

Rob Salter-Church
Senior Partner, Consumers and Competition
Ofgem
9 Millbank
London SW1P 3GE

31 January 2018

By email: CDconsultations@ofgem.gov.uk

Dear Rob

Providing financial protection to more vulnerable customers

We welcome the opportunity to respond to Ofgem's consultation. As noted in our previous response, there are many ways of supporting vulnerable customers. Centrica remains at the forefront of providing support, recognising that different customers have different needs and that those needs change over time. The complex and fluid nature of vulnerability is something that constantly needs to be borne in mind when considering policy interventions. There is accordingly a risk of unintended consequences on an enduring basis from price regulation, which underlines the need for a more extensive consultation process before any final decision is reached in relation to this issue.

We continue to have real concerns about Ofgem's approach to the imposition of price regulation for vulnerable customers. That is why, in parallel with implementing the first iteration of Ofgem's vulnerable customer safeguard cap, we called for a fundamental review of the methodology used to set the level of price protection. We consider this important to mitigate the risk of a tactical intervention becoming entrenched in a way that will not be in the long-term interests of consumers.

Our core concerns centre on the rationale for intervention, its scope and duration, and the level of any cap.

- The rationale for a price cap remains unclear, but now appears to be justified on the basis of fuel poverty, rather than a lack of ability to engage by consumers. This is despite Ofgem's previous insistence that fuel poverty was a matter for government policy. As we previously stressed, clarity over the objective is vital as an unclear policy rationale increases the risk of unintended policy outcomes.
- The present consultation emphasises an ambition to assist 'more' vulnerable customers but with insufficient clarity on the target groups and importantly the underlying criteria for targeting price protection. Expansion of scope – unless

properly targeted with a clear rationale for doing so - further weakens any link with inability to engage. This concern is made more serious given ambiguity over whether price caps for vulnerable customers (however identified) are intended to be temporary or permanent.

- The level of the existing WHD cap, based on the PPM cap methodology, is too low. It is vital that suppliers are able to recover their efficiently incurred costs when serving vulnerable customers. It will not serve the long-term interests of vulnerable customers if price caps impose a commercial penalty on suppliers who cater for vulnerable customer groups.

We think Ofgem has drawn the wrong conclusions from stakeholder criticism of its previous approach, using WHD to target price caps. Ofgem's proposed approach is to move away from WHD and look for a different proxy to target its price cap. But the concern of many stakeholders was that the price cap failed to address the underlying design flaws with WHD as it currently operates. In particular, it does not cover all suppliers, and there is a 'lottery' element to who receives a rebate due to the way support for broader group recipients is administered.

The solution to these problems lies with reform of the WHD scheme. Ideally, the costs of social policy interventions should be met from progressive taxation – not a hidden levy on energy bills, which will tend to be regressive. The WHD scheme should encompass all suppliers and apply on a consistent basis to eligible customers who meet the qualifying criteria. These reforms are straightforward, and stand to offer more low income customers more help more quickly, and do so more fairly than a price cap overlaid on an unreformed WHD scheme.

Therefore, we think Ofgem's focus should be on encouraging government to implement the necessary reforms to extend data matching to all suppliers as soon as possible. This would be entirely consistent with the CMA's recommendation that Ofgem should actively and publicly comment on Government policy that impacts on competition in the energy sector. It also faces fewer legislative hurdles than Ofgem's consultation proposals because primary legislation governing the WHD scheme is already in place. Reform to WHD can potentially be accomplished more quickly than an extended price cap, and may render it unnecessary.

We have significant concerns over Ofgem's fall-back option of using the Priority Services Register (PSR) to determine the scope of price regulation. The PSR was never intended to be a proxy for determining the groups falling within the scope of any price regulation intervention. In addition, there are wide variations between suppliers in the proportion of their customers included on the PSR, reflecting very different approaches by suppliers in how and to what extent they proactively identify customers for inclusion. Aggregating all PSR customers together as simply 'vulnerable' and then using that mechanism as the basis for targeting a price cap therefore threatens to undermine the original purpose of PSR, and create material unintended consequences for competition and consumers more generally.

While the focus should be on reforming WHD rather than extending price caps, the price cap methodology requires urgent review in any event. We have previously highlighted the flaws

with the PPM methodology in a report from Frontier Economics submitted with our response to the previous consultation. Our concerns about the continued use of this methodology, in lieu of a more robust and appropriate methodology to enable the recovery of efficiently incurred costs, remain unchanged. Until these issues are addressed, sustainable investment and innovation necessary to support long term service quality will remain at risk, which we believe should be relevant factors in Ofgem's decision making process.

While the case for a fundamental review remains compelling, the need to address the adverse impacts of the cap as it currently operates is pressing. We therefore identify pragmatic ways in which the PPM methodology might be adjusted in the short term, pending a more thorough review.

These issues are discussed more fully in the accompanying appendix and annexes, which include answers to Ofgem's specific consultation questions and detailed comments on price cap methodology building on Frontier Economics' previous analysis.

If you have any questions about this response, please contact tim.dewhurst@centrica.com in the first instance.

Yours sincerely

Sarwjit Sambhi

Managing Director, UK Home

Appendix

We welcome the opportunity to respond to Ofgem's consultation. Despite serious concerns about Ofgem's policy approach, we are implementing Ofgem's first vulnerable customer price cap right now.

We have previously made clear that our willingness to implement the WHD cap on a pragmatic basis was subject to Ofgem committing to an urgent and fundamental review to prevent the flaws in its tactical intervention becoming entrenched.

Ofgem's proposals to extend price protection to more vulnerable customers do not respond adequately to that call. The need for a fundamental review remains pressing.

- *Ofgem's approach requires a fundamental re-think*

Ofgem's emphasis on extending protection to 'more' vulnerable customers is reflected in the title of the consultation. Ofgem states that it has previously signalled its intention to extend the scope of price protection. Perhaps for this reason, its consultation questions focus on the detail of 'how' protection might be extended with no invitation to address the underlying issues of whether and why such protection is considered necessary and, if necessary, what form it should take.

We do not believe this is the correct starting point. Retail price regulation is one of the most intrusive forms of regulatory intervention with far reaching consequences for consumers and competition. The highly unusual and unsatisfactory consultation process adopted for the first iteration of Ofgem's vulnerable customer price protection did not adequately address these fundamental questions. Moreover, the rationale Ofgem puts forward appears to be shifting markedly (i.e. from ability to engage to addressing fuel poverty). All these factors point to the need to consider the case for intervention from first principles in a way Ofgem has yet to do.

- *Support for vulnerable customers does not imply support for price caps*

We recognise that the importance of energy supply gives rise to a need for certain protections for vulnerable customers. Vulnerability is a broad term, masking important differences in customer characteristics and needs. These needs are various, and we believe Centrica does more than any other supplier to understand and respond to them.

We appreciate that customers on low incomes may find it hard to make ends meet due to their financial circumstances, and any help to lower bills may therefore be welcomed. But we continue to have serious doubts about Ofgem's rationale for introducing price caps as a means of protecting vulnerable customers in the long term.

Major interventions require proper consultation

Ofgem's appeal to urgency does not justify inadequate consultation for a major and intrusive intervention with wide ranging consequences. Ofgem has failed to take proper account of stakeholders' responses to the previous consultation, and has embarked on a new one without a) building a proper evidence base; b) conducting an adequate impact assessment; or c) allowing sufficient time for meaningful engagement with stakeholders.

- *Need for reliable evidence*

There are numerous respects in which the evidence base needed to support policy proposals is insufficient. For example:

- Ofgem makes numerous statements to the effect that vulnerable customers are 'more likely' to be disengaged to assert that vulnerable customers may be unable to engage, and for that reason require protection. The inference is questionable, even if the premise were true, and the group of vulnerable customers in question well defined. The observation that some customers don't engage doesn't establish that they can't engage. But for at least one of the proxies of vulnerability Ofgem proposes to target price protection – PSR – the premise is demonstrably false. Ofgem's own analysis of data compiled by the CMA shows that PSR customers are in fact less likely to be on default tariffs (Ofgem's measure of disengagement) than the population average.¹
- The basis for Ofgem's scope estimates – 2.2 million based on data matching or 2.6 million based on the fall-back 'supplier led' approach – are not fully transparent. However, the latter appears to be based on 2016 data – predating changes which expand the scope of suppliers' regulatory obligations.² Centrica's current estimate for the number British Gas and Sainsbury's Energy PSR customers potentially falling within scope is ~~.....~~. Even allowing for divergences between suppliers in the proportions of their base on PSR, Ofgem's 2.6 million industry estimate appears implausibly low.
- Ofgem chose to issue its consultation proposals without first obtaining necessary information from suppliers. This approach risks denying stakeholders a meaningful opportunity to consider and comment on the outcome of such information gathering while policy proposals are at a formative stage. Ofgem issued a draft RFI on 10 January 2018, inviting comments by 17 January and indicating that a final RFI might follow by the end of January. The final version was issued on 26 January, although Ofgem has indicated that it may have further questions on smart meters that it has

¹ This data does not feature in the consultation document but was exposed in presentation slides at a supplier workshop hosted by Ofgem on 23 January 2018

² Appendix B of the consultation document at 1.25

not yet formulated. On this timetable, there is no prospect of results being available to stakeholders during the exceptionally short consultation window Ofgem has allowed.

- *Need for a rigorous impact assessment*

We remain concerned regarding the lack of any proper impact assessment to support this policy proposal. We highlighted the lack of quantification in Ofgem's previous statutory consultation, and the doubt this cast on assertions that the interventions then proposed were proportionate.

The absence of an adequate impact assessment compromises Ofgem's ability to discharge its statutory duties to ensure proportionality. We do not consider urgency to be sufficient justification to warrant this crucial process shortcoming. Price regulation is a highly intrusive regulatory obligation and the impact will scale with increasing scope. Even on the basis of Ofgem's analysis the scope of its vulnerable customer price cap would increase by a factor of more than three – from around 1 million customers to over 3 million.

Against this background, the need for a robust quantitative impact assessment is plain.

- *Need to allow sufficient time for meaningful consultation*

The present consultation is undermined by a lack of evidence and analysis to inform the consultation proposals. But its timing and the time allowed for response is also a process concern.

The consultation document was published days before Christmas, less than two weeks after the decision to mandate an initial WHD price cap following a heavily truncated consultation.

Ofgem's own consultation guidelines state that for major issues it would normally allow up to twelve weeks, and even for more narrowly defined issues it would expect to allow eight weeks.³ The guidelines do provide for four week consultations for 'urgent issues', which Ofgem describes as follows:

"Urgent issues, or minor changes to existing policy, or if we're following another organisation's timetable, licence, or other regulatory or statutory requirement: four weeks"

However, this is not a minor change. Ofgem is not following another organisation's timetable. There is no licence or other regulatory or statutory requirement. And Ofgem's own (self-imposed) timetable is simply an ambition to extend protection 'in time for next winter'. Ofgem refers to a 'two-tier' market and the 'customer detriment' it claims results from price differentials. This analysis is controversial, but it is not new. If Ofgem considered

³ <https://www.ofgem.gov.uk/consultations/consultations-policy>

that there was a clear case for direct price intervention to protect vulnerable customers, it could have initiated consultation long ago as part of its wider vulnerability strategy, for example. Yet as recently as June 2017 Ofgem confirmed that the licence changes it proposed to underpin a 'principles based' approach to vulnerability did not extend to pricing.⁴ Objectively, therefore, Ofgem cannot plead urgency to justify exceptional curbs on consultation.

Ofgem's objectives are ambiguous and require urgent clarification

- *Need for a clear rationale*

The underlying rationale for intervention remains ambiguous and confused. Without clarity, precision and a proper evidence base, the proportionality of Ofgem's intervention is highly questionable. Indeed, without such an evidence base, it is difficult to see how Ofgem is able to make a considered view regarding the proportionality of this intervention.

We pointed out the confusion around rationale in our response to the previous consultation. Unfortunately, rather than resolving this confusion Ofgem has added to it. Previously, Ofgem said its rationale was to protect vulnerable customers who can't engage. It denied that it was seeking to address fuel poverty, which it said was a matter for government.

In the present consultation, Ofgem insists it is still concerned that vulnerable customers may not be able to engage effectively. But this time, it says that it is also looking to address fuel poverty. Curiously, Ofgem does not directly address or invite comment on its unexplained change in position.

The reason this matters is because inability to engage and fuel poverty are fundamentally different rationales for intervention. Without clarity on rationale, there can be no clarity on targeting, which is critical to assessing the proportionality of any proposed intervention. It is also imperative for Ofgem to be transparent about the legal basis for any proposed intervention. As we have previously noted, on the face of it powers to adjust charges in pursuit of fuel poverty objectives are reserved to the Secretary of State, not Ofgem.

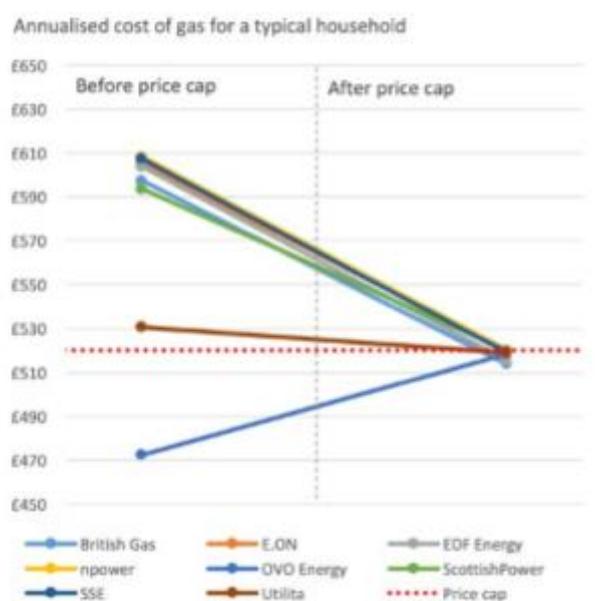
- *Need for consistency and coherence*

Ofgem says that it wishes to protect vulnerable customers through a price cap but, at the same time, that it wishes to preserve incentives for customers to engage. Yet the effect – indeed the objective – of imposing a price cap is to reduce price differentials. Ofgem says it believes a cap can be set at a level consistent with competition below the cap. In principle, this may be possible. In practice, it will depend upon the level at which any cap is set.

⁴ https://www.ofgem.gov.uk/system/files/docs/2017/06/statutory_consultation_-_standards_of_conduct_for_suppliers_in_the_retail_energy_market_0.pdf

Evidence to date on the effect of the PPM cap clearly shows price convergence around the cap.

Figure 1: Prepayment tariffs before and after price cap



Source: Ofgem analysis based on Energylinx data, reproduced from Ofgem State of the Market Report 2017, Figure 2.13

Convergence erodes the price differentials Ofgem (wrongly) associates with customer detriment. But it also erodes the potential gains from switching and incentives to switch that might otherwise have existed.

Academic studies consistently show that price and the prospect of financial savings remain by far the most important factors in driving willingness to engage. In addition, the least engaged customers typically require higher values of potential saving to persuade them to search for a better deal. In the context of the government's draft bill to implement a wider default tariff price cap, the Centre for Competition Policy (CCP) noted:

“The cap is likely to reduce the rate of switching relative to the level which would have occurred in its absence, since the cap is explicitly designed to reduce the price differential between FTTs and SVTs (see response to Question 5, above). The price differential between FTTs and SVTs represents a substantial proportion of the monetary savings available to SVT consumers when they consider switching supplier. A range of CCP research shows that increased monetary savings are associated with an increased probability of switching[49].

For a rational consumer to switch supplier and gain benefit the expected gains from switching must exceed the expected costs. The expected gains from switching are mainly monetary, plus any improvements in customer service, after they have been

suitably discounted to reflect a consumer's uncertainty about these gains being delivered. The expected cost of switching includes the opportunity cost of time spent searching for cheaper tariffs and completing a switch as well as contractual penalties, such as exit fees^[50]. A similar trade-off between monetary and other benefits against the time required to switch applies to a consumer's decision to switch tariffs while remaining with their current supplier.⁷⁵

In the case of the PPM cap, the CMA played down concerns about reinforcing disengagement on the basis that the technical characteristics of 'dumb' prepayment meters already curbed customers' ability to switch tariff. This reasoning does not read across to price caps for vulnerable customers, and becomes even more important if any such cap cannot be closely targeted at customers who genuinely can't engage. The wider the scope of any cap, the more serious this issue becomes, but there is little evidence that Ofgem has given it serious consideration to date.

- *Need for clarity on duration*

We previously highlighted the apparent contradiction between the hard-sunset date envisaged in the statutory consultation and public statements by Ofgem's Chief Executive to the effect that price protection for vulnerable customers would be needed on an enduring basis.

This ambiguity has not been resolved, and ambiguity remains regarding whether vulnerable customer price caps are transient or permanent. This compounds concerns around the lack of precision about scope.

These concerns cannot be dismissed by saying that the vulnerable customer price cap will be superseded by a wider government-imposed cap. As previously noted, Ofgem should be cautious about anticipating a wider cap, for which there is no statutory authority currently, and the terms of which in any event remain to be determined.

Financial protection doesn't necessarily mean price caps

- *Identifying the target group does not determine the appropriate form of intervention*

Once Ofgem has identified the specific problem it is trying to tackle, the question of appropriate targeting and the form of intervention can be considered. If the problem is difficulty engaging, it may be more appropriate to understand and tackle the root cause of that difficulty than to assume that a price cap – which will tend to undermine incentives to engage – is the right answer. If the problem is financial hardship, a communally funded

⁵ <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/prelegislative-scrutiny-of-the-draft-domestic-gas-and-electricity-tariff-cap-bill/written/74931.html>

rebate or income support funded by progressive taxation may be more relevant – and offer more help to the customer concerned – than a price cap.

This used to be Ofgem's position. In response to a government consultation proposing to replace 'social tariffs' with a more consistently targeted Warm Home Discount rebate scheme, Ofgem stated:

*"In our view the best way to tackle fuel poverty is through improving the energy efficiency of housing - which is the sustainable solution - and through the tax and benefits system, which is the least regressive and most flexible way of effecting redistribution. However, we recognise that in the current economic climate providing financial support in this way may not be a realistic possibility and improving the energy efficiency of housing is a long term project which will take time to have effect. Given these realities, we welcome the introduction by government of the Warm Home Discount (WHD) scheme and are committed to working with government to ensure that the arrangements are as effective as possible and that any potential negative impacts on the wider consumer base and competition are minimised."*⁶

Ofgem also stated that it agreed with the principles set out in DECC's consultation document, including the following principle favouring rebates over interference with tariffs due to the risk of distorting competition and customer choice:

"Principle 4: Competitive energy markets By leaving the underlying tariff structure intact, rebates minimise distortion to the energy market by maintaining the incentive for consumers to seek out the best tariff available, and for suppliers to compete across the entire market".⁷

- *Price caps don't solve 'affordability'*

There are many objections to price caps. But in the context of affordability, a price cap is a very blunt instrument. There can be no guarantee that even a price cap which enables suppliers to finance their operations sustainably, recover efficiently incurred costs and earn a reasonable margin will be 'affordable' to a customer on a low income. One of our concerns is that Ofgem's proposed cap will not meet the first three tests, let alone guarantee affordability.

- *Need to consider alternative policy approaches*

Even if a case can be made for financial protection of tightly-defined customer groups, it does not follow that this should necessarily take the form of a price cap. Ofgem needs to consider the overall coherence of its proposed intervention with existing policies to address

⁶ <https://www.ofgem.gov.uk/ofgem-publications/57107/warm-home-discount-consultation-responsepdf>

⁷ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/42589/956-consultation-warm-home-discount.pdf

fuel poverty, encourage energy efficiency and roll-out of smart meters, as well as assessing the cumulative fit with its wider statutory duties.

We see no serious consideration of alternative policy options. Ofgem fails to explain the dramatic reversal of its previous (recent) position that special measures for vulnerable customers should not extend to pricing. Nor does it explain its rejection of the CMA's considered view that a vulnerable customer price cap would be disproportionate.⁸ If Ofgem does not agree with the CMA's view, we would have expected it to set out with full and objective supporting evidence where and why it disagrees with CMA, or what has changed since the CMA's review that could lead to its previous conclusion being overturned

- *Ofgem should push for data matching in the context of WHD reform, not price caps*

We believe a wider review of the government's approach to fuel poverty is appropriate. This review should include both the Energy Company Obligation (ECO) and WHD, with a view to removing small supplier exemptions which artificially reduce the cost base faced by small suppliers. Ideally, such policy costs should be borne from progressive taxation, not by energy suppliers who must then recover those costs from their customers – benefiting some customers at the expense of others.

The present WHD scheme is explicitly based on cross-subsidy, with acknowledgement that the costs of administering the scheme and paying rebates will result in higher average bills for other customers. In the past, the government has argued that redistribution among energy customers is progressive because those who are on average better off subsidise those who are on average worse off.⁹ This reasoning is increasingly suspect, however.

- *The distributional consequences and present funding model for WHD require review*

Ofgem's professed concern about a two-tier market is based on a distinction between engaged customers who shop around and less engaged customers who remain on default tariffs for long periods of time. Record levels of switching¹⁰ cast doubt on the notion that the distinction between engaged and disengaged is as hard-edged and immutable as the two-tier language suggests. But we recognise there is a spectrum of customer behaviour with some customers engaging more than others, or engaging more frequently.

⁸ CMA final report 11.95-11.97

⁹

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/514325/FINAL_Warm_Home_Discount_2016-17_extension_consultation_IA_CONSULTATION.pdf

¹⁰ Ofgem's data portal update for December 2017 reports that switching reached new record levels. In October there were 534,746 electricity switches and 461,000 gas switches. These were respectively the highest level of electricity switching ever recorded in the same month and the highest ever level of gas switching in any month. The number of switches to small and medium suppliers also increased compared to September, by around 13% in electricity and 17% in gas. <https://www.ofgem.gov.uk/data-portal/retail-market-indicators>

Ofgem and government need to recognise the implications for redistribution implied by the current funding model against this background. In practice, the costs of WHD, for instance, will not be recovered on a uniform average basis across all customers. Customers of small, exempted suppliers avoid these costs altogether although their (engaged) customers are likely on average to be more affluent than less engaged customers of obligated suppliers. Competitive pressure to meet the challenge from small exempt suppliers with lower costs means that obligated suppliers are also driven to recover proportionately less WHD costs per customer from engaged customers than from customers who are less engaged.

This is not a failure of competition, as former regulators have recently made clear in evidence to parliament in the context of the government's draft bill for a wider default price cap.¹¹ This is competition working in the context of a market distorted by asymmetric policy obligations. If Ofgem and government are serious about wanting to address the effects of the two-tier market while maintaining policy interventions to support energy efficiency and affordability among customers on low incomes, the appropriate policy response is to fund the cost of interventions from progressive taxation, not to impose price caps. Failing that, to the extent policy makers are content to preserve a cross-subsidy model of funding, they should at least ensure that policy costs are borne equitably by all suppliers to avoid exacerbating the "two tier" dynamic that is the primary concern.

- *Small supplier exemptions must be abolished across the board*

There is mounting evidence that the 250,000-customer threshold for ECO and WHD is impacting small supplier behaviour even if it is not restricting the absolute number of new entrants. The emergence of low cost 'supplier in a box' solutions call into question the entry assistance arguments that may originally have motivated small supplier exemptions. The distortive impact on customer choice and competition can no longer be ignored, and Ofgem should make the case strongly to government – consistent with its statutory duties to advance good customer outcomes through promoting competition – that such exemptions are part of the problem, not part of the solution in the context of the 'two-tier' market Ofgem says it is determined to end.

- *The case for a safeguard cap remains weak – and the case for extension weaker*

We reject Ofgem's characterisation of price differentials as equivalent to consumer detriment. But we urge Ofgem to address the artificial policy distortions that magnify apparent differentials.

Ofgem continues to attach insufficient weight to the risks and unintended consequences of a vulnerable customer price cap. Beyond undermining incentives to engage, distorting

¹¹ <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/business-energy-and-industrial-strategy-committee/prelegislative-scrutiny-of-the-draft-domestic-gas-and-electricity-tariff-cap-bill/written/76483.html>

competition and customer choice, the PPM cap is already endangering efficient cost recovery, putting service levels, investment and innovation at risk.

These risks increase in magnitude the further the scope expands. Ofgem itself estimates the scope of its cap will more than triple – from 1 million to over 3 million households. The reliability of these estimates is open to question. There is good reason to believe they are far too low – especially in fall-back scenario based on Priority Service Registers (PSR). Vagueness around definition and apparent one dimensional focus on increasing scope are an additional cause for concern.

The differential impact on suppliers caused by overlaying an expanded price cap on a market distorted by small supplier exemptions simply fuels supplier asymmetry, exaggerating the 'two tier' market Ofgem says it is committed to ending.

Extending duration and expanding scope exacerbate problems with the existing cap

Ofgem's position on duration is inconsistent and contradictory. It is unclear whether price caps for vulnerable customers is viewed as a temporary stop gap, or whether Ofgem proposes an enduring need for price protection for this customer group.

Meanwhile, Ofgem's two very different approaches to identifying vulnerable customers who might qualify for protection suggests a concerning lack of precision in how Ofgem considers vulnerability should be identified. This amply demonstrates the increasingly weak link between targeting and (any) claimed underlying rationale for price protection.

- *Effective targeting requires precision*

In the context of price caps a 'catch all' approach to identifying vulnerability will plainly not be well targeted on either inability to engage or fuel poverty, even if price protection via a cap were thought to be the appropriate intervention. It is not sufficient to say 'some vulnerable customers may have difficulty engaging' or 'some vulnerable customers may be fuel poor' to justify wide ranging intervention for all 'vulnerable' customers.

- *Provision needs to be made to remove as well as add customers as their circumstances change*

Ofgem also needs to consider when and how customers cease to be eligible for price cap protection. Ofgem's focus on extending scope to include ever more customers fails to consider this important issue. For the WHD cap, Ofgem included customers identified in the previous scheme year as well as the current one on the basis that it did not know numbers for the current scheme year. However, this means that customers who were previously eligible for WHD (based on underlying benefits) continue to qualify for price protection even if their circumstances have changed.

Ofgem added to this problem in its final decision by stating that, from April 2018, customers identified in the previous two scheme years should continue to benefit from the cap. The idea that price cap coverage should be determined by benefit entitlement years previously is hardly a model of effective targeting, but unless addressed will become a recipe for scope creep not recognised in any impact assessment.

- *Underlying problems with WHD must be tackled*

We recognise that Ofgem's proposals for any new approach to defining scope would replace and supersede the existing WHD basis which excludes small suppliers. However, decoupling eligibility for the price cap from WHD does not address the underlying problems that stakeholders have previously flagged with the current operation of WHD. Ofgem's present proposals will not end inconsistent treatment of customers on income/disability benefits – even if the safeguard cap applies across the board, the arbitrary nature of who receives a rebate and who does still needs to be resolved. Customers' choice of supplier will continue to be skewed by small supplier exclusions for WHD, but the extension of price caps will widen the distortion around tariff choice.

- *Ofgem's preferred option (data matched vs income/disability benefits) fails to ensure equal treatment among benefit recipients. Without separate reform of WHD, the lottery element for who receives a rebate remains*

Ofgem has recognised one of the underlying weaknesses of the current WHD scheme; namely how broader group selection is not automatic but instead operates on a 'first come, first served' basis. It argues that moving to consistent data matching and breaking the link with WHD would side-step this problem for the purposes of its proposed price cap.

However, Ofgem overlooks the more fundamental problem that extending automatic price cap entitlement to more benefit recipients does not enable them to access the (potentially more important) WHD rebates without separate reform of WHD itself.

- *PSR is fundamentally unsuitable as a proxy for price caps*

For the first iteration of its vulnerable customer safeguard tariff, Ofgem rejected PSR because it was a poor proxy for customer inability to engage (its claimed rationale for intervention at the time).¹² We agreed, and still agree, with that assessment.

¹² https://www.ofgem.gov.uk/system/files/docs/2017/10/financial_protections_for_vulnerable_consumers_-_technical_document.pdf at paragraph 4.15

We note that Ofgem is shifting its position on possible rationale for intervention by appealing to fuel poverty – having previously stated that was not its primary focus and stressed that fuel poverty policy is a matter for government to lead on.¹³

This imprecision and fluidity is itself a source of serious concern. It creates ambiguity about the aim and purported justification for price protection against which targeting and proportionality could be assessed. However, PSR is plainly no better a proxy for fuel poverty than it is for inability to engage. WHD, the present proxy, does not directly identify fuel poverty and nor would any revised income/benefit based proxy based on data matching. They would, however, identify *low income* due to the eligibility criteria for qualifying benefits. The same cannot be said of PSR, *which does not effectively identify inability to engage, fuel poverty or low income.*

- *PSR is inconsistent between suppliers*

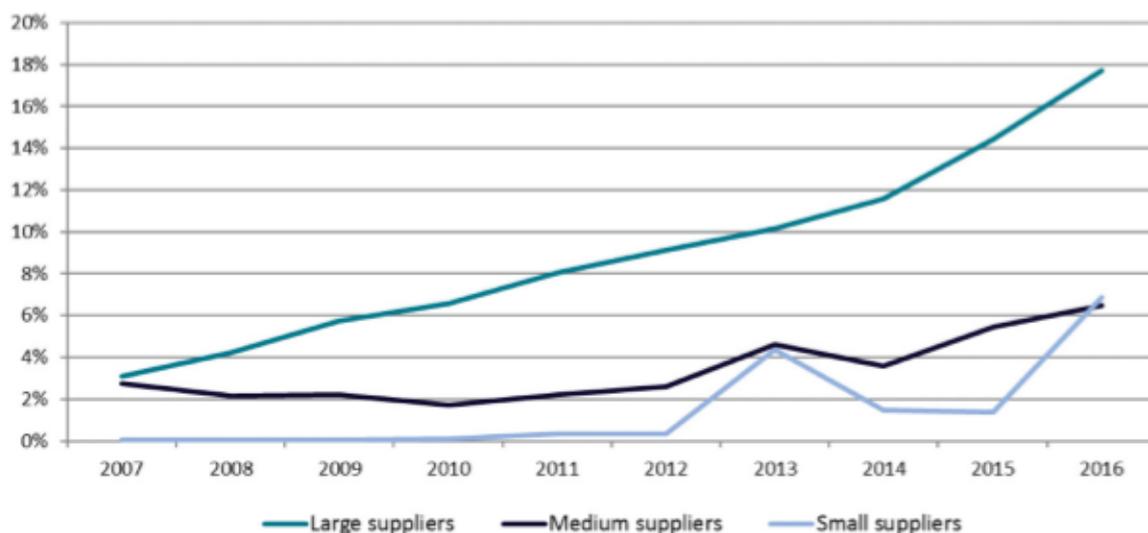
Poor targeting is not the only reason for rejecting the backstop option. Ofgem notes in passing that there are wide variations between suppliers in the proportion of their customers included on the PSR. While some of this difference may reflect underlying differences in the composition of different suppliers' customer bases, there is a strong suspicion that it may also reflect very different approaches by suppliers in how and to what extent they proactively identify customers for inclusion. This should be of concern to Ofgem for other policy reasons. But it is a huge concern in the context of potentially using PSR to target price caps.

For reasons that are unclear, Ofgem has stopped publishing data on social obligations on a per supplier basis, although it recognises that in aggregate there are wide variations in PSR proportions between small, medium and large suppliers.¹⁴

¹³ https://www.ofgem.gov.uk/system/files/docs/2017/10/financial_protections_for_vulnerable_consumers_-_technical_document.pdf paragraph 2.17

¹⁴ Figure 2 below reproduced from Ofgem consumer vulnerability report 2017
https://www.ofgem.gov.uk/system/files/docs/2017/10/consumer_vulnerability_report_web_003.pdf

Figure 2: Proportion of electricity customers on a PSR
(trend is similar for PSR gas customers)



The illustration above, however, is likely to mask further variation within these broad categories.

- *Ofgem's PSR estimates are out of date and unreliable*

Critically, Ofgem says it has used the above data weighted by market share to derive its industry estimate of 2.6 million customers. But this is based on 2016 PSR data, predating Ofgem's recent changes to definition and obligations surrounding PSR which, if enforced consistently across suppliers, are likely to result in significant expansion of the proportion of customers included in PSRs for one reason or another.

- *PSR is about supply continuity, not pricing*

PSR was never intended to be a proxy for targeting pricing interventions. Its primary purpose is around supply continuity and non-financial help. While Ofgem has recently expanded the scope of PSR, it confirmed as recently as June 2017 that the revised licence obligations introduced as part of its vulnerability strategy do not extend to pricing. As noted, customers generally need to engage to be included on the register and suppliers take note of customers' own identification of their vulnerability to understand what kind of special support may be appropriate for the individual customer. Aggregating all PSR customers together as simply 'vulnerable' and then using that tag as the basis for targeting a price cap threatens to undermine the original purpose of PSR.

While customers need to identify themselves to be included on the register, they do not necessarily need to do so directly with their supplier. Data sharing between network operators and suppliers enables a customer to claim priority for service restoration in the

event of a power cut which, with the customer's permission, may then be shared with other parties including suppliers. If the focus of PSR changes from understanding why customers require priority service restoration in the event of supply interruption, for example, to become a route to claiming entitlement to price protection with few if any checks, there is a risk that the original purpose becomes further undermined ('priority' becomes meaningless if everyone becomes a 'priority' customer).

Price cap methodology requires urgent review

While Ofgem's rationale for extending the scope of its vulnerable price cap is unpersuasive, the methodology used to set the existing tariff caps for PPM and WHD customers requires review in any event.

Ofgem's proposal to restrict its analysis to just two methodologies – the PPM approach and a "basket of market tariffs" approach – without due consideration to other options has compromised its ability to make an informed judgement on whether the tariff cap will meet its stated objectives for the control. Refusing to consider other options on the assumption that there would be insufficient time to implement them is an unsatisfactory basis on which to undertake this consultation on measures that will potentially affect more than three million households.

Further, one of the methodological options that Ofgem has put forward, the "basket of market tariffs" option, is not fit for purpose. We have set out our concerns about such a methodology in detail in Annex B, but to summarise:

- A simple basket of tariffs approach would fail to control for legitimate and unavoidable differences in costs across suppliers. In addition, it would fail to control for the fact that the cheapest tariffs in the market are likely to be unsustainable acquisition tariffs.
- There would be a range of additional problems concerning the evolution of the cap over time, resulting from the fact that the tariffs (and suppliers) that make up the basket would be allowed to change from one period to the next. This would generate a cap level that is lower than that which any supplier could reasonably be expected to achieve over the medium term.
- The cap would expose suppliers to risks that they cannot control.

A price cap based on the "basket of tariffs" methodology would therefore not allow suppliers to recover their efficiently incurred costs and leave no room for suppliers to compete on a sustainable basis – thereby failing the criteria that Ofgem has set out for appraising the price cap methodology in its consultation document. While some of these concerns could – in theory – be offset by allowing more headroom over and above level of tariffs in the basket, significant work would need to be undertaken to calculate the appropriate level of headroom, which would result in a methodology that was more complex than the alternative methodologies that Ofgem has ruled out on grounds of impracticability.

The only other option Ofgem considers is the PPM cap. In November 2017, we submitted a report written by Frontier Economics¹⁵ that described and explained the methodological flaws of the PPM cap and looked at the problems that are arising in practice following its introduction. Applying this cap to a wider group of customers without adaptation would not be acceptable.

In Annex B we consider each of the potential adaptations to the PPM methodology that Ofgem has set out for discussion. We conclude that – viewed individually – a number of these changes merit consideration. However, care needs to be taken that, when viewed collectively, the totality of the adjustments will address the flaws in the PPM methodology. In particular, the Frontier Economics report identified that the PPM methodology understates the costs incurred by large, efficient energy suppliers for at least three sets of reasons:

- The methodology does not accurately model the wholesale energy costs that an efficiently-run energy supplier can be expected to incur. In particular, it is likely to have permanently “hard-wired” any wholesale cost advantages that the benchmark firms enjoyed as a result of either their chosen hedging strategies, or simple luck, on the single snapshot date used to calibrate the cap.
- The methodology is based on only two benchmarks (Ovo and First Utility), neither of which is a good comparator for an efficiently-run large energy retailer serving a diverse set of customers. Examples include differences in the size and characteristics of the customers that these companies serve, as well as the business models that they employ.
- The methodology does not accurately model the policy-related costs that an efficiently-run energy supplier can be expected to incur – including both smart costs, and costs associated with new policies.

In Annex B we provide further information on each of these flaws and set out the additional changes that would need to be made to the PPM cap methodology to rectify each issue. The changes that Ofgem has set out for consideration in its consultation paper would – at best – partially address the third category of problems identified by Frontier Economics, and not address the first two categories of concern at all.

While the best solution would be to rectify all these flaws in the PPM methodology by undertaking a full review to ensure that they are properly addressed, if Ofgem deems that there is insufficient time to do this then it should at least ensure that the changes it makes will raise the level of the cap to cover the costs of an efficient supplier.

It is also critical that Ofgem ensures that there is sufficient time to consider – and appropriately consult on – all methodologies prior to setting any wider cap on all standard variable and fixed-term default tariffs. We therefore assume that Ofgem is pursuing a timetable for setting that control to address this.

¹⁵ Frontier Economics, “*Understanding the PPM control*”, 10th November 2017.

The way ahead

We have long supported data matching to target support via WHD. We consider the most effective way of addressing fuel poverty (while maintaining incentives for customer engagement), would be for Ofgem to pursue WHD reform, and a broader removal of small supplier exemptions.

We recognise that Ofgem cannot fully address these issues on its own. But overlaying interventions without a robust and consistent policy rationale is not the way forward.

PSR is fundamentally about supply continuity. It is not, and was never conceived to be, a register of financial hardship. The fall back 'supplier led' option based on PSR, has severe limitations and should not be progressed.

The PPM cap requires fundamental review. Serious shortcomings Centrica has previously identified result in a cap that is already jeopardising recovery of suppliers' efficiently incurred costs. A cap set at a level that fails to allow an efficient supplier to recover reasonable costs can be expected to have adverse implications for quality of service, investment and innovation – risking a consequential adverse impact on consumers. The broader the scope of the cap, the more severe these implications will be.

A full review to identify and address all the flaws with the PPM methodology and consider appropriate alternatives is required. In the short term, Ofgem should adjust the methodology to ensure the cap does not further impair sustainable cost recovery, pending more thorough review.

Annex A – response to Ofgem's consultation questions

Chapter 2 – Scope

Question 1 – *What are your view on our preferred approach to identifying consumers for safeguard tariff protection by primarily relying on data-matching?*

The question presupposes a case for extending safeguard tariff protection which is open to question. Centrica has long advocated data matching to target financial assistance through the WHD scheme. We believe that this should be pursued as a matter of priority, taking precedence over data matching purely for the purposes of a price cap (for which the case is not made). Pursuing a price cap without addressing the underlying problems with the current WHD scheme will merely perpetuate arbitrary differences in the support available to customers on means tested benefits, while distorting competition and customer choice in a way that reinforces the 'two-tier' market Ofgem says it wishes to end.

- *Inclusive data matching yes, price caps no*

On condition that small supplier exemptions are ended, whatever the precise criteria for determining customer eligibility for WHD and the level of financial support, it is appropriate that targeting is based on objective criteria uniformly applied on a consistent basis across all suppliers. In this context, we believe data matching for all suppliers is the appropriate and efficient response, and should be prioritised to ensure greater equity among benefit recipients and between suppliers. If this agenda is pursued expeditiously we are not convinced that safeguard price caps need to be overlaid on top of WHD rebates.

Question 2 - *What are your views on our backstop option that requires suppliers to use the information they hold (such as Priority Services Register and debt information) to identify vulnerable customers?*

For reasons discussed more fully in the Appendix to this response, Ofgem's proposed 'backstop option' is inappropriate and unacceptable.

Question 3 - *Are there other methods for identifying vulnerable customers that we should consider, either alongside or as an alternative to our proposed approach?*

Ofgem needs to clarify much more precisely than it has done to date what the specific rationale is for providing price protection through a price cap. It then needs to explain, with compelling evidence, how that relates to any specific aspect of vulnerability, before this question can sensibly be addressed.

Question 4 – *What are your views on our proposal for all suppliers to be required to provide safeguard tariff protections to vulnerable consumers? What impact would this have on suppliers? Please provide evidence to support your views.*

We are not convinced that safeguard tariff protection is an appropriate policy response on a long-term basis, for the reasons set out in detail in the Appendix to this response. To the extent that price caps do apply, we think they should apply equally across all suppliers.

Question 5 - *What are your views on our proposal regarding the tariff types and meter types our extended safeguard tariff protections would apply to?*

We are not persuaded of the case for maintaining or extending safeguard caps. However, to the extent that they continue in the short term they should exclude prepayment meters that are subject to separate interventions mandated by the CMA, and they should exclude non-default tariffs that customers have actively chosen.

Chapter 3 – Methodology

Question 6 – *Which of our two options for setting the benchmark component of the safeguard tariff would be most effective?*

We see no merit in the 'market basket' approach. As previously highlighted, the PPM methodology suffers from serious weaknesses that require urgent review in any event.

These issues are discussed in more detail at Annex B.

Question 7 – *Do you have any comments on the design issues for either of our two options?*

Yes. Our more detailed comments on design issues are set out in Annex B

Annex B

Comments on methodology options for setting the vulnerable customer safeguard tariff level

Overarching remarks

Ofgem has chosen to consider only two methodologies for setting the vulnerable customer safeguard tariff level:

- an extension of the PPM methodology based on the CMA’s benchmark, and
- a “basket of market tariffs” approach.

In ruling out alternative approaches, on the basis that their development “would not be possible in the time available”¹⁶, we consider that Ofgem has compromised its ability to make an informed judgement on whether the tariff level it will determine will meet its stated objectives for the control.

This is an unsatisfactory basis on which to undertake this consultation: the measures will potentially affect more than three million households and bring the risk of significant detriment. In particular:

- A poorly thought-through methodology that resulted in too tight a vulnerable customer cap would prevent suppliers from recovering efficiently incurred costs from up to 10% of the domestic customer base.
- This would destroy any incentive for suppliers to compete for a significant proportion of customers (and indeed perversely reward suppliers who manage to cease to supply these customers).
- This could in turn distort retail competition more widely, by forcing those suppliers with a higher proportion of vulnerable customers to find ways to subsidise a higher proportion of their customer base. Indeed, Ofgem has itself recognised that one of the key risks of a price cap based on a benchmark that did not represent the costs of an efficient supplier is that it could result in a “waterbed effect” whereby suppliers are forced to try to recover lost revenue from customers not covered by the cap.¹⁷

We would also note that the “basket of tariffs” approach is far more “novel and complex”¹⁸ than some of the alternatives that Ofgem has ruled out for this reason. Further, Ofgem has not provided details of the assessment it made¹⁹ to reach its decision not to consider alternative methodologies.

¹⁶ Ofgem consultation paper on providing financial protection to more vulnerable consumers, 20th December 2017, paragraph 3.9.

¹⁷ Ofgem, Financial protections for vulnerable customers – Technical document, 11th October 2017, page 5.

¹⁸ Ofgem (Dec 2017) paragraph 3.8.

¹⁹ This is referenced in Ofgem (Dec 2017) paragraph 3.8.

It is clearly critical that Ofgem ensures that there is sufficient time to consider, and appropriately consult on, all methodologies prior to setting any wider cap on all standard variable and fixed-term default tariffs. We therefore assume that Ofgem is pursuing a timetable for setting that control to address this. Failure to conduct a thorough and systematic analysis of all the methodological options for such a wide-ranging cap would be unacceptable.

Notwithstanding these concerns, for the purposes of constructively responding to this consultation we provide our views on the relative merits of the two options on which Ofgem is seeking views. By way of a summary:

- We do not support a “basket of tariffs” approach, since the methodology described by Ofgem would in all likelihood generate a tariff cap that bore no relation to the costs and risks that suppliers actually face in serving vulnerable customers.
- The PPM methodology addresses some of the shortcomings of the “basket of tariffs” approach, but still suffers from significant flaws – the majority of which would not be addressed by the specific adjustments on which Ofgem is consulting.
- If Ofgem deems that there is insufficient time to do this and still intends to proceed, it should ensure that the changes it makes to the existing PPM cap methodology will raise the level of the cap to ensure that it covers the costs of an efficient supplier.

We provide further explanation of each of these points below.

1. The “basket of tariffs” approach described by Ofgem would in all likelihood generate a tariff cap that bore no relation to the costs and risks that suppliers actually face in serving vulnerable customers

The “basket of tariffs” option, as set out in the consultation, cannot be considered an acceptable methodology for a vulnerable customer cap and we strongly oppose its use.

Overall appraisal against Ofgem's assessment criteria

In the consultation document, Ofgem sets out four criteria for the assessment of potential methodologies. These are:

- (i) to reflect efficiently incurred costs without being influenced by the behaviour of suppliers.
- (ii) to facilitate a degree of competition under the safeguard tariff level and provide an incentive for consumers to engage with the market.
- (iii) to minimise distortions to competition and any other unintended consequences.
- (iv) to ensure that the costs of administration, monitoring and compliance are proportionate and not overly burdensome.

Having reviewed this methodology, we believe that:

- a price cap based on the “basket of tariffs” methodology would fail to meet criterion (i) in that it would not allow suppliers to recover their efficiently incurred costs
- for the same reason it would also fail against criteria (ii) and (iii), since it would leave no room for suppliers to compete on a sustainable basis
- while these concerns could – in theory – be offset by allowing more headroom over and above level of tariffs in the basket, significant work would need to be undertaken to calculate the appropriate level of headroom, meaning that the methodology would fail criterion (iv).

We explain these conclusions in turn below.

The “basket of tariffs” approach described by Ofgem would fail to satisfy assessment criteria (i), (ii) or (iii)

To satisfy assessment criteria (i), (ii) and (iii), an appropriate tariff cap methodology must take proper account of the costs and risks faced by an efficiently run supplier. There are two general ways that this can be achieved:

- directly model the individual costs associated with supplying the relevant customer group to build up a suitable tariff level to cover all costs and allow for an appropriate margin, or
- use the tariffs offered in the market by benchmark firms identified as efficient and make targeted adjustments to these tariffs to control for differences in costs and risk that are outside of suppliers' control.

Given its design, the “basket of tariffs” approach would need to follow the second of these options. However, a number of significant – and computationally complex – adjustments would need to be made to ensure that the resulting tariff cap genuinely reflected the efficiently incurred costs of supplying the target customer group.

In practice, the adjustments that Ofgem puts forward in its consultation would fall well short of this requirement. Our resulting concerns about the cap can be split into three groups.

- There would be specific problems associated with the level of the cap in any given snapshot period.
- There would be a range of additional problems concerning the evolution of the cap over time.
- Aspects of the cap would be highly opaque, exposing suppliers to risks that they cannot control.

We describe and explain each of these concerns in turn.

Concerns with the level of a “basket of tariffs” cap

A simple basket of tariffs approach would fail to control for legitimate and unavoidable differences in policy and other costs across suppliers. In addition, a simple basket of tariffs approach would fail to control for the fact that the cheapest tariffs in the market are likely to be unsustainable acquisition tariffs. Such tariffs can only be commercial if a portion of acquired customers eventually migrate to higher tariffs.

Ofgem suggests that these issues could be addressed through the selection criteria for inclusion in the basket. Indeed, we note that Ofgem could control for policy cost differences by restricting the relevant suppliers to only those fully obligated for all policies. However, it is not clear how Ofgem would control for other legitimate cost differences or to exclude unsustainable acquisition tariffs without significant additional work.²⁰

Concerns with the evolution of a “basket of tariffs” cap

In addition to our concerns over the initial level of any cap based on a basket of market tariffs, there are a range of problems that relate to how the tariff cap would be updated over time.

Ofgem suggests that the tariffs (and suppliers) that make up the basket would change over time, depending on which were the cheapest in the market. This means that the cap would be designed to follow a level that is lower than any supplier could reasonably be expected to achieve over the medium term.

One of the main fluctuating costs of suppliers is their wholesale costs. The lowest tariffs in the market at any point in time are likely to reflect suppliers with the lowest wholesale costs. The basket methodology would essentially select suppliers for inclusion within the benchmark based on whether they had been in luck with their wholesale costs. This means that a basket-based cap would be likely to follow the lower envelope of possible wholesale costs. However, any supplier following a consistent hedging strategy would not be able to achieve those costs consistently. Instead any individual supplier could only achieve such wholesale costs if they had perfect foresight over wholesale markets and constantly changed their hedging strategy.

Nor are wholesale costs the only concern in this regard. Smart meter rollout costs, for example, may also fluctuate across suppliers over time, depending on the extent to which different suppliers front- or backload their rollout plans. A price cap based on the cheapest tariffs in the market at any one time risks tracking the lower envelope of these costs and therefore systematically understating the cost associated with any single rollout strategy.

²⁰ While excluding tariffs from non-obligated suppliers can utilise a simple definition, there is no simple definition of an acquisition tariff.

Concerns regarding the risks to which a “basket of tariffs” cap would expose suppliers

The “basket of tariffs” cap is opaque in terms of the allowances it provides for various cost categories and how these change over time. This exposes suppliers to significant risks from the potential mismatch between the movement of their costs and the level of the cap. For example, even if the basket were based on specific benchmark suppliers, other suppliers would still not know the hedging strategy that is implicit within the cap. If suppliers do not know what hedging strategy is implicit within the cap they cannot seek to match their cost base to the cost base that is allowed under the cap. In contrast, the PPM cap stipulates the hedging strategy that is used to roll forward costs. Even though problems remain with the PPM approach in this regard, the stipulation of the 6-2-12 hedging strategy allows suppliers to try to match this hedging strategy to minimise their risk exposure.²¹ As the basket of tariffs approach would not allow for such wholesale cost risk management it would greatly increase the risks that suppliers are exposed to in terms of being able to recover their wholesale costs.

While these concerns could in theory be mitigated by permitting an appropriate level of headroom, this would add significant complexity to the methodology

The consultation document suggests that one way to offset the risk that the “basket of tariffs” methodology could set a cap at too low a level would be to add more headroom. In principle, this would be a simple approach. However, in practice Ofgem would need a way of identifying how much headroom it would need to add to generate an appropriately cost reflective cap. This would require a separate exercise to determine the costs that an efficient supplier would incur in serving such customers. Ofgem's consultation does not appear to acknowledge or propose this. Yet without doing this work, Ofgem would essentially just be making a number up.

In practice, any such exercise to determine the appropriate level of headroom (or to make appropriate like-for-like adjustments to the basket tariffs themselves) would

²¹ “6-2-12” refers to the hedging strategy that the CMA's PPM methodology assumes for the purposes of updating the level of the cap over time. The phrase “6-2-12” denotes the process that the methodology follows to estimate wholesale costs for this purpose:

- Wholesale prices are observed over a **six**-month period.
- There is then a **two**-month lag between the end of the observation period and the start of the price cap period.
- The wholesale prices observed during the six-month window are the forward prices for energy delivered over a **twelve**-month period.

The PPM methodology repeats this process every time the cap is updated, and uses the evolution of these observed wholesale prices between one price cap period and the next to create its wholesale cost index.

The hedging strategy implied by the PPM price cap requires a significant lead time to be implemented. For example, the commodity index going into the calculation of the PPM price cap for the period Oct'18-Mar'19 starts pricing on 1st Feb'18. This implies that suppliers need to start hedging up to 13 months before delivery (Feb'18 for Mar'19 delivery) to be able to replicate the index and minimise risk.

considerably add to the complexity of the methodology, and could require regular updating, which would increase administration costs. In other words, if Ofgem were to attempt to improve the “basket of tariffs” approach to satisfy assessment criteria (i), (ii) and (iii) around ensuring that the cap is cost reflective and allows space for competition, it would likely then fail assessment criterion (iv) around ensuring that the costs of administration, monitoring and compliance are proportionate and not overly burdensome.

2. The PPM methodology addresses some of the shortcomings of the “basket of tariffs” approach, but still suffers from significant flaws

The PPM tariff cap methodology avoids some of the shortcomings of the “basket of tariffs” approach. Both tariff methodologies are essentially “top-down” in nature in the sense that they identify a set of benchmark tariffs based on the actual prices of certain suppliers²². However, in designing the PPM methodology, the CMA made certain adjustments to the benchmark tariffs that means that the resulting cap better reflected the costs of a large and fully-obligated standalone supplier. In particular:

- a) The CMA restricted the benchmark tariffs to those of two mid-tier firms, Ovo and First Utility, meaning that the policy costs underpinning the benchmark tariffs were more comparable to those faced by the six large energy firms.
- b) The CMA reduced the risk that the basket of tariffs informing the benchmark would consist solely of unsustainably low acquisition tariffs by considering all tariffs offered by Ovo and First Utility on a snapshot date, rather than only their cheapest deals.
- c) The CMA also recognised that Ovo’s and First Utility’s tariffs as a group were unsustainably low given that these suppliers were making losses at the time that the initial level of the benchmark was calibrated, and adjusted the tariffs to a level consistent with these suppliers making a small positive margin.

Nonetheless, the PPM cap methodology still suffers from a number of flaws that mean that it also scores poorly when judged against Ofgem’s evaluation criteria. Not only do these flaws mean that the methodology fails to produce a tariff cap that reflects efficiently incurred costs; but in practice they tend to go in the same direction, meaning that the methodology systematically understates these costs and leaves insufficient headroom for suppliers to compete effectively.

In November 2017, we submitted a report written by Frontier Economics²³ that:

- described and explained these methodological flaws in detail, and

²² This is in contrast with a “bottom-up” methodology, which would seek to construct a tariff cap based on an explicit assessment of the costs involved in supplying the target customer group.

²³ Frontier Economics, “*Understanding the PPM control*”, 10th November 2017.

- considered what the emerging evidence of the effect of the cap on the PPM market indicated about the effect of these issues in practice, including that the cap:
 - ~~.....~~²⁴ ~~.....~~ and
 - even though the cap has been in force for less than a year, there are already signs that it is having an impact on supplier and customer behaviour in a way that is consistent with a reduction in competition.²⁵

3. Some of the adjustments on which Ofgem is consulting will improve the cost reflectivity of the PPM methodology – but material problems will remain.

In its consultation document, Ofgem has recognised that there are design issues with the existing PPM methodology. We welcome this acknowledgement and the willingness to consider implementing changes to address these issues.

Ofgem has itself suggested that changes could be made to the following elements of the methodology:

- The uplift applied to the cap to account for **different payment methods**.
- The methodology used to calibrate the cap at **nil consumption**.
- Whether to separate out **DCC charges** and treat them as a pass-through cost.
- Whether to separate **smart costs** out from ‘other’ costs and roll these forward over time using an index other than CPI.
- Whether to change the **weighting of costs** between categories in the initial benchmark (in particular for E7 electricity customers, but potentially for other customers as well).
- Whether to include a separate index for the **cost of shape** in the wholesale cost element of the PPM cap.
- Whether there would be a case for making any adjustment to the level of **headroom** built into the cap.

Ofgem also indicates that it would welcome any evidence regarding further design issues relating to the PPM methodology – and would consider other potential changes to address these as long as these could be straightforwardly implemented in the time available.

²⁴ ~~.....~~

²⁵ For further information on this empirical evidence, please refer to Section 3.2 of the Frontier Economics (2017) report.

In what follows:

- (a) We first set out Centrica’s views on the merits of each of the specific changes to the PPM cap on which Ofgem is seeking feedback.
- (b) We then consider:
 - How far these proposed changes address our concerns about the most significant flaws in the PPM cap methodology.
 - What additional changes would need to be made to the methodology to address the concerns that are still outstanding.
 - What this collectively implies about the likely level of the PPM cap if it were extended to vulnerable customers.
 - What precautions Ofgem should take in light of this when considering potential changes to the PPM cap in the round.

(a) Viewed individually, a number of the specific changes to the PPM cap methodology on which Ofgem is seeking views are sensible in principle.

(i) Should adjustments be made to the payment method uplift applied to the benchmark?

Ofgem indicates in paragraphs 3.39 to 3.49 of its consultation that it is considering making adjustments to the PPM tariff cap methodology to take account of differences in the cost to supply customers using different payment methods. We agree that such adjustments merit consideration, but only to the extent that they help ensure that the resulting tariff cap reflects the genuine costs and risks that efficient suppliers face in serving vulnerable customers on each payment method.

This does not simply mean ensuring that the payment cost differentials assumed by the methodology reflect actual payment method cost differentials. In addition to this, it is essential that Ofgem considers the interplay between any changes it makes to the payment method uplift assumptions and other issues with the PPM cap methodology that also need addressing. Failure to address these other issues would mean that payment uplift adjustments that in principle look sensible when viewed in isolation could in fact impair the overall cost reflectivity of the methodology when considered in the round. This is a real risk given that, for the reasons explained in the above-mentioned Frontier Economics report, the existing PPM cap methodology systematically – and materially – understates suppliers’ costs and leaves insufficient headroom for effective competition.

As noted in the Frontier report, the materiality of these shortcomings in the PPM methodology is demonstrated by the fact that ~~✂~~.....²⁶~~✂~~ This exceeds the CMA’s estimates of the PPM cost uplift over direct debit (£63) even before taking into account that the CMA recognised that standard credit customers have a higher cost to serve than PPM

²⁶ Frontier Economics (2017), Section 3.1.

customers. In this context, any payment method cost adjustment that further reduced the level of the vulnerable customer tariff cap (relative to the PPM cap) would risk reducing the cost reflectivity of the vulnerable customer cap.

The best solution would be to address the existing flaws in the PPM methodology by undertaking a full review to ensure that all of the flaws that have been identified are properly addressed. If Ofgem deems that there is insufficient time to do this, it should ensure that the changes it makes to the existing PPM cap methodology will raise the level of the cap to ensure that it covers the costs of an efficient supplier.

(ii) Should specific adjustments be made to the methodology used to calibrate the cap at nil consumption?

Ofgem indicates in paragraphs 3.30 to 3.35 of its consultation that it is considering changing the methodology used by the PPM tariff cap for setting the PPM safeguard tariff at nil consumption. Ofgem's thinking here appears to be motivated by similar considerations to its thinking about whether adjustments should be made to the payment method uplift: in other words, since the benchmark at nil consumption is based on PPM standing charges set by the six large energy firms, it will include a prepayment method cost uplift that needs to be adjusted for a cap that will apply primarily to standard credit and direct debit customers.

Our views here are the same as those set out above.

- We agree that such adjustments would be sensible in principle, but only to the extent that they help ensure that the resulting tariff cap reflects the genuine costs and risks that suppliers face in serving vulnerable customers on each payment method.
- In particular, Ofgem must consider the interplay between any changes it makes to the cap at nil consumption and other issues with the methodology that also need addressing. Unless the other flaws in the CMA's methodology are also addressed, it would be better not to make additional changes that could exacerbate the problem by tightening the cap even further.

(iii) Should the methodology be adjusted to separate out DCC charges?

DCC charges have increased substantially since the benchmark bill was estimated in a way that has not been reflected in the PPM methodology indexation. For example, the DCC Fixed Charge was £2.38 per electric meter and £1.79 per gas meter in 2015 and,

including the addition of the DCC Fixed Alt HAN Charge, had risen to £8.23 per electricity meter and £6.32 per gas meter by in 2018/19.^{27,28}

Given that they are outside of suppliers' control, they should be treated as a pass-through cost going forward, as is already the case for network charges.

The adjustments that would be required to enable pass through of the DCC fixed charge and the Fixed Alt HAN Charge are simple, given that the charges are the same for all suppliers. The published charging statement of the DCC could be used to identify the charges that would have been reflected in the Ovo and First Utility benchmark when the cap was first set, and it could be removed and replaced each time the new cap is calculated with the charge for the relevant period. Each year the DCC produces indicative charging statements in January for the following regulatory period which runs from 1 April to 31 March. Ofgem could use these indicative charging statements to set the allowance within cap level for the period April to September. This provides the two-month lead time required before it comes into force. For the October to March cap periods Ofgem should use the latest version of the charging statement issued by DCC available by a suitable time in July to allow for calculation. This will typically be the charging statement issued by DCC in March.

We would suggest that the other DCC charges (that are related to the number of communication hubs) are picked up alongside the treatment of other smart meter costs, described in the next section.

(iv) Should changes be made to the treatment of other smart meter costs?

We consider that changing the way smart costs are treated within the PPM control is fundamental to its continued use. The reasons for this have been set out in the report we submitted by Frontier Economics.²⁹

- The number of meters being installed in each year will be expected to rise month on month until sometime in 2018 or 2019 (depending on each supplier's individual plan). As the number of installations increase, the unit cost per customer to be recovered in the tariff cap will also need to increase.
- A number of the costs associated with the cost and installation of the meters are amortised, and therefore will continue to become cumulatively more important as smart meter numbers increase.

²⁷ The DCC recovers funds from energy suppliers to cover the costs of its activities through a number of different charges. Some of these charges are calculated with reference to a supplier's smart meter rollout programme, such as the number of smart meters a supplier has. Others, by contrast, are based on the total number of meters that a supplier has. The DCC "Fixed Charge" and the DCC "Fixed Alt HAN Charge" are both calculated based on the total number of meters a supplier has. A full list of the charges that the DCC levies can be found in the latest DCC charging statement: https://www.smartdcc.co.uk/media/446700/charging_statement_ry1819_-_issue_0.1_draft_for_notice.pdf

²⁸ The Fixed Alt HAN Charge was not payable in 2015 but is now charged on the same basis as the DCC Fixed Charge.

²⁹ Frontier Economics (2017).

- Meters are likely to become more expensive to install over time, as the “harder” to reach customers become a larger percentage of the pool of customers left to convert.

Because of these changes, an unadjusted historic measure of cost that is only indexed by inflation is clearly not appropriate.

As Ofgem identifies, to properly reflect the cost of smart meters, two issues will need to be addressed.

- A value for the net smart meter costs within the original benchmark will need to be identified, as no such value was identified by the CMA in its report.
- An indexation methodology will then need to be applied. This will need to reflect the evolution of costs and benefits over time.

We believe that a practicable methodology for making these adjustments can be put in place and will put forward a suggested methodology for achieving this. We are aiming to provide this to Ofgem as a separate submission in mid-February, given the short time frames associated with this consultation.

(v) Should the weighting of cost categories be changed for E7 and/or other customers?

We believe that the CMA made an error in the way that it determined the weights for the policy cost index. This issue is highlighted in the weighting given to policy costs in the Economy 7 (E7) tariff. However, it also affects the single rate electricity (SRE) and single rate gas (SRG) price caps.

The weighting applied to the policy cost index for the E7 tariff is too low because the CMA assumed that “policy and other costs would be the same” for E7 and SRE and that “the difference between the competitive benchmark for E7 and the competitive benchmark for single rate electricity relates to differences in wholesale cost.”³⁰ This meant that the costs apportioned to policy costs for an SRE bill (consumption 3,200 kWh) and an E7 bill (consumption 4,600 kWh) were essentially the same at £66.86 and £66.98 respectively.³¹

However, the majority of policy costs which suppliers incur in relation to customers are driven by consumption levels, as set out in as set out in Table 1 and Table 2 below.

Relevant policies

The allowance within the electricity and gas price caps for policy costs is supposed to cover the aggregate costs to suppliers of a number of different policies. Although these

³⁰ CMA final report Para 14.139.

³¹ We believe that the small difference between these two values is due to rounding differences in the calculations used to derive them.

can vary over time, the main policies that were applicable at the time that the benchmark was calculated are set out in the following tables, alongside a summary of how the costs vary for suppliers.

Table 1. Relevant policies for a domestic electricity supplier in 2015

Policy	Description
Assistance for Areas of High Electricity Distribution Charges (AAHEDC)	Funds are recovered from all authorised suppliers to provide reduced distribution charges to consumers in the north of Scotland. Charges are based on consumption levels.
Contracts for Difference	The costs of administering the scheme and of support payments to low carbon generators are recovered from suppliers. Charges are levied on eligible supply measured in MWh.
The Energy Company Obligation	The Policy requires suppliers over a certain size to deliver against carbon reduction and affordable warmth targets through the use of energy efficiency measures. A supplier’s share of the total target is determined by their market share measured in MWh supplied. Administration costs are borne by individual suppliers.
Feed-in-tariffs	The costs of administering the scheme and of support payments to renewable generators are spread across suppliers based on their market share as measured by MWh supplied.
Renewables Obligation	Suppliers are obliged to purchase traded certificates in proportion to the volume of electricity that they supply.
Warm Homes Discount	Suppliers over a certain size are required to spend money providing rebates to certain customers. The spend obligation for each supplier is determined based on their number of customer accounts.

Table 2. Relevant policies for a domestic gas supplier in 2015

Policy	Description
The Energy Company Obligation	The Policy requires suppliers over a certain size to deliver against carbon reduction and affordable warmth targets through the use of energy efficiency measures. A supplier’s share of the total target is determined by their market share measured in MWh supplied. Administration costs are borne by individual suppliers.
Warm Homes Discount	Suppliers over a certain size are required to spend money providing rebates to certain customers. The spend obligation for each supplier is determined based on the number of customer accounts.

As well as adjusting the weights for E7 at the TDCV, it will also be necessary to adjust the weights that have been used at nil consumption. This is because the CMA made a similar error there when it “defined wholesale costs to be equal to zero and maintained the ratio between policy and other costs observed at medium TDCV.”³² This means that the weighting of policy costs in the benchmark at nil consumption is too high, something that affects all three price caps.

As shown in Table 1 and Table 2, the only policy cost that should be included at zero consumption is the cost of the WHD. In 2015, the WHD policy cost per customer account was approximately £6.64³³. This should then determine the policy cost component for all three price caps in 2015 at nil consumption. Reducing the share of policy costs in the nil consumption benchmark requires this to be reapportioned to a different cost category. At nil consumption there are no wholesale costs and therefore the reduction in policy costs should be offset by an increase in the share of costs categorised as “other costs”.

We can derive an appropriate estimate of the policy cost for an E7 customer consuming at the TDCV of 4,600 kWh in 2015 by basing it on the level of policy costs that a SRE customer consuming 4,600 kWh would face:

$$\begin{aligned} & \text{E7 Policy Cost (4,600 kWh)} \\ & = \\ & \text{WHD policy cost} + [\text{SRE Policy Cost (3,200 kWh)} - \text{WHD policy cost}] * \frac{4,600}{3,200} \end{aligned}$$

This results in a policy cost component in the 2015 benchmark of £93.26 for E7 customers, compared to a £66.86 component for SRE customers. Given that the total level of the benchmark is fixed and that wholesale costs were used by the CMA as a balancing item in their analysis, this increase in the policy cost allowance should be accommodated by an equivalent reduction in the wholesale cost allowance at TDCV.

A summary of the changes we are proposing, based on an estimated WHD cost of £6.64, is presented in the following tables.

³² CMA final report Para 14.140.

³³ We have based this calculation on the actual spend by obligated suppliers (based on Ofgem data) and the customer numbers of obligated suppliers.

Table 3. Original and corrected cost category splits for the E7 PPM benchmark

Category	Original cost category splits at nil consumption	Corrected cost category splits at nil consumption	Original cost category splits at TDCV (4,600 kWh)	Corrected cost category splits at TDCV (4,600 kWh)
Wholesale Costs	£0	£0	£274.14	£247.86
Policy Costs	£27.93	£6.64	£66.98	£93.26
Other Costs	£31.24	£52.53	£74.88	£74.88
Total	£59.17	£59.17	£416.00	£416.00

Table 4. Original and corrected cost category splits for the SRE PPM benchmark

Category	Original cost category splits at nil consumption	Corrected cost category splits at nil consumption	Original cost category splits at TDCV (3,200 kWh)	Corrected cost category splits at TDCV (3,200 kWh)
Wholesale Costs	£0	£0	£189.33	£189.33
Policy Costs	£25.81	£6.64	£66.86	£66.86
Other Costs	£28.87	£48.04	£74.81	£74.81
Total	£54.68	£54.68	£331.00	£331.00

Table 5. Original and corrected cost category splits for the SRG PPM benchmark

Category	Original cost category splits at nil consumption	Corrected cost category splits at nil consumption	Original cost category splits at TDCV (13,500 kWh)	Corrected cost category splits at TDCV (13,500 kWh)
Wholesale Costs	£0	£0	£277.93	£277.93
Policy Costs	£8.40	£6.64	£18.42	£18.42
Other Costs	£43.44	£45.20	£95.65	£95.65
Total	£51.84	£51.84	£392.00	£392.00

(vi) Should adjustments be made to the cap to account for changes in the cost of shape?

Ofgem recognises that there may be an issue regarding whether the wholesale index used within the PPM methodology appropriately “reflects the cost of buying energy to match the shape of demand over time, known as shaping costs.”³⁴ Ofgem is right to raise this issue as there are reasons to believe the current methodology understates the growth in shaping costs since 2015. To address this Ofgem should increase the share of the wholesale cost index that is linked to the peakload contract for future price cap periods.

The existing approach to wholesale costs

The original 2015 benchmark bill is decomposed into wholesale costs, policy costs and other costs using data from the 2015 consolidated segmental statements (excluding SSE). This generates a wholesale cost figure for the benchmark period. All of this initial allowance is indexed forwards assuming that suppliers' wholesale costs are represented by a 6-2-12 hedging strategy. For electricity, a fixed 70:30 split between baseload and peakload contracts is assumed.

The hedging strategy used in the indexation approach implies lower wholesale costs in 2015 than the allowance made in the price control. The CMA attributes this difference (£25.28 for electricity and £21.60 for gas at TDCV³⁵) to First Utility and Ovo Energy's costs of shape. The cost of shape implicitly allowed for in the original benchmark is inflated using the same index as for bulk wholesale energy purchases. However, trends in the cost of shape may follow a different pattern to that of bulk energy costs.

The impact of Solar PV

There are many reasons why the cost of shape may not follow the same trend as general wholesale costs. Some of these reasons are set out in more detail in the Frontier Economics report.³⁶ In addition to the points raised in that report there have been structural changes in the wholesale market that impact the cost of shape. Between June 2015 and June 2017 the capacity of solar PV in the UK increased by nearly 50%.³⁷ This development means that the current indexation methodology utilising a fixed baseload/peakload split is increasingly likely to understate the true cost of purchasing electricity for a domestic consumption profile.

Solar PV generates electricity, irrespective of the wholesale electricity price. Solar output follows a daily cycle with low output in the morning, a peak in the middle of the

³⁴ Ofgem (Dec 2017) para 3.78.

³⁵ These have been calculated based on the figures in Table 14.7 of the CMA EMI final report.

³⁶ See section 2.2.1 in Frontier Economics (2017).

³⁷

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/669772/Solar_photovoltaics_deployment_November_2017.xlsx

day and declining output into the evening. This means that solar PV acts to depress prices during the middle of the day.

The peakload contract represents the time weighted average price of purchasing electricity for delivery between 0700 and 1900 on week days. While solar PV depresses prices within this period, it does so predominantly within a subset of it (the middle of the day). The price of electricity in the morning and evening part of this contract period remain higher.

The daily shape of domestic demand

Domestic demand is not flat across the 0700 to 1900 period. Domestic load profiles have two peaks, one in the morning and another in the evening. This means that the cost of supplying a domestic customer is more influenced by the price of electricity in the periods 0700 to 0900 and 1700 to 1900 than by prices in the middle of the day. Therefore, factors that depress the peakload contract price, but not the price of electricity during the morning and evening domestic peaks, will increase the cost of shape. The current indexation methodology does not capture this impact.

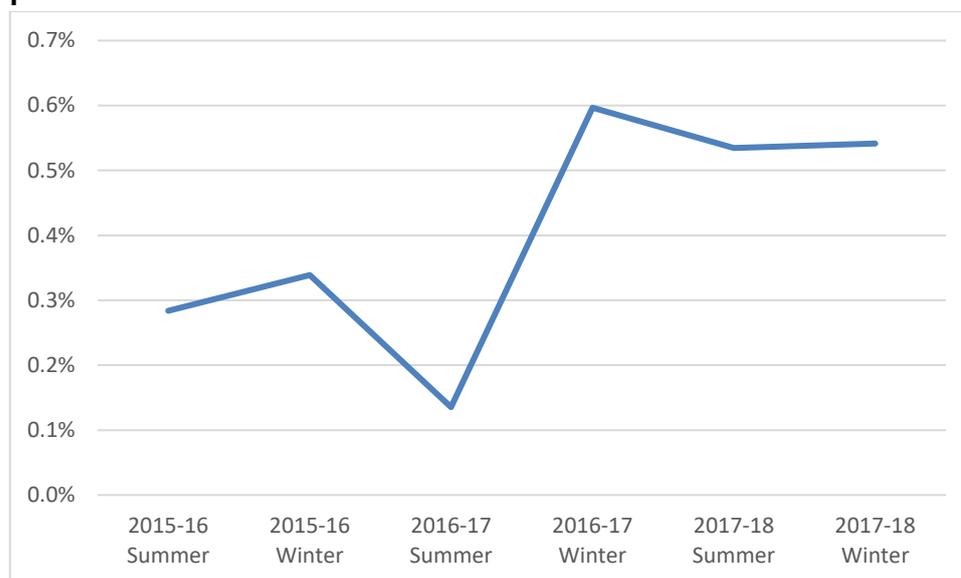
The monthly shape of domestic demand

As well as exhibiting a daily shape profile, domestic electricity demand also varies across months. The current PPM methodology for wholesale costs effectively assumes that the consumption for each month in a 6-month season is the same. However, electricity demand changes between months within a season. For example, demand is higher in December and January than in the other four months covered by the winter contract. This means that change in the relative price of electricity between months can lead to increases in the cost to supply domestic consumers that are not captured by the wholesale indexation methodology. The trend in these costs is illustrated in Figure 1 below, which shows that the cost of purchasing electricity to match the monthly profile of domestic electricity has been growing relative to a simple seasonal approximation of the domestic load profile.

Suggested improvements

Ideally the wholesale cost index should either directly reflect the actual shape of domestic demand or the cost of shape should be indexed separately from the cost of bulk energy purchases. The first of these options would require the wholesale index to be based on more granular and time specific contracts. However, such granular contracts are not generally traded with sufficient liquidity far enough in advance to form part of the PPM methodology. The second option would require an index that tracks the cost of shape and is externally published, yet we are not aware of any such suitable indices.

Figure 1 Shaping cost premium of monthly load profile over a seasonal load profile for domestic consumers



Source: British Gas based on class 1 domestic monthly demand profile.

Given that directly accounting for the cost of shape is unlikely to be feasible, Ofgem should revisit the assumed 70:30 split that is held constant within the PPM methodology to update it to account for market developments. The weighting that is given to the peakload contract within the wholesale index should reflect the weighted average cost of electricity associated with supplying customers on a standard domestic demand profile. This will more closely replicate the costs faced by a supplier than if a simple baseload / peakload split is used. Figure 2 calculates the appropriate baseload/peakload split based on the Elexon class 1 domestic load profile and actual wholesale price data.³⁸

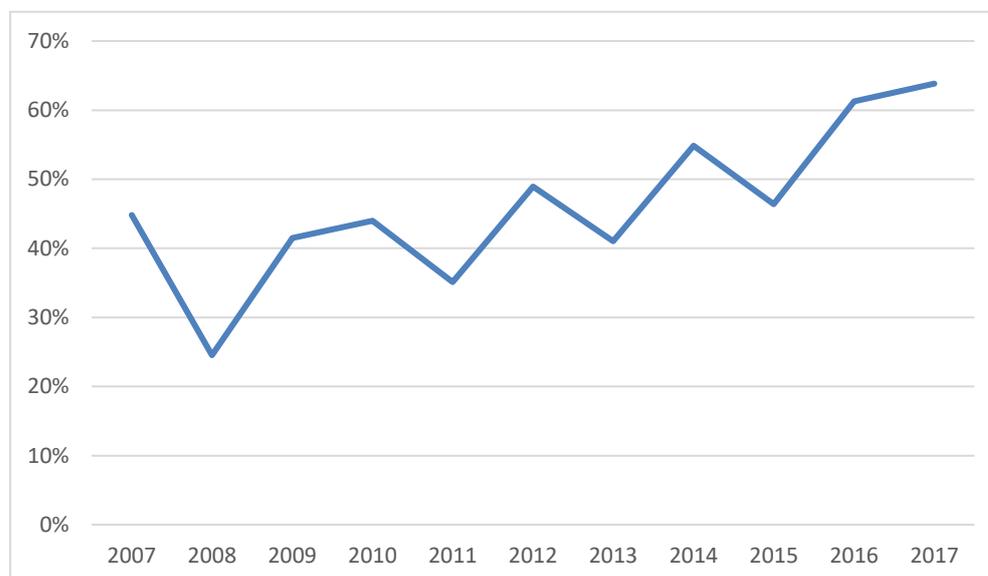
³⁸ To undertake this calculation we use the following relationship.

$$\frac{\sum_{i=1}^n P_i V_i}{\sum_{i=1}^n V_i} = Y P_p + (1 - Y) P_b$$

1. Pp is average price of electricity for delivery in weekday peak periods (0700 to 1900) for the relevant year
2. Pb is the average price for baseload electricity in the relevant year
3. Pi is the price of electricity for each individual half hour period in the relevant year
4. Vi is a supplier’s average domestic consumption per relevant domestic electricity customer in each half hour period in the relevant year
5. Y is the weighting of the peakload contract in the wholesale cost index

Y can be calculated using published data. Pp, Pb and Pi (half hourly) are obtained from APX whilst Vi (half hourly) is based on the class 1 load profile available from Elexon.

Figure 2. Peak costs as a proportion of total wholesale costs



Source: British Gas, based on class 1 domestic demand profile.

Based on our analysis, using a fixed load profile, by 2017 the appropriate share of peak costs in the index was more than 60%, substantially higher than the 30% assumed by the CMA. Ofgem should therefore revisit this assumption based on this proposed methodology, and keep it under review on an ongoing basis.

(b) Viewed collectively, however, these changes would do little to address the significant concerns regarding the PPM methodology identified above.

Table 6 below compares the issues with the PPM tariff cap methodology identified in the Frontier Economics report against the changes that Ofgem flags for consideration in its consultation. This shows that while some of the specific changes on which Ofgem is seeking views are sensible, they will not address many of the shortcomings in the methodology. As such, without further changes, the features of the methodology that are generating too tight a cap for PPM tariffs will simply carry over to the vulnerable cap.

The table also describes the additional steps that would need to be taken to address the outstanding problems with the PPM cap methodology. As it indicates, there are in principle steps that Ofgem could take to address these deficiencies head on – though in practice these would require significant remodelling of elements of the methodology.

Table 6. – Assessment of options for addressing issues with PPM cap methodology identified by Frontier Economics

Area of concern	Specific issue	Most likely impact on the cap	Would the changes on which Ofgem is consulting address this issue?	If not, what additional changes to the PPM cap methodology would be needed to address the issue?
<p>1. The PPM cap methodology does not accurately model the wholesale energy costs that an efficiently-run energy supplier can be expected to incur</p>	<p>Inconsistency between calibration and indexation hedging strategies</p>	<p>Cap too low</p>	<p>No</p>	<p>Need to adjust the original June 2015 calibration to replace Ovo's and First Utility's actual wholesale costs with what their wholesale costs would have been if they had been following the same a "6-2-12" hedging strategy that the methodology employs for the purposes of rolling forward the wholesale costs to subsequent periods</p>
	<p>CMA's methodology may have hard-wired in any transitory wholesale cost advantages arising from luck</p>	<p>Cap too low</p>	<p>No</p>	<p>Need to investigate Ovo's and First Utility's actual wholesale costs during the period used to calibrate the initial level of the cap (June 2015) to establish whether they had any temporary cost advantages at the time above and beyond those being delivered by their hedging strategies</p>
	<p>The methodology makes inappropriate assumptions around baseload/peak electricity weightings</p>	<p>Cap too low</p>	<p>Potentially (Ofgem is considering introducing a separate index for the cost of shape. The same logic would suggest that this separate index could – and should – also be created for peak product costs)</p>	
<p>2. The chosen benchmark firms (Ovo and First Utility) are not good comparators for an efficiently-run large energy retailer serving a</p>	<p>PPM tariff cap fails to control for the effects of average consumption levels for Ovo and First Utility</p>	<p>Cap too low</p>	<p>No</p>	<p>Need to establish how far standing charges typically fail to recover all fixed costs and then adjust the standing charge at nil consumption to accommodate this</p>
	<p>PPM tariff cap fails to control for higher proportion of Ovo and First Utility customers who are online</p>	<p>Cap too low</p>	<p>No</p>	<p>Need to:</p> <ol style="list-style-type: none"> 1. Identify an appropriate cost to serve differential for online/offline customers 2. Calculate the weighted average difference in cost to serve across between Ovo/First Utility and

Area of concern	Specific issue	Most likely impact on the cap	Would the changes on which Ofgem is consulting address this issue?	If not, what additional changes to the PPM cap methodology would be needed to address the issue?
diverse set of customers				other suppliers (based on different relative proportions of online only customers when the cap was calibrated in 2015) 3. Apply this cost uplift to the cap
	1.25% permitted margin lower than the sustainable margin in a competitive retail market	Cap too low	No	Mechanically straightforward to adjust the permitted margin built into the cap. Further work would be required to identify what a competitive margin would be in light of the concerns raised by industry stakeholders about the assumptions underpinning the CMA’s analysis of economic profitability that informed the 1.25% permitted margin figure
	Adjustments made to benchmark firms’ overhead costs materially affect the cap, but are highly opaque	Unclear – but likely to be material	No	In the first instance, need greater clarity as to the steps that the CMA took to control for potential differences in overheads
3. The methodology does not accurately model the policy-related costs that an efficiently-run energy supplier can be expected to incur	The methodology relies on an incorrect assumption that the benchmark adequately covers smart meter rollout costs, and does not consider how unit costs can be expected to change over time as the smart meter rollout gathers pace	Cap too low	Potentially (Ofgem is consulting on changes to the way in which smart meter rollout costs are built into the methodology and it would depend on how this was applied.)	
	The costs associated with the programme to move to faster and more reliable switching need to be taken into account	Cap too low	No	While these costs are not yet certain, they are material under a number of the proposals currently being discussed (e.g. the range considered in Ofgem’s June 2017 Switching Programme options paper ranged from £200m to £700m over the 15 year period)

4. These problems with the PPM methodology mean that Ofgem should ensure that the changes it makes will mean that it covers the cost of an efficient supplier.

Our analysis points to the following conclusions with regard to the option of using the PPM cap methodology as the basis for capping the tariffs of vulnerable customers.

- There are significant problems with the PPM methodology that are individually and collectively likely to result in a cap level that is too low (i.e. that will not adequately reflect the costs and risks associated with serving vulnerable customers).
- The methodological adjustments on which Ofgem is consulting will not adequately address these issues. Moreover, there is the risk that certain changes – such as the removal of the PPM cost uplift – could potentially exacerbate them by adjusting the cap down in some instances.
- The best solution would be to address the existing flaws in the PPM methodology by undertaking a full review to ensure that all of the flaws that have been identified are properly addressed.
- If Ofgem deems that there is insufficient time to do this and still intends to proceed, it should ensure that the changes it makes to the existing PPM cap methodology will raise the level of the cap to ensure that it covers the costs of an efficient supplier.