Ofgem consultation - Monitoring trends in suppliers' expected costs consultation

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?

1. E.ON agrees that Ofgem should provide estimates of ongoing trends in suppliers' costs, providing that these estimates closely resemble the costs of supplying energy to customers. Previous estimates have overstated future profitability, and have been used by the media and consumer groups to put pressure on suppliers to reduce prices and/or highlight excess profits. If an estimate is to be produced, input from E.ON, and other suppliers, should be central in the creation and subsequent approval of this calculation.

2. Our main concern around the supply market indicators (SMI) is the use of Ofgem average consumptions, which are historically based and tend to be larger than customers are forecast[1] to use in the future. These reductions in consumption, driven by energy efficiency (especially with regard to improved heating and insulation, improved lighting and appliance efficiencies, plus the recent increase in self-generation which has had an impact on electricity average sizes) need to be factored in.

3. Ofgem would need to ensure any published data is accurate and explained well. It would be important to provide customers with a clear view of key element cost movement to provide adequate insight.

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

4. We have used the SMI as a comparison against our own projections, and to gauge how we were performing against industry benchmark. We feel that the approach used was not representative of our customers as we set out in our response to Q1.1 and therefore provides us with limited benefit.

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

5. The SMI should have a range rather than a single specific value of supplying a customer. Within our internal cost projections we include expected risk values. The SMI doesn't capture these and their impact can be sizeable. We would urge Ofgem to consider the potential differences between a central expected outcome (the current SMI) with other possible outcomes, and use this to provide a range.

6. We would support the extension of the revised SMI to cover all suppliers given that there are now over 40 domestic energy supplier and the smaller suppliers now have a significant share of the market.

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?

1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524704/Domestic_energy_bills_in_2015_-_The_impact_of_variable_consumption.pdf (chart 3)

7. The use of an index will clearly show the directional movements without the stakeholder being caught up on the monetary value of a bill. However, the movement from a cost based evaluation, to a percentage based one could also cause cause confusion, e.g. a 5% reduction in overall costs results in a movement from 100 to 95 in that index. However a £100 to £95 reduction in revenues should not be expected, as the £ value for a 5% cost reduction would be less than a 5% revenue reduction.

8. We would seek clarification on whether users of the SMI would expect the percentage points movements for individual items to add up to the overall movement, or be expected to take each movement in isolation, e.g. figure 2.1

9. The date chosen for the base position will become the basis for all future cost movements and if there is any volatility at this point then this will be reflected in all future SMI reports.

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?

10. We would recommend separate indexes for electricity and gas. In terms of presentation, this will depend on who Ofgem consider to be the target audience for the SMI and what they will use it for. This should drive how the SMI is presented but it should be done so in a clear and simple way.

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

11. Yes we agree that quarterly should be sufficient, though commentary should be provided in periods of volatility.

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

12. We do not believe that trends in supplier's prices should be provided alongside the cost index. There is a risk that changes in costs would make users expect exactly the same level of change in prices, which are not comparable bases. Also there's a question of timing and different hedging strategies which may mean that suppliers' cost bases are not moving at the same pace as the SMI.

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

13. While some of the mentioned indirect costs could be controlled by an individual supplier, other costs are mandatory and/or defined by industry codes and practices for example, metering costs. Consolidated Segmental Statements (CSS) cannot provide information regarding indirect costs breakdown, but it would be useful to see the dynamic movement of some indirect costs. However Ofgem must be mindful that indirect costs are prone to large fluctuations as they may contain large one off items such as system upgrades. Ofgem should factor these into any calculations. The information about typical costs and/or expected movements could be gathered via industry bodies – DCC, Energy UK, etc., and would be as open and transparent as the index's methodology requires.

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

14. A large proportion of costs run April-March, whereas supplier accounts run January-December. Either would be an appropriate base, and maybe both would be useful, as evaluating projected changes in the cost base is difficult with a January-December baseline.

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?

15. We strongly agree with the proposal to no longer estimate a rolling expected margin. The accuracy of previous estimated margin expectations was a big concern and was extremely misleading. Rolling margins are not useful, and can give very large swings in profitability, especially if costs are volatile.

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?

16. A separate SMI should be created for prepayment, based on the cap methodology and prepayment specific characteristics, which are prescriptive and rigid. We would recommend a separate hedge assumption compared with the overall SMI. To avoid any confusion regarding differences between the two indices, each should be clearly defined and an explanation of the differences provided.

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

17. We agree that suppliers' operating costs should not be included with the exception of the costs outlined in our response to question 2.5.

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

18. We have concerns over the use of medium TDCVs. The rest of the SMI seeks to provide a forward looking view, however TDCVs is a historic observation that is updated infrequently and is reducing significantly over time [2] (table 1). We also refer to chart 3 in *"Domestic energy bills in 2015: The impact of variable consumption"* which is temperature and seasonally adjusted and demonstrates a downward trend in annual domestic energy consumption. Instead of using medium TDCVs, we would suggest that Ofgem devises a projected TDCV, based on the information used for the current TDCV, and an assumed impact of energy efficiency plus self-generation. A TDCV also doesn't take into account the wide range of consumption across all customers.

19. We recognise that using TDCVs which are used elsewhere across the industry makes comparisons easier. If TDCVs are to be used, then we would again welcome commentary to explain the differences between CSS and SMI comparisons which are both based on difference consumption profiles and therefore may cause confusion for stakeholders.

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?

20. Whilst we agree with the proposal generally, we have some concerns over the methodology suggested for calculating weights. Firstly, for gas and electricity should be kept separate to avoid incentivising suppliers to level up costs and lead to cross-subsidising. Secondly, the CSS is based on

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/524704/Domestic_energy_bills_in_2015_-_The_impact_of_variable_consumption.pdf (table 1)

the consumption profile of the customers of the large suppliers not on TDCV and so the weights of different cost elements may significantly vary between the two.

21. If the CSS is used, the most recent CSS should be used to calibrate against the same period from the SMI, with Ofgem investigating & reviewing their own calculations where there's sizeable differences between the projection and the actual outcome.

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

22. Ofgem's proposal to base the wholesale cost element of the index on the price of wholesale gas and electricity contracts for delivery in the coming 12 months is a good reflection of wholesale costs for customers on fixed term contracts but not for those on a Standard Variable Tariff (SVT). We believe there is a greater diversity of forward purchasing strategies in the market than just 12 months forward, and if the SMI were to present this as the only approach used, it may not identify competitive diversification of purchasing strategies in the market. This range of hedge would still expose a supplier to material volatility and as such would be likely to be at the shortest end of a hedging horizon.

23. Using last year's demand data would assume that the weather repeats itself, instead of using a normal profile applied to the average annual consumption. It also assumes fluctuations driven by the timing of Easter, weekends in the month, etc. wouldn't drive any differences. In addition to this, a 30/70 peak/baseload is flawed, as the relationship between peak and baseload fluctuates through the year.

24. For gas, our view is that it is better to use prices for delivery in the next three months instead of the first six months.

25. Concerning prices each month being weighted according to historic consumption data in that month, with electricity consumption proposed to be based on the governments "energy trends" publication, we believe that Ofgem should take a more granular source of historical demand information if it can be identified. Additionally, this may expose price shape to non-weather normal influences, so a weather-corrected demand would be more appropriate

26. There should be a seasonality aspect considered with the Peak/Baseload split given the patterns of usage in summer versus winter.

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

27. In regards to the collection of information on supplier's purchasing strategy, an anonymised survey may give stakeholders some expectation of transparency, but this information may also mean that there would be less incentive to differentiate purchasing strategy within the market and impact competitive opportunities.

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

28. For gas, the proposed weighting does not take into account consumption differences across regions. With varied quality of housing stock and temperature across the country, applying equal

weighting to each customer will understate the likes of northern Scotland, the South West, East Anglia & Eastern regions, and overstate the weighting of London.

29. For electricity, the proposal only uses profile class 1 consumption data, and doesn't take into account a large number (20% per point 3.24) of economy 7 customers, whose demand shape is quite different. Concerns with phasing annual consumption raised in point 3.4 above will also impact these costs, with April being the month when most of these rates change, any incorrect phasing will produce an incorrect answer, even if the cost rates are accurate.

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

30. We would recommend use of the network operator forecasts, with visibility of the number of meters in each region, a straight division of revenue by number of meters should give a fair approximation of the average cost per meter for suppliers in each region.

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

31. To represent non-standard electricity meters to the same degree of accuracy as unrestricted electricity and gas, this information should be provided. Customers with these meters tend to spend more time contacting suppliers than those with unrestricted meters. Providing tailored information to them may help with their queries.

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?

32. We agree with the proposal.

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?

33. We agree that this is representative of a detailed consumption approach as applied to individual bills, with the caveat that the basis of allocation of impact assessment costs is restricted to the obligated energy market only. I.e. Any customers of non-obligated suppliers should be excluded from the apportionment.

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?

34. We agree this is theoretically a more accurate representation of the true cost of the programme, rather than a high level estimate derived from initial impact assessments.

35. We would observe however that these costs vary significantly across the full scheme period and are not therefore representative of scheme costs at any one point in time and are therefore not a basis for real time decision making.

36. Factors affecting cost profiles for example include market and supplier availability over time; strategic and accounting approaches; and the impact of drop out or delayed removal of non-qualifying measures.

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?

37. We do not agree with the proposal to use the most recent government impact assessment to estimate the expected cost of FiT. Reporting is done regularly on the volume of FiT installations and this information should be used, along with a projection of the expected installs.

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?

38. We believe that this is fairly representative of a detailed consumption approach as applied to individual bills, with the caveat that the basis of allocation of impact assessment costs is restricted to the obligated energy market only. We believe this is what is implied by the term participating suppliers

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?

39. We agree with the proposal.

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

40. We agree with the proposal for forward looking estimates. However, should the scenario arise where a period has passed and so the drawdown from the TRAs is known, then this should be included in addition to the Interim Levy Rate (ILR).

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?

41. We agree with the proposal in principle. The approximation of Peak" to be 17:30 – 18:00, rather than the true 16:00-19:00, is reasonable, but would skew the distribution of costs between domestic/SME/Corporate supply businesses. We would like to point out that the methodology does not make any indication as to how Ofgem propose to forecast for the element of costs not known, e.g. the capacity to be procured in the T-1 auction.