centrica

Amar Kadri
Ofgem
9 Millbank
London
SW1P 3GE

14th September 2016

By email: Amar.Kadri@ofgem.gov.uk

Dear Amar,

Monitoring trends in suppliers' expected costs

Thank you for the opportunity to comment on Ofgem's proposal to estimate trends in supplier costs. We support customers having accurate, complete and not misleading information to enable them to make informed choices. While we are unconvinced that a cost index supports this objective, we welcome Ofgem allowing stakeholders to provide feedback and voice concerns through this consultation.

We are sceptical that any cost index can accurately represent suppliers' expected or actual future costs. We strongly opposed Ofgem publishing the Supplier Market Indicator (SMI) because it was regularly misinterpreted by the media and other stakeholders. We welcome Ofgem's acceptance that "publishing an uncertain estimate of suppliers' margins...risks generating confusion"[1]. It is important that any new index does not lead to false predictions about future supplier profit margins.

Should Ofgem proceed with an index, we agree that it should only look at costs and not prices, so as to avoid crude and incorrect estimates of "margins" or "profits".

Before introducing an index, Ofgem should:

1) Set out a clear policy objective.
2) Determine whether an index is most likely to achieve the intended effect, not result in damaging unintended consequences for consumers or competition and be the most proportionate solution.
3) Ensure that the index is complete, accurate, not misleading and otherwise fair both in terms of its content and in how it is presented to consumers by third parties as well as Ofgem.

[1] Para 2.13, Pg. 9, Monitoring Trends in Suppliers Costs
https://www.ofgem.gov.uk/system/files/docs/2016/08/smi_review_consultation_-_final.pdf

We believe Ofgem could do more to meet each of these three criteria of good regulation.

1. Setting out a clear policy objective

Ofgem policy initiatives should be based on evidence that the proposed policy will help to achieve a stated objective. Ofgem has not explained why it is appropriate for the energy regulator to try to estimate the ongoing trends in suppliers' costs. Given the risk for misinterpretation by stakeholders, Ofgem should explain why it believes that the regulator should publish such an index. In this consultation, Ofgem does not:

a) explain how the index will help Ofgem achieve its objectives
b) explain how publishing estimates of suppliers' expected costs facilitates competition
c) provide evidence that consumers are interested in supplier costs

2. Determine whether an index is most likely to achieve the intended effect, not result in damaging unintended consequences for consumers or competition and be the most proportionate solution.

We believe that Ofgem should consider the effect of any policy intervention on consumers and competition and should consider and set out a range of alternatives. Ofgem has missed an opportunity to systematically and completely set out the costs, benefits and risks of its proposals or how those benefits and risks compare to alternative options. While Ofgem is consulting on various aspects of the proposed index methodology, it does not consider alternative options such as not publishing an index. We believe Ofgem should explain the effect, if any, of not publishing an index.

3. Ensure that the index is complete, accurate, not misleading and otherwise fair both in terms of its content and in how it is presented to consumers by third parties as well as Ofgem.

Any index published by Ofgem should be based on data and a methodology that produces results that are complete, accurate, and not misleading. We agree in principle with Ofgem that the index should be reliable, transparent and easy for stakeholders to understand. However, we believe that Ofgem should make a stronger commitment to the index being accurate, and be very clear in explaining any inaccuracies.

We agree with Ofgem that any cost index will need to be positioned carefully to avoid being misused or misunderstood by stakeholders. Managing external interpretation is especially important if the index adopts a different methodology to that used to calculate the prepayment price-cap or that used in the Financial Reporting Remedy. To minimise confusion in this situation, Ofgem should:

a) Carefully explain the differences between the various cost indexes and outline any assumptions that may reduce the accuracy of the index.
b) Publish any cost index at the same time as the prepayment price-cap is updated, i.e. once every 6 months. If Ofgem publishes the cost index on a quarterly basis, the two additional publications should occur between the price-cap updates.

We believe that publishing the model used to calculate the index is the best way for Ofgem to ensure transparency around the index. Publishing the model in full will enable suppliers and other stakeholders to understand how the index has been calculated.

We provide answers in Appendix 1 of this consultation to the detailed questions asked by Ofgem.

If Ofgem takes forward the idea of an index, we would like to work with Ofgem on both the methodology and positioning of the index. For instance, we ask that Ofgem shares the draft positioning of the index with suppliers for comment prior to publication. If you have any questions about this response, please contact me by calling 07769 548 906 or emailing Thomas.Lowe@centrica.com.

Yours sincerely

Thomas Lowe

Regulatory Manager
Retail Market Policy
Centrica

Appendix 1 – Centrica response to consultation questions

Question 1.1: Do you agree that Ofgem should provide estimates of ongoing trends in suppliers' costs, in addition to the analysis we publish of realised costs for previous financial years?

We do not believe that Ofgem has adequately explained the policy objective of estimating the ongoing trends in suppliers' costs. Given the risk for misinterpretation by stakeholders, Ofgem should explain why it believes that the energy regulator should publish such an index. We believe that Ofgem could do more to:

a) explain how estimating supplier costs will help Ofgem achieve its objectives
b) provide evidence that consumers are interested in supplier costs
c) explain how publishing and monitoring supplier costs facilitates competition

Any information published by Ofgem should be complete, accurate, and not misleading. Suppliers face different costs for a range of reasons, including their wholesale purchasing strategy and the weather. It is impossible to estimate future costs for even one supplier with complete accuracy. Any inaccuracy in the estimates of the data or the methodology creates the risk of the information published by Ofgem being misleading. If Ofgem proceeds to try to estimate future supplier costs, then Ofgem will need to set out the assumptions used and clearly explain that the estimates will differ from the reality faced by suppliers.

Question 1.2: Did you use the SMI? What were its advantages and disadvantages?

We monitored the SMI because the media misinterpreted the data and wrote misleading articles about supplier margins. We have provided examples of some of the inaccurate and unhelpful articles in Appendix 2.

The main disadvantages to the SMI are well-known from previous engagement with Ofgem and relate to:

- The misrepresentation of supplier margins
- The inaccuracy of the methodology used to estimate wholesale costs
- The inaccuracy of the consumption estimates, which were too high, especially for gas, and were not adjusted for actual weather

To avoid the sort of stakeholder confusion and inaccuracy produced by the SMI, Ofgem should make clear that any replacement is:

a) a theoretical construct used to provide an indicative view of the costs that suppliers might face
b) Ofgem's estimates will differ from the reality faced by suppliers.

Question 1.3: Are there additional or alternative criteria that we should take into account in deciding on how to replace the SMI?

As set out in our response to Question 1.1, Ofgem should be clear on what policy objective it is trying to achieve by replacing the SMI. Ofgem should demonstrate that there is consumer demand for information about supplier costs.

In addition to the information being complete, accurate and not misleading, we believe that Ofgem should consider the following additional criteria:

- Any inconsistency with the CMA prepayment price cap index and the financial reporting opportunity cost benchmarks should be clearly explained.
- The methodology should be independently verified to provide confidence that the costs are as accurate as possible.
- The distinction between (accurate) historic costs reported in the Consolidated Segmental Statements (CSS) and (inevitably inaccurate) forward-looking estimates should be clearly communicated.
- The impact of weather on how costs are reported should be minimised.

Question 2.1: Do you agree with our proposal to use a cost index? What do you see as the advantages and disadvantages of the alternative approach of calculating a £ estimate of costs per customer for a given level of consumption?

We are sceptical that any cost index can accurately represent suppliers' expected or actual future costs. However, we agree with Ofgem that an index estimating cost trends over time is less likely to be misrepresented than alternative approaches. An index is also consistent with the approach taken to the CMA prepayment price cap.

Should Ofgem proceed with an index, we agree that it should only look at costs and not prices, so as to avoid incorrect estimates of "margins" or "profits". We also agree that an index that shows change relative to a past benchmark as per Figure 2.1 of the consultation would be better than showing a £ estimate of costs per customer. Showing changes in trends rather than absolute figures will be less misleading for customers because customers will have less specific expectations about how the trends will translate into their actual bills.

If Ofgem is to use a cost index then it needs to be comparable to consumers' experiences in the market. Ofgem should explicitly state that the benchmark delivery period and the calculation delivery period may be different to help consumers understand what the index is showing. Ofgem should also make clear that the index is based on the costs associated with a 12 month fixed term contract rather than the Standard Variable Rate which most consumers have chosen.

Question 2.2: How can we present trends in expected costs in a way that is easiest for stakeholders to understand? What, if any, charts should be included on our website?

Should Ofgem proceed with an index, we believe that showing changes in the cost index in percentage terms and relative to a past benchmark would minimise the risk of misleading consumers relative to other approaches, e.g. a £ estimate of costs per customer. The charts in Figure 2.1 of the consultation appear to meet this objective.

Any index of costs must make clear that it is an estimate and that the reality faced by suppliers is likely to be different. The main assumptions behind the index must also be clearly explained, including how any weighting assumptions have influenced the overall cost changes. Managing external interpretation is especially important if the index adopts a different methodology to that used to calculate the prepayment price-cap or that used in the Financial Reporting Remedy. To minimise confusion, Ofgem should carefully explain the differences between the various cost indexes and outline any assumptions that may reduce the accuracy of the index.

Ofgem publications should be predictable and so Ofgem should publish the index on a set date that is communicated in advance to stakeholders, including suppliers.

Question 2.3: Is quarterly an appropriate frequency for our updates?

We believe that quarterly or six-monthly publication would be an appropriate frequency for these updates. The frequency of updates should reflect how costs change and consider the implications on pricing expectations. Some costs can change quickly, e.g. wholesale costs, while others change more slowly, e.g. Transmission and Distribution costs. Ofgem should carefully explain that cost movements in one quarter do not necessarily mean that prices will change in the next quarter. More information about wholesale costs is provided in response to question 3.4.

Ofgem should publish any cost index at the same time as the prepayment price-cap is updated, i.e. once every 6 months. If Ofgem publishes the cost index on a quarterly basis, the two additional publications should occur in the quarters between the price-cap updates. Ofgem publications should be predictable and so Ofgem should publish the index on a set date that is communicated in advance to stakeholders, including suppliers.

Question 2.4: What information on trends in suppliers' prices should we provide alongside the cost index?

We do not believe that Ofgem should provide information about suppliers' prices alongside the cost index. There is a significant risk of confusion if Ofgem tries to communicate supplier prices alongside the index. Direct comparison of prices and costs is only possible if the price information reflects the basis of the costs. The costs faced by suppliers differ in a variety of ways. For example, small suppliers are not subject to environmental and social obligations, while suppliers may not procure energy on the same basis as outlined in the cost index. The index is simplified and does not represent a typical supplier, so significant explanation of the index and the relationship between costs and prices would be required. Even a detailed explanation risks confusion unless consumers have a good understanding of the methodology used in the cost index.

Question 2.5: What, if any, additional information should we provide about trends in the individual categories of suppliers' costs?

Any index should say whether incremental costs from the smart meter roll-out and the Faster and More Reliable Switching (FMRS) programme are included in the index. If the costs are included, the Department for Business, Energy and Industrial Strategy (BEIS) impact assessments are the best starting point for incorporating industry level costs. These costs could sit under operating cost or under environmental and social costs. We accept that it will be difficult to separate the cost of the smart roll-out obligation from the counterfactual where the obligation did not exist and to take account of the fact that suppliers will have different roll-out strategies. If Ofgem decides not to include the costs in the index, it should explain in the commentary that the costs (a) exist and (b) are not included.

More generally, Ofgem should set out its thresholds for including or excluding costs in the index. If the threshold is set too high, then the index will be inaccurate. We note that AAHEDC (Assistance for Areas with High Electricity Distribution Costs) and DCC (Data Communications Company) costs have been excluded. If these costs are excluded because they are not considered material, Ofgem should be transparent about the thresholds applied and the implications for the inclusion or exclusion of these and other costs.

Question 2.6: How should we choose the base period relative to which the index is calculated, and how frequently should we update this?

We believe that Ofgem should rebase the index only as often as is necessary to maintain the accuracy of the index. Other major indexes, e.g. RPI, are rebased infrequently. We are unclear how frequent updating of the base year will affect year on year comparison and are concerned that stakeholders will find it more difficult to determine the accuracy of the index over time. We believe that Ofgem should review and report on the accuracy of the index annually to allow stakeholders to understand the relative accuracy of the index.

Question 2.7: Do you agree with our proposal to no longer estimate a rolling expected margin throughout the year? If you disagree, how should expected margins be calculated?

We agree that rolling expected margin should no longer be estimated in the index. The rolling expected margin included in the SMI was inaccurate, was repeatedly misinterpreted by the media as profit and undermined trust in the industry. We agree with Ofgem that "publishing an uncertain estimate of suppliers' margins...risks generating confusion"[2]. It is important that any new index does not lead to false predictions about future supplier profit margins.

Question 2.8: What do you see as the implications of the prepayment price cap on how the SMI should be replaced? Would publishing the indices used to update the cap every six months be sufficient on its own to provide the necessary transparency around trends in suppliers' expected costs?

Ofgem should explain the differences between the prepayment price cap index and cost index methodologies. The explanation is particularly important when the indexes show very different expected results. Ofgem should also consider how to explain the differences between the costs shown in the CSS and those reported in the two other indexes.

Question 3.1: Should the supplier cost index include suppliers' operating costs? If so, how should these be estimated?

We agree with Ofgem that a forward-looking estimate of suppliers' operating costs would inevitably be inaccurate and should be excluded from the index. However, there should be transparency around the costs associated with the government-mandated smart meter roll-out and the FMRS programme as these costs will impact supplier costs over the coming years. If smart metering and FMRS costs are not included, then Ofgem should explain the exclusion of these costs and the likely materiality of doing so.

Question 3.2: Do you agree with our proposal to hold consumption fixed over time at medium TDCVs in estimating trends in expected costs?

We agree that consumption should be held fixed over time at medium TDCV. We expect Ofgem will update the index as the TDCVs change every two years. Ofgem will need to explain that medium TDCVs will differ from the actual consumption reported by suppliers in the CSS.

Question 3.3: Do you agree with our proposal to rely on the most recent CSS to calibrate the relative importance of different elements of suppliers' costs?

We agree that using the most recent CSS as a benchmark is sensible. Ofgem should make clear that CSS data is only provided by the six largest suppliers and therefore cannot be said to be representative of other suppliers' costs breakdown, especially the small suppliers not obligated under ECO and WHD.

---

[2] Para 2.13, Pg. 9, Monitoring Trends in Suppliers Costs
https://www.ofgem.gov.uk/system/files/docs/2016/08/smi_review_consultation_-_final.pdf

Any index should be corrected for weather during the previous year, as weather will impact both customer consumption but also wholesale costs and associated hedging strategies.

Question 3.4: Do you agree with our proposed approach to estimating trends in wholesale costs?

Ofgem should be clear in its communications that:

a) The index is a theoretical construct and will only, at best, simulate the costs faced by a typical supplier
b) Ofgem's proposed approach to wholesale costs is more likely to represent the costs faced by a supplier offering 12 month fixed term contracts than Standard Variable Rate.

Estimated wholesale costs will rise and fall, potentially very quickly, with each update. Ofgem's proposed methodology for estimating wholesale costs is more likely to be volatile because energy is purchased for 12 months in a non-rateable way. Ofgem should carefully explain such volatility to prevent misunderstanding and stakeholder confusion.

Ofgem should provide more detail about the technical calculations proposed for the cost index. Ofgem has published insufficient detail to allow full evaluation of the methodology. For example, taking gas prices for the first 6 months and then using seasonal prices runs the risk of misrepresenting the balance of the season prices where it is split between months and seasonal prices.

We also request that Ofgem reconsider the following elements of the proposed wholesale cost methodology:

- A baseload/peak split of 70:30 is not appropriate for electricity residential customers. We have made similar representations to the CMA on the prepayment price-cap. Using settlement profiles rather than historical volumes would give a better view of forward volumes.
- The forward cost can be evaluated but there are further shaping and balancing costs that suppliers incur that are not accounted for. These figures will be incorporated within the CSS.
- The CSS figures include weather effects that would need to be corrected to bring them to a Seasonal Normal Demand level.

Question 3.5: What, if any, regular information should we provide on suppliers' purchasing strategies, and what these mean for suppliers' costs?

Information about companies' hedging strategies is commercially confidential and should not be disclosed in any circumstances.

Question 3.6: Does our proposed approach accurately reflect the expected annual network charges faced by a supplier for a typical domestic customer?

We broadly agree with Ofgem's approach to estimating network costs. However, we request that Ofgem reconsider the following aspects of their methodology:

a) **Local Distribution Zones (LDZ) exit zones**. It would be more accurate for Ofgem to use a weighted average rate than, as is proposed, to use a simple average of the transmission charges in each exit zones within a region to produce an average rate for that region. Ofgem could use the capacity values provided for each exit zone in the Gas Distribution Network (GDN) licence to provide this weighting. Whatever approach is adopted, Ofgem should be consistent with the figures in the model proposed by the CMA for the prepayment price-cap

b) **Peak period consumption.** For transparency, Ofgem should publish the source used to calculate the proportion of annual electricity consumption taking place during peak periods. The source of the 30% to 70% split between peak and baseload is not stated.
c) **DNO Loss Adjustment Factors (LAFs)**. Ofgem should publish which DNO LAFs they have used.
d) **Transmission Network Use of System Charges (TNUoS)**. Ofgem should not apply transmission losses for TNUoS charges.
e) **Balance System Use of System Charges (BSUoS)**. Ofgem should not use the National Grid monthly balancing services summary to project BSUoS costs. Instead, Ofgem should roll forward actual BSUoS rates from a recent prior period. Ofgem should explain whether the index will include any losses for the calculation of BSUoS.

Question 3.7: Are there additional information sources or alternative assumptions that we could use to improve our estimates?

Ofgem should annually review any index methodology and report on the accuracy of that index. The index should be able to be updated to reflect major changes in the market. As Ofgem acknowledges, 'approaches to hedging change over time and vary from supplier to supplier'[3]. For instance, assumptions in the index may need to be updated if 12 month fixed term tariffs do not become the market's primary product or if Time of Use tariffs become a larger part of the market.

Please see our answer to Question 3.6 above for recommendations of alternative sources and assumptions around network charges.

Question 3.8: Should we also seek to provide information on trends in costs for customers with non-standard electricity meters?

We believe that providing information on trends in non-standard electricity meter costs is unnecessary and risks further consumer confusion.

Question 3.9: Do you agree with our proposed approach to estimating the cost to suppliers of the Renewables Obligation scheme? Is there additional or alternative information that we should use to estimate these costs?

We think that Ofgem's approach is reasonable, in so far as it is consistent with the prepayment price cap methodology.

Question 3.10: Do you agree with our proposed approach to estimating the expected costs associated with the ECO scheme? Is there additional or alternative information which we should use to estimate these costs?

The Government impact assessment may be the best available public source of information. However, we continue to hold concerns that the impact assessment has historically underestimated the costs faced by suppliers.

Question 3.11: What are the pros and cons of using information collected from suppliers on their forecast ECO costs to estimate the expected costs of the programme?

[3] Para 3.10, Pg. 17 Monitoring Trends in Suppliers Costs, https://www.ofgem.gov.uk/system/files/docs/2016/08/smi_review_consultation_-_final.pdf

Please see our answer to Question 3.10.

Question 3.12: Do you agree with our proposed approach to estimating the expected costs associated with the FiT scheme? Is there additional or alternative information which we should use to estimate these costs?

We think that Ofgem's approach is reasonable, in so far as it is consistent with the prepayment price cap methodology.

Question 3.13: Does our proposed methodology accurately reflect the expected costs faced by customers relating to the WHD scheme? Is there additional or alternative information which we should use to estimate these costs?

We think that Ofgem's approach is reasonable, in so far as it is consistent with the prepayment price cap methodology.

Question 3.14: Does our proposed methodology accurately reflect the expected costs faced by suppliers in meeting the supplier obligation with respect to Contracts for Difference? Is there additional or alternative information which we should use to estimate these costs?

We think that Ofgem's approach is reasonable, in so far as it is consistent with the prepayment price cap methodology.

Question 3.15: Do you agree that reserve payments to the TRA should be excluded for the purposes of calculating the cost index?

We think that Ofgem's approach is reasonable, in so far as it is consistent with the prepayment price cap methodology.

Question 3.16: Does our proposed methodology accurately reflect the expected costs that suppliers will face in meeting the supplier obligation with respect to capacity market payments? Is there additional or alternative information which we should use to estimate these costs?

We think that Ofgem's approach is reasonable, in so far as it is consistent with the prepayment price cap methodology.