase their operating costs.

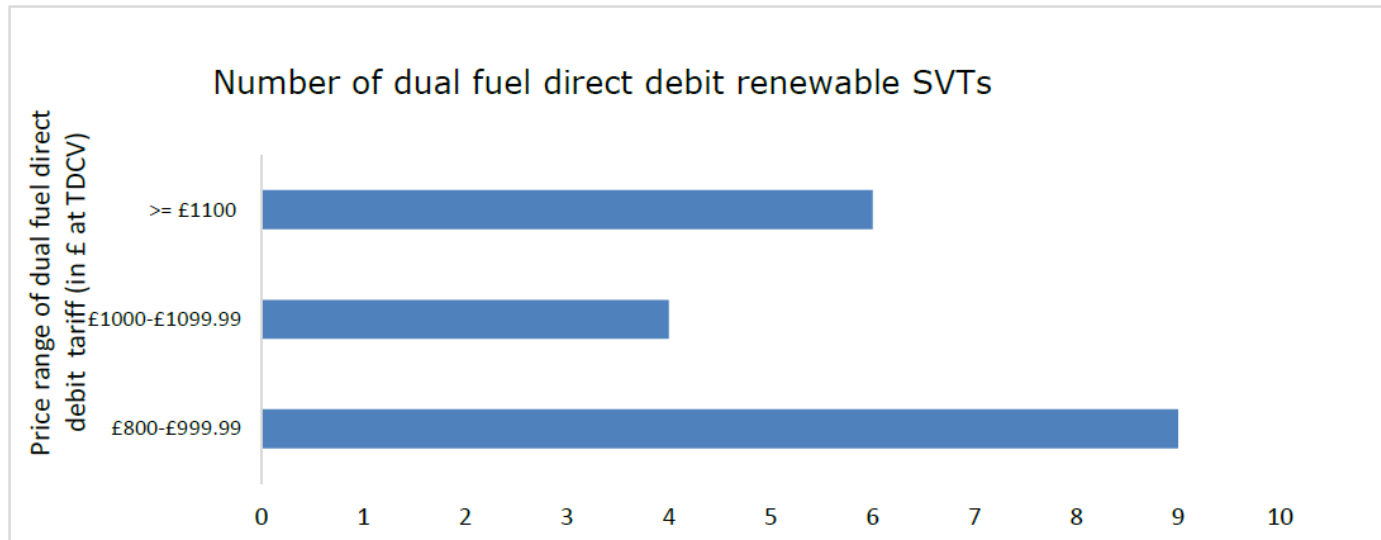
Review

- In 2019 we propose to undertake a review of the SMNCC using updated supplier costs and rollout profile data.
- This review recognises **the additional uncertainty** around how smart costs will develop over time.

We propose to allow suppliers to apply for a derogation from the default tariff cap for renewable tariffs

By default the tariff cap should apply to all SVTs, but we propose to **provide a route for suppliers to apply for derogations for renewable electricity and/or gas SVTs** that have been chosen by the suppliers' customers.

Figure A10.1: price range of dual fuel direct debit renewable SVTs



Source: The original sources of all data are Energylinx (up to May 2017) and EnergyHelpline (June 2017)

We propose to allow suppliers to apply for a derogation from the default tariff cap for renewable tariffs

We have an existing process for receiving and considering derogation requests from supply licence conditions. We propose that we would build upon this process, but would need to tailor it for assessing renewable SVT derogation requests. In particular, we propose that we would:

- **Provide a bespoke derogation request** form with questions specific to renewable SVT derogation requests, with supporting guidance on completing that request form.
- **As a transitional measure only when the default tariff cap is introduced, run a two-stage derogation process**, fast-tracking priority derogation requests to provide a decision on a time-limited derogation, followed by an in-depth review of derogation requests to provide a decision on a more enduring derogation.

Criteria for assessing

Outcome 1: the tariff is an SVT that consumers have chosen to be on.

Outcome 2: 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.

Outcome 3: 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.

We propose to transfer WHD customers onto the direct debit SVT cap

- When we introduced the existing safeguard tariff for WHD customers we were clear that this was a temporary measure until either the default tariff cap or a broader vulnerable safeguard tariff came into effect.
- **We propose to maintain this position and transfer existing WHD consumers that are on the safeguard tariff and those consumers that are identified as eligible for the WHD up until 31 March 2019 on to the default tariff cap.**
- Transferring the WHD consumers on the existing safeguard tariff onto the DD default tariff cap will ensure that this vulnerable group of consumers do not experience an unexpected increase in their energy bills upon the end of the existing safeguard tariff.

Any questions?

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

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