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Default Tariff Cap: Policy Consultation

Appendix 2 - Adjusted version of the existing safeguard tariff

Consultation - supplementary appendix

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Overview:

The energy market works well for consumers who shop around. Suppliers compete for these engaged consumers, offering low prices to gain or retain their custom.

But the retail energy market is not working for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should be.

To address this problem, Government has introduced legislation into Parliament which would require Ofgem to design and put in place a temporary cap on all standard variable tariffs and fixed-term default tariffs. We anticipate that Parliament will approve the Domestic Gas and Electricity (Tariff Cap) Bill in the summer, and the default tariff cap will come into force at the end of 2018.

We are now consulting on how we might design and implement the default tariff cap. This supplementary appendix to the main consultation document sets out our proposals in relation to the option of using an adjusted version of the existing safeguard tariff to set the level of the cap. This document is aimed at those who want an in-depth understanding of our proposals. Stakeholders wanting a more accessible overview should refer to the main consultation document.

Associated documents

Policy consultation for Default Tariff Cap – Overview
https://ofgem.gov.uk/system/files/docs/2018/05/default_tariff_cap_-_policy_consultation_-_overview.pdf

Links to supplementary appendices

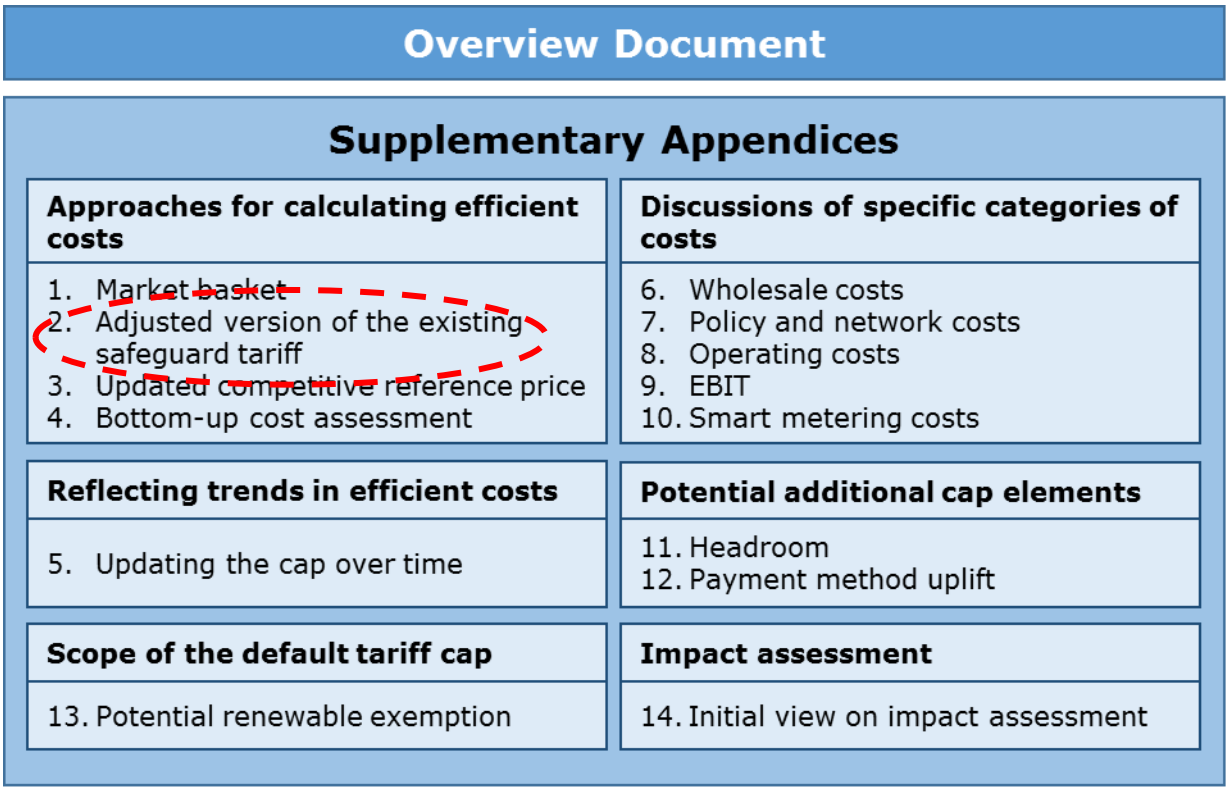
- Appendix 1 - Market basket: https://ofgem.gov.uk/system/files/docs/2018/05/appendix_1_-_market_basket.pdf
- Appendix 2 - Adjusted version of the existing safeguard tariff https://ofgem.gov.uk/system/files/docs/2018/05/appendix_2_-_adjusted_version_of_the_existing_safeguard_tariff.pdf
- Appendix 3 – Updated competitive reference price https://ofgem.gov.uk/system/files/docs/2018/05/appendix_3_-_updated_competitive_reference_price.pdf
- Appendix 4 – Bottom-up cost assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_4_-_bottom-up_cost_assessment.pdf
- Appendix 5 – Updating the cap over time https://ofgem.gov.uk/system/files/docs/2018/05/appendix_5_-_updating_the_cap_over_time.pdf
- Appendix 6 – Wholesale costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_6_-_wholesale_costs.pdf
- Appendix 7 – Policy and network costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_7_-_policy_and_network_costs.pdf
- Appendix 8 – Operating costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_8_-_operating_costs.pdf
- Appendix 9 – EBIT https://ofgem.gov.uk/system/files/docs/2018/05/appendix_9_-_EBIT.pdf
- Appendix 10 – Smart metering costs https://ofgem.gov.uk/system/files/docs/2018/05/appendix_10_-_smart_metering_costs.pdf
- Appendix 11 – Headroom https://ofgem.gov.uk/system/files/docs/2018/05/appendix_11_-_headroom.pdf
- Appendix 12 – Payment method uplift https://ofgem.gov.uk/system/files/docs/2018/05/appendix_12_-_payment_method_uplift.pdf
- Appendix 13 – Renewable tariff exemption https://ofgem.gov.uk/system/files/docs/2018/05/appendix_13_-_renewable_tariff_exemption.pdf
- Appendix 14 – Initial view on impact assessment https://ofgem.gov.uk/system/files/docs/2018/05/appendix_14_-_initial_view_on_impact_assessment.pdf

Document map

This supplementary appendix to the main overview document sets out our proposals for the option of using an adjusted version of the existing safeguard tariff to set the level of the cap.

Figure 1 below provides a map of the default tariff cap documents published as part of this consultation.

Figure 1: Default tariff cap – policy consultation document map



Links to these documents can be found in the 'Associated documents' section of this document

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1. Overview

An overview of this appendix and the high level advantages and disadvantages for the approach of using an adjusted version of the existing safeguard tariff to set the level of the default tariff cap.

Overview

1.1. In our first working paper[1] on setting the default tariff cap we set out the four approaches we are considering as options to estimate an efficient level of costs for the purposes of setting the initial level of the cap. This appendix provides detail of the considerations we have made regarding the option of using an adjusted version of the existing safeguard tariff cap[2] to set this level. The existing safeguard tariff cap is also commonly referred to as the prepayment cap, or prepayment safeguard tariff.

1.2. Under this approach, the allowance for an efficient level of costs would be based on the Competition and Markets Authority's (CMA's) competitive benchmark used to set the level of the existing safeguard tariff. This benchmark is based on the average price of two competitive mid-tier suppliers in 2015. The CMA made a number of adjustments to this reference price to account for differences between the cost base of the benchmark companies and the market more generally.

1.3. Chapter 2 provides an overview of the existing safeguard tariff methodology.

1.4. Chapter 3 provides an overview of the adjustments we would be minded to make if we were to use the adjusted existing safeguard tariff option. These adjustments would ensure the methodology is suited to the context of the default tariff cap, which will be implemented for a larger and different segment of the market than the existing safeguard tariff cap. Chapter 3 also outlines our considerations on adjustments to the existing safeguard tariff to account for variations in cost that may not be related to efficiency, were we to use this approach.

1.5. Chapter 4 provides an overview of the methodological changes we would be minded to make to the benchmark at nil consumption, if we were to use this option.

[1] Ofgem (2018), Working paper #1: setting the default tariff cap
[2] The existing safeguard tariff is one of the remedies introduced following the Competition and Market Authority's (CMA) investigation into energy markets. It's temporary, and is due to expire at the end of 2020 when the smart meter rollout is expected to complete. It covers all domestic prepayment customers (except those with a fully interoperable smart meter).

1.6. Chapter 5 outlines the adjustments we would be minded to make to how an adjusted version of the existing safeguard tariff would be updated over time, and how this differs from the approach for the existing safeguard tariff.

High level advantages and disadvantages of an adjusted safeguard tariff cap

1.7. The key advantage of the existing safeguard tariff methodology is that stakeholders have had experience to assess and understand it, as have we. Although it could be applied in its current form, we are considering whether methodological changes are needed to ensure that the benchmark is suitable for a larger and different market segment.

1.8. The key disadvantage of using the existing safeguard tariff methodology could be that we would not make adjustments for all aspects of the methodology which have been criticised by stakeholders.

1.9. Specifically, in response to our December 2017 consultation on providing financial protection to more vulnerable consumers[3], stakeholders raised concerns regarding the choice of benchmark supplier; two suppliers may be an inadequate sample size to represent an efficient level for an industry wide price cap, and that tariffs from 2015 are now out of date. Under this approach, we would not adjust the suppliers chosen for the benchmark and the date of tariffs used.

1.10. We are, however, considering whether other adjustments to the existing safeguard tariff methodology could make it more suitable to set the level of the default tariff cap, which we describe in Chapter 3.

1.11. In making our final decision on the approach to setting the initial level of the default tariff cap (should we decide to use this option), we will consider whether or not the number of adjustments we would make to the existing safeguard tariff would erode the advantages of previous experience and understanding of the methodology, by potentially adding uncertainty and potential for error to the approach.

[3] Ofgem (2017), Providing financial protection to more vulnerable consumers, Appendix D.

2. The existing safeguard tariff methodology

An overview of the existing CMA benchmark methodology that was used to set the initial level of the prepayment cap.

Overview

2.1. In this chapter we provide an overview of the methodology the CMA used to set the benchmark in the initial level of the prepayment safeguard tariff.

2.2. We previously provided a more comprehensive overview in our December 2017 consultation on providing financial protection to more vulnerable consumers[4], and we provide that detail in the annex at the end of this document. Further detail on the methodology can be found in the Final Report, and relevant appendices, of the CMA's Energy Market Investigation[5].

The existing safeguard tariff

2.3. The prepayment safeguard tariff came into force on 1 April 2017. It applies to all customers with prepayment meters, except those with fully interoperable smart meters. The prepayment safeguard tariff applies to all tariffs, whether these are fixed or variable.

2.4. The cap was set, and is updated, based on a methodology produced by the CMA. This method is specified in the licence condition, which the CMA introduced. We have responsibility for updating the level of the prepayment safeguard tariff, in line with the approach set out in the license.

2.5. The competitive benchmark for the prepayment safeguard tariff methodology is based on the average direct debit price of two mid-tier suppliers in 2015 (Ovo Energy and First Utility). The CMA collected information to estimate the average prices of these suppliers.

[4] Ofgem (2017), Providing financial protection to more vulnerable consumers, Appendix D
[5] CMA (2016), Energy market investigation – final report, Section 14

2.6. The CMA made a number of adjustments to the average prices of these two suppliers, to ensure the benchmark was comparable to the prices of other suppliers, including larger suppliers. These comprised of adjustments to allow for:

- the difference in the costs these suppliers incurred in relation to social and environmental programs as a result of their smaller size
- a standardised approach to the amortisation of customer acquisition costs
- the level of overhead costs that would be expected for a company that was neither growing nor shrinking
- removing the network cost element, to account for cost differences due to regional distribution of customers
- a normal rate of return (ie an average EBIT margin) of 1.25%.

2.7. The prepayment safeguard tariff methodology includes separate benchmarks for a gas consumer, a single rate electricity consumer and an Economy 7 electricity consumer.

2.8. The benchmark at nil consumption (equivalent to a standing charge) was set differently: the CMA defined the level of the price cap at nil consumption to be equal to the average standing charge of the Six Large Energy Firms' prepayment tariffs as at 30 June 2015, weighted by customer numbers.

2.9. The benchmark was not specific to prepayment customers. The analysis was carried out for gas or electricity consumers paying by direct debit, and the competitive benchmark was then uplifted to allow for the additional costs the CMA estimated a supplier would incur in serving a prepayment customer.

2.10. The CMA's benchmark excluded costs resulting from network charges. This reflects that these costs will depend heavily on a supplier's mix of customers (with charges varying by region and meter type). This component of prices was estimated by combining published network charges with assumptions around consumption, load factors and other variables which influence the amount a supplier is charged.

2.11. An allowance for headroom was also added to the overall level of the cap, to enable suppliers to offer competitive deals beneath the level of the prepayment safeguard tariff. This headroom level is set as a percentage figure fixed over the life of the tariff, and has separate levels for electricity and gas, fixed across all suppliers.

3. Our proposed approach for setting the cap

Our considerations on whether the existing safeguard tariff would need adjusting if we were to use it when introducing a tariff cap for customers with Standard Variable Tariffs (SVTs) or default tariffs.

Considering different contexts

3.1. The existing safeguard tariff and the default tariff cap have different contexts.

3.2. The existing safeguard tariff methodology was designed in the context of the prepayment safeguard tariff. The existing cap methodology applies to prepayment customers on any tariff. This cap was introduced due to limited competition in the prepayment market.

3.3. The default tariff cap will apply to a larger and different segment of the market. This segment includes customers on Standard Variable Tariffs (SVTs) or default tariffs, paying by direct debit and standard credit methods. These differences affect consumers' circumstances and suppliers' costs to serve.

3.4. As set out in Chapter 2, the CMA calculated a competitive benchmark and then applied a payment method uplift and headroom to set the initial level of the cap. We would be minded-to adopt a similar approach.

3.5. The competitive benchmark was based on direct debit tariffs; therefore, we would apply an uplift to the benchmark to account for the additional costs to serve standard credit customers. Our minded-to approach on how we would apply a payment method uplift is explained in Appendix 12. We present our proposals for headroom in Appendix 11.

QA2.1: Do you agree with, or have views on, our approach to adjusting the CMA's methodology to make its benchmark suitable for the default tariff cap? In particular, how we propose to address: additional standard credit costs, existing overheads and customer acquisition adjustments, and other potential adjustments to operating costs.

3.6. Given the different context of the default tariff cap, in this section we describe our considerations on whether we should adjust the existing competitive benchmark to make it more suitable for the default and SVT market. We consider adjustments for:

- overhead costs
- customer acquisition costs
- smart metering costs
- other potential cost variations

Overhead costs

Issue

3.7. As noted in Chapter 2, the CMA made a downward adjustment to the existing safeguard tariff cap for the level of overhead costs that would be expected for a company that was neither growing nor shrinking, and was operating at scale. We have collected cost data from suppliers that show their realised costs since 2015, including the benchmark suppliers. We will use this data to verify whether the assumptions made by the CMA in 2015 have been borne out *in practice*. We will consider the potential explanations and implications of deviation, if we find any.

3.8. This section sets out how we might treat the CMA's adjustment for overhead costs, if we were to conclude that it was not appropriate for the default tariff cap. Note that we have not yet assessed the data.

Background

3.9. The CMA undertook analysis to understand the impact on the costs of First Utility and Ovo Energy if they were operating at a larger scale and in a steady state (ie a stable number of customers). As part of this analysis, they concluded that an adjustment was required to the overhead costs for the benchmark suppliers as a proportion of their revenues. This analysis and the methodology of the adjustment are described in detail in Appendix 10.1 of CMA's Final Report[6].

3.10. The CMA gathered information that Ovo Energy had incurred financial losses in 2014 and 2015 largely due to the costs of scaling up its management function and acquiring a large number of customers over a relatively limited period of time. Furthermore, it had spent the previous two years investing in a smart meter business. The CMA reasoned that this appeared consistent with the fact that Ovo Energy's reported overhead costs had increased relatively over that period[7].

[6] CMA (2016), Energy market investigation - final report, Appendix 10.1
[7] CMA (2016), Energy market investigation - final report, Appendix 10.1, Paragraphs 34 and 36

3.11. The CMA reasoned that as the benchmark suppliers grew in size and stabilised their customer bases, their overhead costs would reflect the infrastructure required for their actual customer base, rather than that targeted in the future. This would mean their overhead costs would be likely to decline as a proportion of revenue. The forecasts collected by the CMA provided some indication of the potential extent of such declines for the benchmark companies[8].

3.12. The CMA noted that First Utility's financial results over the assessed period were not affected in the same way as Ovo Energy's results, and were therefore likely to provide a better indication of the level of such costs that a large, stable energy supplier should be expected to incur. They therefore adjusted Ovo Energy's and First Utility's overhead costs as a proportion of revenues to be in line with First Utility's actual overhead costs[9] in 2014 and 2015[10].

3.13. In principle, we do not disagree with the CMA's rationale. However, we are now able to use data on realised costs to assess whether the way that the CMA adjusted costs has been borne out *in practice*.

Options

3.14. If data supports the CMA's adjustments, we propose leaving the benchmark as it is (ie Option 1 below). If we consider that data does not support the adjustment, we propose considering the following options:

1. Option 1: Do nothing. Retain the CMA's adjustment for overheads in our adjusted safeguard tariff cap.

2. Option 2: Remove the adjustment made by the CMA, leaving the average of the two benchmark suppliers.

3. Option 3: Remove the adjustment made by the CMA, and make our own adjustment to the safeguard tariff reference price to reflect an efficient level of overhead costs. This would be a similar approach to that set out in Table A3.1 of Appendix 3.

Our current position

3.15. We will consider whether we should retain the CMA's adjustment for overheads, and the relative merits of alternative options.

[8] CMA (2016), Energy market investigation - final report, Appendix 10.1, Paragraph 37
[9] CMA (2016), Energy market investigation - final report, Appendix 10.1, Paragraph 38
[10] CMA (2016), Energy market investigation – final report, Paragraph 10.28

3.16. In coming to a final decision we will seek to verify whether Ovo Energy's overhead cost levels have risen or fallen, or have not fallen to the extent expected by the CMA. We will also assess whether or not Ovo Energy's and First Utility's costs are reasonable comparators for an efficient level of overhead costs (by considering them against the context of cost data provided by other suppliers).

3.17. This analysis will demonstrate if the assumed level of overhead costs in the existing benchmark is reflective of an efficient level of costs expected by a large and stable supplier. If that isn't the case, retaining the CMA's adjustment would risk us understating the efficient level of costs when setting the default tariff cap.

3.18. Option 2 would mean the reference price would now also reflect Ovo Energy's overhead costs as a proportion of revenue in 2015. Taken together with First Utility's overhead levels, we would assess whether this reflects an efficient level of overhead costs in the benchmark for 2018-19. There would however, be a risk that including both Ovo Energy's and First Utility's overhead levels from 2015 would not accurately reflect an efficient level of costs, depending on cost trends since.

3.19. Option 3 would be based on our considerations of what is an efficient level of operating costs from 2017 for the bottom-up cost assessment and updated reference price approaches to setting the cap. This option however, increases the risk of adding potential uncertainty and room for error, and reduces the advantage of previous experience and understanding of the methodology.

3.20. For Option 3, we would also increasingly rely on bottom-up cost assessment information, rather than price data. Due to asymmetries in information there is a risk that we then overcompensate, overstating efficient costs. As discussed in the main consultation document, we could account for the potential risk that the CMA benchmark provides a low estimate in other ways. For instance, by leaving the benchmark unadjusted (option 1 above) and taking the mid-point between it and the benchmark produced using a bottom-up cost assessment (if for example, we were concerned that the bottom-up method contained inherent risks that it provided a high estimate).

Customer acquisition costs

3.21. The existing safeguard tariff benchmark methodology already includes an adjustment for a standardised approach to the amortisation of customer acquisition costs. The CMA's rationale and methodology for this adjustment are detailed in Appendix 10.1 of CMA's Final Report[11].

[11] CMA (2016), Energy market investigation - final report, Appendix 10.1:

Issues

3.22. There are however specific points that were raised by Oxera[12], in the critique of CMA's consumer detriment analysis they prepared for Scottish Power, on the CMA's customer acquisition costs adjustment methodology. These specific points included:

- exclusion of customer acquisitions costs before 2012
- average customer life assumed by the CMA (six years)
- potential differences in cost accounting between firms

Our minded-to position

3.23. We are minded to maintain the current customer acquisitions adjustment in our adjusted version of the existing safeguard tariff methodology.

3.24. However, we will need to consider the different interactions between this adjustment based on our final decision on options for an overheads cost adjustment, set out in the previous Overhead costs section.

Rationale and analysis

3.25. We have assessed the CMA's analysis and have verified that they did include customer acquisition costs before 2012.

3.26. We have not seen clear evidence to date to that First Utility and Ovo Energy would have significantly different average customer lives than the assumed industry average, but we will consider further evidence on this matter. The CMA also noted that the impact of using a shorter customer life is relatively small[13].

3.27. We do not think it is likely that any potential impact from differences in cost accounting would warrant the removal of this adjustment from our adjusted version of the existing safeguard tariff.

[12] Oxera (2017), CMA Energy Market Investigation – critique of CMA consumer detriment analysis
[13] CMA (2016), Energy market investigation - final report, Appendix 10.1, Paragraph 31

Smart metering costs

3.28. We are minded to adjust the existing safeguard tariff methodology to account for potential variations in smart metering costs, where material differences are identified. Appendix 10 sets out our proposed approach.

Other potential adjustments

3.29. Appendix 8 sets out our consideration of other possible factors that may drive variation in operating costs, but which are not related to relative efficiency or inefficiency.

3.30. The merit, materiality, and practicality of adjustments for these factors vary across the different approaches to setting the default tariff cap.

3.31. For an adjusted existing safeguard tariff approach, we are currently minded-to not make any other potential adjustments for operating costs. However, we will continue to consider further adjustments before our final decision.

3.32. Our rationale for not including these further adjustments under an adjusted safeguard tariff approach is that we would further erode the advantage to this model of previous experience and understanding of the methodology, by potentially adding uncertainty and potential for error to the approach. This risk is increased given that variation in factors could be correlated, and it may therefore be difficult to disentangle the individual effect of each.

3.33. It would likely also be more difficult to make adjustments in the context of the adjusted version of existing safeguard tariff, as the reference price benchmark is based on 2015 tariffs and for two particular benchmark suppliers. This could raise data constraints which are not likely to be as prominent for other approaches.

4. Our proposed approach for setting the cap at nil consumption

Our considerations on whether the existing safeguard tariff would need adjusting at nil consumption if we were to use it when capping tariffs for customers with SVTs or default tariffs.

Benchmark at nil consumption

4.1. The structure of the existing safeguard tariff cap is defined at two points: nil consumption and typical consumption. The straight line defined by these two points is extrapolated to define the price cap for levels of consumption greater than typical consumption.

4.2. The CMA set the benchmark at nil consumption differently to the benchmark at typical consumption. It defined the level of the price cap at nil consumption to be equal to the average standing charge of the "Six Large Energy Firms"[14] prepayment tariffs as at 30 June 2015, weighted by customer numbers.

4.3. The CMA set the cap at nil consumption at a level consistent with the prevailing prepayment standing charges of the Six Large Energy Firms, to ensure that the structure of the cap was broadly reflective of the structure of existing prepayment tariffs.

4.4. The level at nil consumption was broken down into components for headroom, prepayment uplift, policy costs and other costs. This established the weighting used to update the cap at nil consumption over time. Network costs and wholesale costs at nil consumption were defined to be equal to zero, as they were costs related to consumption. The prepayment uplift and headroom were therefore assumed to be already captured within the standing charge values, and were not included as additional allowances.

4.5. The default tariff cap is applicable to direct debit and standard credit customers, as opposed to traditional prepayment customers. To account for this, if we chose this option, we would be minded to replace the current cap at nil consumption with one based on the direct debit standing charges of the Six Large Energy Firms as at 30 June 2015, weighted by customer numbers[15]. This would better reflect the segment of the market the cap is applicable to. Table A2.1 sets out these annual direct debit

[14] The Six Large Energy Firms were defined by the CMA in their Energy Market investigation to be Centrica plc (Centrica), EDF Energy plc (EDF Energy), E.ON UK plc (E.ON), RWE npower plc (RWE), Scottish and Southern Energy plc (SSE) and Scottish Power.
[15] This information was published in Appendix 10.2 of CMA's Final report. We would calculate this adjustment based on the unrounded version of these numbers, provided to us by the CMA.

standing charges. These numbers are based on rounded numbers published by the CMA[16] and do not include value-added tax (VAT).

Table A2.1: £, Average annual direct debit standing charge for the "Six Large Energy Firms" as at 30th June 2015, weighted by customer numbers

Electricity Standard meters	Electricity Economy 7	Gas
£59.86	£68.62	£85.78

Source: Information from Appendix 10.2 to the CMA's final report

4.6. Under this proposed approach, we would be minded to maintain the CMA approach of not applying any additional headroom allowance to the standing charges when setting the benchmark at nil consumption.

4.7. Responses to our December 2017 consultation[17] highlighted that there may be difficulties associated with using direct debit standing charges to calculate the benchmark at nil consumption, as the application of specific direct debit discounts are often applied as a pro-rated discount on the standing charge. This could result in the direct debit standing charges used understating the underlying fixed costs of serving nil consumption customers. However, since the average standing charges take into account data from six suppliers, differences in pricing policies may average out, or reduce extremes away from the underlying fixed cost. We will consider this issue further when making our decision on how we set the benchmark at nil consumption.

4.8. The cap at nil consumption would need to reflect that this cap is also applicable to standard credit as well as direct debit customers, and so we are also minded to apply our payment method uplift approach, discussed in Appendix 12, to the benchmark at nil consumption.

QA2.2: Do you agree with how we propose to adjust the benchmark at nil consumption?

[16] CMA (2016), Energy market investigation - final report, Appendix 10.2, Annex A, Table 2
[17] Ofgem (2018), Providing financial protection to more vulnerable consumers – summary of consultation responses, Section 3b

5. Updating the cap

Our considerations on how we would update the level of the cap over time for an adjusted version of the existing safeguard tariff.

Indexing

5.1. Our proposal for indexing the cap is an exogenous indexation approach, in line with the existing safeguard tariff cap methodology. Further details on this proposal are described in Appendix 5. Irrespective of whether we use a reference price or bottom-up cost assessment approach to set the level of the cap, the level of the cap would be set by combining a historical baseline with indices tracking trends in forecast and expected costs.

5.2. For the adjusted safeguard tariff cap approach, the initial historical baseline would continue to be 2015. We would therefore apply the revised indexing approach from the 2015 base year out to winter 2018-19 to set the initial level of the cap and update this level over time.

QA2.3: Do you agree with our proposed approach for updating the level of the adjusted safeguard tariff cap?

Weighting

5.3. Appendix 3 sets out our consideration of different options of weighting cost components for indexing in an updated competitive reference price approach.

5.4. We are minded-to adopt a similar methodology as proposed for that approach, and no longer use the existing safeguard tariff cap weighting methodology[18]. This includes the approaches proposed for weighting at nil consumption and Economy 7 policy cost weighting.

5.5. There are practicality issues we will need to consider when applying an updated methodology to the existing safeguard tariff, given that it is based on a 2015 base year. Given these issues, and depending on data availability, potential options that we are considering are:

1. Use the absolute values developed under the bottom-up cost assessment for wholesale costs, and environmental and social costs. We would subtract these from the safeguard tariff benchmark. The residual would

[18] CMA (2016), Energy market investigation – final report, Section 14

be treated as an estimate for operational costs and the normal rate of return.

2. Subtracting the benchmark suppliers' operating costs from the safeguard tariff benchmark, and weighting wholesale costs, and environmental and social costs, based on percentages developed as part of our bottom-up cost assessment.

3. Weight cost components based on the realised cost data for 2015 of the benchmark suppliers.

6. Responses to stakeholder feedback

Summary of the responses to our working papers in relation to an adjusted version of the existing safeguard tariff, and any additional stakeholder feedback received to date.

Overview

6.1. We have previously requested stakeholder views on an adjusted version of the existing safeguard tariff as part of our December 2017 consultation on 'Providing financial protection to more vulnerable consumers'[19]. We published a summary of responses to this consultation in March 2018[20].

6.2. We have also received responses relating to an adjusted version of the existing safeguard tariff through our previous working papers, primarily through our first working paper[21] on setting the default tariff cap and our fifth working paper[22] on updated competitive reference price.

6.3. In this appendix, we have discussed points that were raised by stakeholders in response to the use of an adjusted version of the existing safeguard tariff to set the cap, and the benchmark at nil consumption. Responses relating to wholesale and hedging costs, headroom, policy costs, smart metering costs, EBIT margins and payment method uplifts are discussed in more detail in other relevant appendices of this Policy Consultation.

[19]Ofgem (2017), Providing financial protection to more vulnerable consumers,
[20]Ofgem (2018), Providing financial protection to more vulnerable consumers – summary of consultation responses
[21] Ofgem (2018), Working paper #1: setting the default tariff cap
[22] Ofgem (2018), Working paper #5: Updated competitive reference price

7. Consultation response and questions

We want to hear from anyone interested in this document. Send your response to the person or team named at the top of the front page.

We've asked for your feedback in each of the questions throughout it. Please respond to each one as fully as you can. The full list of consultation questions is available in Chapter 7 of the main consultation document.

Unless you mark your response confidential, we'll publish it on our website, www.ofgem.gov.uk, and put it in our library. You can ask us to keep your response confidential, and we'll respect this, subject to obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004. If you want us to keep your response confidential, you should clearly mark your response to that effect and include reasons.

If the information you give in your response contains personal data under the Data Protection Act 1998, the Gas and Electricity Markets Authority will be the data controller. Ofgem uses the information in responses in performing its statutory functions and in accordance with section 105 of the Utilities Act 2000. If you are including any confidential material in your response, please put it in the appendices.

Chapter 3 - Our proposed approach for setting the cap

Question A2.1: Do you agree with, or have views on, our approach to adjusting the CMA's methodology to make its benchmark suitable for the default tariff cap? In particular, how we propose to address: additional standard credit costs, existing overheads and customer acquisition adjustments, and other potential adjustments to operating costs.

Chapter 4 - Our proposed approach for setting the cap at nil consumption

Question A2.2: Do you agree with how we propose to adjust the benchmark at nil consumption?

Chapter 5 – Updating the cap

Question A2.3: Do you agree with our proposed approach for updating the level of the adjusted safeguard tariff cap?

Annex: PPM Safeguard tariff methodology

1.1. This annex is a repeat of the description of the existing prepayment safeguard tariff methodology we published as part of our December 2017 consultation on 'Providing financial protection to more vulnerable consumers'[23].The 'prepayment safeguard tariff' methodology referred to in this annex is equivalent to the 'existing safeguard tariff' methodology we refer to throughout this document.

1.2. The prepayment safeguard tariff came into force on 1 April 2017. Although the licence condition was introduced by the CMA, we have responsibility for updating the level of the prepayment safeguard tariff. This is based on a methodology specified in the licence condition.

1.3. The prepayment safeguard tariff applies to all customers with prepayment meters, except those with fully interoperable smart meters. The prepayment safeguard tariff applies to all tariffs, whether these are fixed or variable.

1.4. The prepayment methodology sets the prepayment safeguard tariff at different levels for gas, standard electricity and Economy 7 electricity customers in each of the 14 electricity network charging regions (a total of 42 safeguard tariff levels for each period). The safeguard tariff defines a maximum amount that can be charged to prepayment customers for any given level of consumption.

1.5. The level of the safeguard tariff is updated every six months, on 1 April and 1 October. We publish the revised levels of the safeguard tariff approximately two months in advance. Table 1 shows the breakdown of the prepayment safeguard tariff that applies for the period 1 October 2017 to 31 March 2018.

[23] Ofgem (2017), Providing financial protection to more vulnerable consumers, Appendix D

Table 1: Breakdown of the prepayment safeguard tariff, 1 October 2017 – 31 March 2018[24,25,26]

	Electricity (single rate)	Gas	Electricity (economy 7)	Dual fuel (with single rate electricity)
Competitive benchmark	£327.86	£304.41	£380.19	£632.27
Payment method cost uplift	£24.74	£40.21	£24.74	£64.95
Headroom	£14.92	£11.99	£13.81	£26.91
Network allowance (GB average)	£135.58	£122.46	£141.86	£258.05
Safeguard tariff (excluding VAT)	£503.10	£479.07	£560.59	£982.17
Safeguard tariff (including VAT)	**£528.26**	**£503.02**	**£588.62**	**£1,031.28**

Source: Ofgem calculations

Benchmark, payment method uplift and network charges

1.6. The competitive benchmark for the prepayment methodology is based on the average direct debit price of two mid-tier suppliers in 2015. The CMA collected information to estimate the average prices of these suppliers.

1.7. The CMA made a number of adjustments to the average prices of these two suppliers, to ensure the benchmark was comparable to the prices of other suppliers, including larger suppliers. These comprised adjustments to allow for:

- the difference in the costs these suppliers incurred in relation to social and environmental programs as a result of their smaller size
- a standardised approach to the amortisation of customer acquisition costs
- the level of overhead costs that would be expected for a company that was neither growing nor shrinking
- removing the network cost element, to account for cost differences due to regional distribution of customers
- a return (ie an average EBIT margin) of 1.25%.

1.8. The prepayment methodology includes separate benchmarks for a gas consumer, a single rate electricity consumer and an Economy 7 electricity consumer.

1.9. The benchmark at nil consumption was set differently. The CMA defined the level of the price cap at nil consumption to be equal to the average standing

[24] A separate safeguard tariff is not published for dual fuel – the values in the final column are derived by summing the values for electricity (single rate) and gas.
[25] Level of the safeguard tariff is expressed for current medium Typical Domestic Consumption Values (TDCVs). These are: 3,100kWh for single-rate electricity, 4,200kWh for Economy 7 electricity, and 12,000kWh for gas. We recently amended the TDCVs with effect from 1 October 2017 – these are the latest values.
[26] Network component is a simple average across the 14 electricity distribution regions.

charge of the Six Large Energy Firms' prepayment tariffs as at 30 June 2015, weighted by customer numbers.

1.10. The benchmark was not specific to prepayment customers. The analysis was carried out for a gas or electricity consumer paying by direct debit, and the competitive benchmark was then uplifted to allow for the additional costs the CMA estimated a supplier would incur in serving a prepayment customer. Table 2 sets out the values of these cost uplifts – and those for a customer paying by standard credit.[27]

Table 2: CMA estimates of payment method cost differentials

	Premium to direct debit	
	Range	Central estimate
Prepayment		
- Electricity	£19-£33	£24
- Gas	£31-£48	£39
- Dual fuel	£50-£81	£63
Standard credit		
- Electricity	£39-£69	£47
- Gas	£45-£81	£53
- Dual fuel	£84-£150	£100

Source: Information from Appendix 9.8 to the CMA's final report

1.11. The CMA's benchmarks exclude costs resulting from network charges. This reflects that these costs will depend heavily on a supplier's mix of customers (with charges varying by region and meter type). This component of prices was estimated by combining published network charges with assumptions around consumption, load factors and other variables which influence the amount a supplier is charged.

Headroom

1.12. The prepayment methodology includes a headroom level of 4.23% for electricity and 3.48% for gas, fixed across all suppliers. This percentage is applied to all elements of costs except the network allowance. It therefore scales with consumption, and will vary over time according to movements in the cost indices. The percentages were intended to deliver around a £30 headroom for a dual fuel prepayment consumer with typical consumption.

1.13. In setting this level of headroom the CMA took into account the impacts on customers and suppliers, through: the reduction in detriment for prepayment

[27] Full details of the CMA's estimates are provided in: CMA (2016), Energy market investigation – final report, appendix 9.8

consumers, the impact on profitability for suppliers, and the effect on competition.[28]

1.14. The chosen level of headroom was expected to result in around two-thirds of prepayment customer detriment being reduced for customers with each fuel/meter combination, and a greater proportion of detriment being reduced in some cases.[29] At most, almost 100% of the detriment was expected to be addressed for single fuel gas customers with single rate meters.[30] The chosen level of headroom was expected to generate an average saving of £71 per customer.[31]

1.15. For a hypothetical supplier, a zero headroom level under the prepayment methodology would have covered efficient costs and allowed for a 1.25% EBIT margin for the supplier's single fuel prepayment tariffs. Including headroom increased the weighted average EBIT margin across all tariff types to around 4% at medium Typical Domestic Consumption Value (TDCV), for an efficient supplier. This margin was in line with the large suppliers' views on a reasonable competitive margin for retail supply.[32]

Updating the safeguard tariff

1.16. Under the prepayment methodology, we update the level of the prepayment safeguard tariff twice a year. The two periods run from 1 April to 30 September and from 1 October to 31 March. We publish the levels of the safeguard tariff around two months before the start of each period.

1.17. The level of the prepayment safeguard tariff is set according to developments in a series of cost indices. Different indices are used to approximate trends in different components of the safeguard tariff – these are set out in Tables 3 and 4 below.

1.18. In order to apply weights to various indices when updating the competitive benchmark (which covers wholesale, policy and other costs), the prepayment methodology includes an assumption about the proportion of the competitive benchmark which was made up of each cost category.[33]

[28] CMA (2016), Energy market investigation – final report, paragraph 14.251
[29] CMA (2016), Energy market investigation – final report, paragraph 14.258 and table 14.13
[30] CMA (2016), Energy market investigation – final report, paragraph 14.259
[31] CMA (2016), Energy market investigation – final report, paragraph 14.261
[32] CMA (2016), Energy market investigation – final report, paragraph 14.269
[33] CMA (2016), Energy market investigation – final report, table 14.4

Table 3: Indices used to update level of prepayment safeguard tariff – electricity (single rate)

Element		Indexed using
Competitive benchmark	Wholesale costs	Prices of winter / summer forward contracts covering the Charge Restriction Period, and the subsequent season
	Policy costs	Office for Budget Responsibility forecasts of environmental levies for financial year
	Other	Consumer Price Index (inflation)
Payment method cost uplift (prepayment)		Consumer Price Index (inflation)
Network cost / balancing services component		Charges published by National Grid and electricity distribution network operators

Source: Information from Chapter 14 of the CMA's final report

Table 4: Indices used to update level of prepayment safeguard tariff – gas

Element		Indexed using
Competitive benchmark	Wholesale costs	Prices of quarterly forward contracts covering the Charge Restriction Period, and the subsequent two quarters
	Policy costs	Consumer Price Index (inflation)
	Other	Consumer Price Index (inflation)
Payment method cost uplift (prepayment)		Consumer Price Index (inflation)
Network cost / balancing services component		Charges published by National Grid and gas distribution companies

Source: Information from Chapter 14 of the CMA's final report