



3rd Floor North
200 Aldersgate Street
London EC1A 4HD
Tel: 03000 231 231

citizensadvice.org.uk

14 September 2016

Dear Graham

Response to 'Monitoring trends in suppliers' expected costs'

Thank you for providing us with the opportunity to give written feedback on your proposals to introduce a replacement for the Supply Market Indicator ('SMI'), and for setting out time earlier in the year to discuss your emerging thinking. This submission is non-confidential and may be published on your website.

At a high level, we are wholly supportive of the policy intent to reintroduce a close-to-real-time monitoring mechanism for supplier costs but are concerned that the proposed design of this mechanism appears in areas to be a step backward from the old SMI and may reduce supplier accountability.

We provide answers to the consultation questions in the appendix to the letter, but first set out our views on where we think the SMI can add value - and the key components that are necessary to deliver on that policy intent. While you have not explicitly named your proposed replacement monitoring tool, we refer to it as the 'new SMI' in this response for simplicity.

The value in the SMI

Retail energy bills are a source of significant consumer anxiety.¹ In real terms, retail gas prices have nearly doubled, and electricity prices are up by about two-thirds² in the last decade, far outstripping wage growth. Increasing bills have coincided with rising supplier profitability³ and public trust in the sector remains low. Multiple regulatory investigations into the sector have suggested that it not as competitive as it could be, with the CMA most recently concluding that excess profits and inefficiency were features of the current market⁴:

¹ BEIS's Public Attitudes Tracking Survey currently shows that more consumers are worried about energy bills than about food, transport or mortgage/rent bills. <http://tinyurl.com/jnewfx4> 58% of participants in Which?'s Consumer insight tracker in July 2016 expressed worry about energy bills, putting it in the top three consumer financial worries alongside fuel prices and public spending cuts. For the majority of the last four years, energy bills have been the number one worry shown by the tracker. <http://tinyurl.com/ht59tqo>

² See DUKES 'Fuel price indices in the domestic sector in real terms 1997 to 2015.' The gas index increased from 61.9 in 2005 to 122.6 in 2015 (up 98%), the electricity index increased from 72.2 in 2005 to 118.9 in 2015 (up 65%). <http://tinyurl.com/b5f8m6c>

³ The Consolidated Segmental Statements show average domestic supply profitability increasing from 0.9% in 2009 to 3.9% in 2015. <http://tinyurl.com/hovz6ud>

⁴ Page 8, 'Modernising the energy market,' CMA, 24 June 2016.

“domestic customers as a whole paid an average of £1.4bn a year more than they would have done under well-functioning retail markets over the period 2012 to 2015, reaching £2bn in 2015. We estimate that suppliers made excess profits of around £650 million a year from 2012 to 2014, which would imply that a large proportion of the detriment is driven by inefficiency.”

This picture remains disputed, with a number of suppliers contending that the CMA's analysis is wrong. The opacity of the energy supply chain, which is highly vertically disaggregated and contains many moving input costs, inadvertently facilitates public dispute. This room for dispute reached crisis point in autumn 2013, where a round of supplier price rises resulted in prominent public, political and industry dispute on what was driving consumer bills.

The situation has calmed somewhat since, but in our view this is more likely driven by 2014-16 being a period of limited retail price movement than because the causes of dispute - cost opacity, and a widespread perception that the market is insufficiently competitive - have gone away. While those underlying factors remain in place, the potential for renewed dispute remains in place too, and may re-erupt with any future retail price increases.

The old SMI were unpopular with parts of industry because they reflected a projection of the likely direction of future costs and profits for Standard Variable Tariff ('SVT') accounts based on currently observable input cost trends. Some suppliers argued that this was unhelpful usually citing one or both of two reasons for holding that view. The first, that it was speculative and it would be better to deal with known facts i.e. to constrain public commentary to historically observable known profits set out in the Consolidated Segmental Statements ('CSS'). The second, that, in their view, the old SMI tended to overstate supplier profits and that it therefore misled rather than informed the public.

In our view, both arguments are weak and easily rebutted.

It is the case that the CSS are less disputed than the old SMI were (and indeed, that any projection of costs, such as the proposed new SMI, will be). But the CSS are, by definition, dated - they represent a snapshot picture of historic costs. At the time of writing, the most recently available CSS are for the calendar year 2015.⁵ But supplier retail price movements, whether up or down, are invariably justified based on a combination of current and forward costs, whether wholesale, network, or policy delivery related. So, were there to be a round of retail pricing announcements this autumn, the CSS would be of little use in judging whether they were justified. This is important, because it means that in isolation, eg if they were the only cost reporting policy in place, the CSS do not help consumers, or their advocates, hold suppliers accountable for contemporary price movements. So we share your view that there is a need for a monitoring tool that shows a picture of current cost drivers, and not simply historic cost drivers.

⁵ With the exception of SSE, where they are for 1 April 2015 to 31 March 2016.

The argument that the SMI tended to overstate supplier profits has always been, in our view, somewhat misleading. It often manifested in the observation that the old SMI implied a profit margin perhaps three or four percent above that shown in the CSS, and that it followed from this that the old SMI were methodologically wrong and tending to overestimate profits.

In our view, this was to compare apples with pears. The CSS show the aggregate profitability of all domestic supply (eg including both SVT and other customers such as those on fixed term deals) while the old SMI was showing a projection of costs and profits for a notionally typical SVT customer only. The scope of the two instruments therefore captured markedly different customer bases. While neither Ofgem, nor the CMA in its market investigation, have published data explicitly showing historic or current profit margins on SVT accounts there is sizeable evidence in the public domain to suggest that it is likely to be substantively higher than the margin on the wider customer base including those on acquisition deals. For example, the CMA noted that dual fuel SVT customers of the Big 6 (excluding prepayment customers, who have a very restricted range of tariffs) could have made average annual savings of around £330 in mid-2015 if they had switched.

So there is strong evidence that SVT customers are more profitable than the average customer based on all deals. This premium is not quantifiable based on data in the public domain, but the margins reported by the old SMI did not appear outlandish given the price spread between retention and acquisition tariffs. That the picture the old SMI portrayed - of sticky customers getting a raw deal - was uncomfortable to industry is undeniable. But that does not mean that this picture was wrong.

For that reason, we do not share industry discomfort with the SMI indicating possible profit trends for SVT customers. Quite the reverse: we think this may be a helpful message. One of the core challenges prompted by the CMA investigation is finding a way to engage SVT customers with the switching process. Pointing out that loyalty is not paying - that suppliers make much more money from them than from active consumers - seems more likely to be a helpful nudge than an unhelpful one if we are trying to encourage consumers to shop around.

We are therefore uncomfortable with your proposal to remove any projection of possible profit trends from the new SMI. This is likely to result in the loss of a major nudge to consumers to switch.

For connected reasons, we are also uncomfortable with your proposal to remove any tracking of suppliers' internal costs from the new SMI. You note that:

"We would exclude from the cost index those costs that suppliers incur in relation to their own retail operations (for example, the costs of billing, metering and bad debt). Suppliers will set their price so as to try and cover these costs,

which made up approximately 16% of an average dual fuel bill in 2015. However, compared to the other categories of costs, they are more likely to be fixed, are more difficult to forecast, and are to a greater extent within suppliers' control."

That fixed costs are harder to forecast than variable ones is not a wholly convincing argument - if anything they should be more stable and less speculative. It is also unclear to us why these costs being to a greater extent within suppliers' control than other costs is an argument in favour of their exclusion. Ofgem has statutory information gathering powers, it receives historic internal cost information through the CSS, and cost information should be available for the delivery of environmental and social policy schemes through either impact assessments or ongoing performance reporting. In combination, we think these tools should enable it to provide a reasonable forecast for suppliers internal costs.

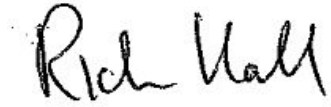
In combination, an exclusion of any estimate of supplier profits, and any estimate of suppliers internal costs, is likely to mean that around a fifth to a quarter of the total end consumer bill is not being tracked by the new SMI. This will mean the monitoring tool provides an incomplete picture of cost trends and reduces supplier accountability. So we therefore recommend that Ofgem considers including supplier cost, and supplier profit, forecasts in its new SMI. Without these, the value of the tool will be greatly reduced.

As a compromise position, if you remain firm in your view that you will not include profit estimates, we ask that you at least consider including an (energy) retail price index alongside, or superimposed on top of, the supplier cost index (as shown in Figure 2.1). If the two indexes fail to track each other - if prices do not follow costs - this should still help to hold suppliers to account. Further, such a measure can be constructed from publicly reported information that Ofgem already holds - you already monitor tariffs in the marketplace and average bills. You allude to such an approach in paragraph 2.7, and while we consider it suboptimal compared to publishing a projected profit, it would nonetheless be more informative approach than failing to put cost drivers in the context of retail prices at all.

As a final contextual observation, we note that one simple way to tackle large suppliers complaints that the old SMI overstated profits by only showing SVT trends would be to publish parallel charts showing trends for other types of tariffs too. If, as seems highly likely, the true picture is that SVT customers are highly profitable, but that acquisition tariffs are sold closer to cost, we have no problem at all with the SMI demonstrating this message. Indeed, sending out a simultaneous message that suppliers make a lot of money from disengaged SVT customers, and none at all from savvy switchers, could be an extremely helpful message to encourage consumer engagement.

In the following pages we provide comments to the more detailed questions posed in your consultation. We trust that these are clear, but would be happy to discuss any matter raised in more detail if you would find that helpful.

Yours sincerely

A handwritten signature in black ink that reads "Rich Hall". The signature is written in a cursive, slightly slanted style.

Richard Hall

Director of Strategic Infrastructure, Consumer Futures team

Q1.1 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?

Yes, we do.

Retail energy bills are a source of significant consumer anxiety. In real terms, retail gas prices have nearly doubled, and electricity prices are up by about two-thirds in the last decade, far outstripping wage growth. Increasing bills have coincided with rising supplier profitability and public trust in the sector remains low. Multiple regulatory investigations into the sector have suggested that it not as competitive as it could be, with the CMA most recently concluding that excess profits and inefficiency were features of the current market:

“domestic customers as a whole paid an average of £1.4bn a year more than they would have done under well-functioning retail markets over the period 2012 to 2015, reaching £2bn in 2015. We estimate that suppliers made excess profits of around £650 million a year from 2012 to 2014, which would imply that a large proportion of the detriment is driven by inefficiency.”

This picture remains disputed, with a number of suppliers contending that the CMA's analysis is wrong. The opacity of the energy supply chain, which is highly vertically disaggregated and contains many moving input costs, inadvertently facilitates public dispute.

Set against this backdrop, there is a need for regulatory action to try and better inform the public debate on what is, or is not, driving consumer bills. The CSS are a useful component part of that toolkit, but they are also, by definition, dated - they represent a snapshot picture of *historic* costs. At the time of writing, the most recently available CSS for Big 6 suppliers are for the calendar year 2015. Supplier retail price movements, whether up or down, are invariably justified based on a combination of *current and forward* costs, whether wholesale, network, or policy delivery related. So, for example, were there to be a round of retail pricing announcements this autumn, the CSS would be of little use in judging whether those price movements were justified. This is important, because it means that in isolation, eg if they were the only cost reporting policy in place, the CSS do not help consumers, or their advocates, hold suppliers accountable for contemporary price movements. We therefore strongly share your view that there is a need for a monitoring tool that shows a picture of current cost drivers, and not simply historic cost drivers.

Q1.2 Did you use the SMI? What were its advantages and disadvantages?

Yes, both Citizens Advice and its predecessor organisations Consumer Focus and Consumer Futures made use of the SMI. It was an extremely useful tool for understanding trends in supplier costs and their possible implications for the trajectory of retail energy bills.

Its main advantage was that it was a powerful tool for trying to keep suppliers honest. Repeated investigations, most recently by the CMA, have suggested significant imperfections in the retail market with far too many customers stuck on poor value SVT deals. The SMI shone a light on the diminishing competitive intensity in the SVT market. Contrary to supplier claims the SMI were misleading, the picture they presented of steadily fattening margins did marry up with the expansion of retail profits shown over time in the CSS. Secondary advantages included its simplicity - in our view, it distilled an extremely complex series of cost drivers into an easily digestible message - and its timeliness, with frequent publication allowing pressure to be maintained on suppliers.

Their main disadvantage was that they became a source of significant public dispute, with no obvious supplier buy-in. As a consequence, a number of suppliers and their representatives appeared to expend significant effort in criticising it. This often focused on the claim that the SMI were misleading or creating confusion, but such claims appeared in large part driven by the use of false comparisons by those critical parties. Most typically, this took the form of an argument along the lines that 'The SMI show a margin of around X%, but the CSS show supplier margins are three or four per cent below that. Therefore, the SMI methodology is wrong and is overestimating our margins.'

In our view, that contention was always unreasonable because it was not a like for like comparison. The CSS show the aggregate profitability of all domestic supply (eg including both SVT and other customers such as those on fixed term deals) while the old SMI was showing a projection of costs and profits for a notionally typical SVT customer only. The scope of the two instruments therefore captured markedly different customer bases.

The CMA and previous inquiries have shown there is strong evidence that SVT customers are more profitable than the average customer based on all deals. This premium is not quantifiable based on data in the public domain, but the margins reported by the old SMI did not appear outlandish given the price spread between retention and acquisition tariffs. That the picture the old SMI portrayed - of sticky customers getting a raw deal - was uncomfortable to industry is undeniable. But that does not mean that this picture was wrong.

In our view, the most appropriate solution to this confusion is not for the regulator to cease providing reporting on projected SVT margin but for those market participants who were actively undermining the SMI to cease mis-portraying what it shows to defend their commercial positions.

We would like to suggest a compromise solution that could address the concern expressed by suppliers that the SMI do not show their aggregate profitability while continuing to provide the useful projection of indicative SVT margins set out in the old SMI. In our view, such a solution could be as simple as showing one set of cost/margin charts for SVT customers and parallel charts showing trends for other types of tariffs/customers.

If, as seems highly likely, the true picture is that SVT customers are highly profitable, but that acquisition tariffs are not, we have no problem at all with the new SMI demonstrating this message. Indeed, sending out a simultaneous message that suppliers make a lot of money from disengaged SVT customers, and none at all from savvy switchers, could be an extremely helpful message to encourage consumer engagement. If the provision of separate analysis for acquisition products suggests that suppliers are selling fixed price products below cost, it could also usefully shine a torch on price predation.

Q1.3 Are there additional or alternative criteria that we should take into account in deciding on how to replace the SMI?

The three criteria you put forward seem very sensible to us and we fully support them. You may wish to also include "timely" - it is quite important this reporting is relatively frequent and contemporaneous for it to offer value beyond the CSS.

Q2.1 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?

There are advantages and disadvantages to both approaches and they are not mutually exclusive - they are simply alternative ways of articulating the same underlying data.

The main advantage of the £s approach is that it is more intuitively intelligible to non-economists. Consumers understand what a pound is, and a message that the average bill may move from £1,050 to £1,145 may be more instinctively easy to

grasp for more people than that an index may move from 104 to 113.4, even if both are simply articulating the same percentage change.

Conversely, for those trying to understand whether affordability pressures are becoming better or worse, the most informative measure is likely to be an index because it can be more rapidly contextualised against inflation or wage growth trends which are more typically articulated in %s.

In practice, most users should be able to convert between the two fairly easily but you may wish to consider expressing in both formats simply to save them that hassle.

If relying on a cost index approach it will be important for you to contextualise the relative weightings of individual components within that index. Many users are unlikely to have a detailed understanding of their relative contribution to final bills. Knowing the relative change in an individual component without a sense of its absolute level could create confusion rather than reducing it. We note the Energy and Climate Change Committee made similar observations in its July 2013 report on Prices, Profits and Poverty when it suggested that energy companies should articulate the reasons for price movements in both pounds and percents:

'we recommend that the regulator compel energy companies to:

[...]

b) Identify the various components which make up the costs of the bill (i.e. wholesale price of fuel, costs of supply (i.e. transmission, distribution and metering), the costs of UK/EU policy (including support for low-carbon/renewables and energy efficiency schemes) and company margins (i.e. operating costs and profit);

c) Express price changes in pounds and pence as well as percentages.⁶

⁶ Paragraph 25, 'Prices, profits and poverty,' ECCC, July 2013. <http://tinyurl.com/hux9g3w>

Q2.2 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?

As stated in our previous answer, we think it would be useful to report measures in both £s and %s. This should not create any significant resource burden once the templates are set up as they will be driven from the same data set.

It would also be useful if the underlying spreadsheets used to calculate the result were put in the public domain. This could help stakeholders understand how the maths flows through to the final projections. It may also help if they wish to look at things like modelling the effect of different assumptions, noting that disputes over underlying assumptions on things like hedging strategy have erupted in the past.

Some cost components are unlikely to change (i.e. the VAT rate), or be slow evolving and/or little disputed (i.e. network charges). It is unlikely you will need to go into significant detail in your presentation of trends in those areas. We would suggest you focus more detail on those parts of the bill that are likely to be faster moving and/or subject to dispute. These are most likely to be social and environmental policy and wholesale cost trends.

For social and environmental policy costs we think there would be value in breaking these down by scheme. This is because past public disputes have often been focused on individual schemes (such as the ECO dispute in autumn 2013) and also because they vary significantly in their individual costs. Work by our predecessor organisation Consumer Focus found that consumers had a very poor grasp of the contribution of policy costs to their retail bills.⁷

You are convening a roundtable later this month, and still have the opportunity of further discussions with stakeholders before your revised reporting goes live. You may wish to road test mocked up examples of possible charts/tables in those discussions as a means of helping you to get richer feedback on the final presentation of data.

⁷ 'members of the public were surprised that only 7 per cent of today's bill was spent on environmental or social levies. [...] Most expected the share of their bill needed to subsidise social and environmental policy to be higher. Political and media criticism of the policy, often exaggerating costs, has clearly affected public opinion. Many wanted to take the information home and share it with family and friends, they were genuinely surprised.' Observations from deliberative workshops. 'Who pays?' Consumer Focus, 2012. <http://tinyurl.com/hwjue58>

Q2.3 Is quarterly an appropriate frequency for an updates?

We would prefer monthly, in order to keep up the pressure on suppliers to ensure that retail prices reflect underlying costs. It would also reduce the risk of surprises as the movement in the indices from report to report should be smoother with a shorter lag time.

But we recognise that there are resource implications associated with the frequency of publication, and can therefore understand why you may favour quarterly. We strongly suggest this is the minimum frequency you consider however - if it were to slip to six monthly, yearly, etc the utility value of this tool would be markedly reduced, and it might cease to become informative of contemporary cost trends.

Q2.4 What information on trends in suppliers' prices should we provide alongside the cost index?

You will need to provide some information on trends in suppliers prices as without this the provision of cost information is rather meaningless; the value in the SMI is in showing how costs are affecting, or may come to affect, retail prices.

As outlined in our answer to Q1.2, our preferred approach is that you continue to show a rolling expected margin throughout the year. In such an approach, the trend line should be based on a weighted basket of relevant retail tariffs in the market (eg if the index is only showing SVT costs, the relevant retail index should only comprise SVT tariffs, and so on).

If you are refocusing the new SMI away from concentrating on SVT tariffs to looking at the whole market, as you appear to be, then you will need to find some way to articulate the very different retail price trends that are seen in acquisition and retention tariffs. These appear to have significant underlying cost differences to SVT (most notably, but not exclusively, in relation to wholesale costs) and there is a very wide spread, often of several hundred pounds at average consumption level, between suppliers' acquisition and retention deals. Acquisition deals tend to be launched, repriced and scrapped with high frequency while SVT is more typically repriced once or twice a year. Given this divergence, you may want to consider providing a 'acquisition index' and a 'retention index' figure.

Q2.5 What, if any, additional information should we provide about trends in the individual categories of suppliers' costs?

Per our response to Q2.2, we suggest there will be greatest need to contextualise or explain information where it relates to data items that are either rapidly evolving or badly understood/disputed. We suggest that you may wish to provide some commentary or bespoke additional charts where a figure has moved markedly since the previous quarter's report.

Q2.6 How should we choose the base period relative to which the index is calculated, and how frequently should we update this?

We have no strong views on whether the index is periodically rebased or not.

Q2.7 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?

No, we do not. The presentation of an indicative margin trend is an incredibly powerful tool in articulating whether or not energy retailers are pricing cost reflectively and the level of competitive intensity they face. It can also provide a timely reminder to consumers that loyalty does not pay and that suppliers make far more money from them than from savvy switchers.

We were entirely comfortable with the old SMI and did not share the criticisms of it expressed largely by incumbent suppliers.

We think you could calculate an expected margin by reusing the old methodology.

Q2.8 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 month be sufficient on its own to provide the necessary transparency around trends in suppliers' expected costs?

If the cost trends affecting other groups of customers are being reported quarterly through the new SMI, it may make sense to also include the indices used to update the PPM price cap. This would reduce the risk of surprises in any

movement in the cap, and allow comparison in trends between those customers and other groups of customers.

Q3.1 Should the supplier cost index include suppliers' operating costs? If so, how should these be estimated?

Yes, we think that it should include suppliers' operating costs.

You note that:

"We would exclude from the cost index those costs that suppliers incur in relation to their own retail operations (for example, the costs of billing, metering and bad debt). Suppliers will set their price so as to try and cover these costs, which made up approximately 16% of an average dual fuel bill in 2015. However, compared to the other categories of costs, they are more likely to be fixed, are more difficult to forecast, and are to a greater extent within suppliers' control."

In combination, an exclusion of any estimate of supplier profits, and any estimate of suppliers internal costs, is likely to mean that around a fifth to a quarter of the total end consumer bill is not being tracked by the new SMI. This will mean the monitoring tool provides an incomplete picture of cost trends and reduces supplier accountability. That fixed costs are harder to forecast than variable ones is not a wholly convincing argument - if anything they should be more stable and less speculative. Likewise, we are not sure why these factors being within more within suppliers' control than others is relevant to whether or not they should be reported.

Ofgem has statutory information gathering powers, it receives historic internal cost information through the CSS, and cost information should be available for the delivery of environmental and social policy schemes through either impact assessments or ongoing performance reporting. In combination, we think these tools should enable it to provide a reasonable forecast for suppliers internal costs.

Basing supplier costs on past years operating costs (as shown by the CSS) with an efficiency factor applied (an RPI-X type measure) to expect anticipated operational improvement over time may be an appropriate approach here.

Q3.2 Do you agree with our proposal to hold consumption fixed over time at medium TDCVs in estimating trends in expected costs?

Yes. If a breakdown of costs is only going to be provided at one consumption level, it makes sense for this to be at medium consumption - as near as possible to that of the notionally average consumer.

Q3.3 Do you agree with our proposal to rely on the most recent CSS to calibrate the relative importance of different elements of suppliers' costs?

Yes. While the CSS may lag real time costs, there is a lack of alternative information in the public domain that would provide a better approach. Using the CSS for these weightings has the added advantage of reducing the scope for dispute when compared to a speculative figure.

In the event of rapid expansion or contraction in one area, and policy costs is possibly the most likely candidate given the fast expansion in the Levy Control Framework (LCF) budget, there may be a need for some additional commentary to be added to the figures to explain any risk that the use of time-lagged CSS may have on the under or over-estimation of that cost category.

A fall back or alternative option to get this cost breakdown may be to use your statutory information gathering powers to seek more contemporary data from suppliers.

Q3.4 Do you agree with our proposed approach to estimating trends in wholesale costs?

Yes, it seems sensible and is consistent with the CMA's observations. But there may also be some value in showing similar trends for a longer hedge in addition to, rather than instead of, the one year model - see our answer to Q3.5 below.

Q3.5 What, if any, regular information should we provide on suppliers' purchasing strategies, and what these mean for suppliers' costs?

It appears to us that many suppliers acquisition and retention tariffs are fundamentally differently hedged. In simple terms, that fixed term deals are hedged purely over the life of that contract - usually 12-18 months - while energy purchases for SVT are typically made for a longer forward period, perhaps 2-3 years. This contributes (though is not the sole factor) to a very wide price spread

between acquisition and retention deals, and to fixed deals being launched and replaced far more frequently than SVT prices are changed.

Your proposed approach more closely resembles the hedging strategy of acquisition deals, and may therefore give a better sense of the extent to which these are cost reflective than it does for SVT customers. Given the majority of customers are on SVTs, and that public debate, and dispute, often focuses on whether they are getting a fair deal, it would seem prudent that your analysis does also cater for movement in wholesale cost trends affecting SVT customers. Without this, you run the risk that the relevance of the new SMI may be disputed.

This could take the form of commentary around how the picture may be different based on a longer hedge, but rather than providing a qualitative descriptive analysis - which would be at risk of misinterpretation - it may be simpler to also include charts showing a longer hedge as well as the 12 month one proposed.

Q3.6 Does our proposed approach accurately reflect the expected annual network charges faced by a supplier for a typical domestic customer?

Yes, it appears appropriate.

Q3.7 Are there additional information sources or alternative assumptions that we could use to improve our estimates?

No, we think these are reasonable information sources and assumptions.

Q3.8 Should we seek to provide information on trends in costs for customers with non-standard electricity meters?

If the costs of serving these customers materially differs from those on standard electricity meters this may be appropriate.

Q3.9 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?

ROCs are tradable, so the buy-out price may not accurately reflect the actual cost to suppliers of purchasing certificates. Indeed, because the buy-out price is effectively a backstop price it should form a ceiling on market prices. Because of that, the approach suggested, of using the buy-out price, appears at risk of over-estimating supplier RO costs.

Exchange trading suggests that in recent periods this over-estimation is likely to be relatively immaterial.⁸ But this could change, and you should keep an eye on this if you plan to use the buy-out price as a proxy. From a methodological standpoint, we would be more comfortable if you used an exchange-based price, provided it is sufficiently liquid.

Q3.10 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?

No, we would rather you used real world costs rather than impact assessment costs where possible and we think this may be an area where close to real time real world costs are available.

BEIS used to report actual ECO costs for the obligated suppliers based on monthly reporting from those suppliers. These reports appear to have been discontinued⁹, but it may be that these information streams of actual costs are in place. The ECO2 Order contains cost reporting provisions. We would encourage you to speak to BEIS to see if those reporting streams are still in place and to make use of that data where you can.

It is particularly important that ECO cost estimates are realistic for multiple reasons.

Firstly, because it is currently the largest single energy policy levy applied to retail bills. So errors in estimation here will be more material than for other policies.

Secondly, because it has been one of the principal historic sources of dispute on bill cost drivers - it was heavily blamed by suppliers for the price rise round in autumn 2013. This dispute became so pronounced that the ECO policy was changed as a result.

⁸ For example, the outturn prices on ePower's e-ROC auctions are running fairly close to buy-out prices. <http://tinyurl.com/hhtdlvb>

⁹ An example from 2013: <http://tinyurl.com/ju4xkw2>

Thirdly, because it remains a source of ongoing dispute on costs. For example, the National Insulation Association and other energy efficiency and fuel poverty organisations have recently accused the government of overestimating scheme delivery costs by more than £200m/year.¹⁰

Clearly your forward look of costs can only be based on projections, not actuals. But we would strongly prefer those projections to be based on recent historic actuals, not estimates from impact assessments.

Q3.11 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?

Pros: there is less scope for suppliers to subsequently dispute these costs. Given suppliers historic unwillingness to accept the old SMI, some buy-in from them may be important if the new SMI are not to become as hotly disputed as the old ones. One would hope that suppliers would provide accurate information given the reputational and legal consequences of giving misleading information to a regulator.

Cons: there is no guarantee that these forecasts will become actuals; forecasts are not binding. For accounting purposes, it may be prudent for a supplier to take a conservative view of possible future costs which could result in their systematic overestimation.

Q3.12 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?

As previously, we would prefer if policy cost estimates were informed by actual implementation cost data rather than impact assessments where possible though we are unsighted on whether existing reporting lines for this are in place to either BEIS or Ofgem.

We note that past government estimates of FIT roll-out have been significantly out, with 2012 targets for 2020 deployment met already exceeded in 2015. We hope that current and future impact assessments will narrow that gap substantially, but it would be prudent for you to seek additional information from

¹⁰ 'Government overstated estimated ECO costs says NIA,' Utility Week, 26 August 2016. <http://tinyurl.com/z3elnvt>

suppliers and renewable installers trade associations to allow you to sanity check whether impact assessment figures remain credible.

Q3.13 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?

Yes, this appears to be an appropriate methodology.

Q3.14 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?

Yes, this appears to be an appropriate methodology.

Q3.15 Do you agree that reserve payments to the TRA should be excluded for the purposes of calculating the cost index?

Yes, we do not think the face-value of TRA payments should be included, although we think there may be an argument for making some allowance for the costs associated with providing that funding. This is because there will be some costs to suppliers associated with tying up working capital in the TRA. Realistically, those costs will flow through to consumer bills.

Q3.16 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?

Yes, this appears a reasonable methodology.