

Default Tariff Cap: Policy Consultation Overview document

Consultation

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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 well for consumers who remain on their supplier's default tariff. Our work, and the Competition and Markets Authority's investigation, has shown there is insufficient competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should.

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 cap will come into force at the end of 2018 in order to provide protection to consumers this winter.

In this policy consultation, we propose how we might design and implement the default tariff cap proposed by the Bill. This includes how we could set the initial level of the cap, to best achieve the Bill's intentions and how we might periodically adjust the cap up or down, to reflect underlying cost changes. We seek views from stakeholders on our approach, and how the cap will affect consumers, suppliers, and the market as a whole. We expect to publish the final statutory consultation in August.

Please send us your responses to this consultation by **12.30pm Monday 25 June 2018**.

Context

Our ambition is for all customers to get better outcomes in the way they meet their heat and power needs. The energy market is transforming, as a result of technological change and the roll-out of smart meters. We have a broad programme of work which aims to capitalise on this change and create a future retail market, which helps more customers engage and enables greater innovation.

Our work will tackle problems with the existing industry code frameworks, reduce barriers for innovators to try new business models, and it will put data at the heart of the new market, making it easy for customers to allow third parties to access their data, even if it is held by a different company. In this new retail market, the most vulnerable have specific protections tailored to their needs and all consumers will get a better deal whether or not they engage.

However, implementing these changes and creating a new retail market will take time. In the meantime, government is introducing legislation so we can introduce a default tariff cap as a ‘back-stop’ for less engaged consumers – ensuring suppliers do not charge unjustifiably high prices.

We have already introduced price protection for those who need it most. The PPM cap protects customers with prepayment meters. Our safeguard tariff protects consumers receiving Warm Home Discount. On Friday 3 May, we published a consultation on the licence modifications required for suppliers to extend the safeguard tariff to consumers claiming certain qualifying benefit claims. This means we can protect these customers this winter if there are any delays to the legislation needed for the default tariff cap.

The default tariff cap extends protection to all consumers who do not engage in the market frequently. This consultation sets out how we might design the cap to ensure that consumers on default tariffs receive lower bills, and suppliers improve their efficiency. This consultation builds on a series of working papers (and stakeholders’ responses) that we published in March and April. These exposed some of the key design issues for the default tariff cap.

Associated documents

Links to supplementary appendices to this document

- 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

Links to other associated documents

- Open letter on an update on our plans for retail energy price caps
<https://www.ofgem.gov.uk/publications-and-updates/update-our-plans-retail-energy-price-caps>
- Default tariff cap working paper – setting the level of the cap
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-setting-level-cap>
- Default tariff cap working paper – market basket
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-market-basket>
- Default tariff cap working paper 3 – our thinking on including a headroom allowance
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-3-our-thinking-including-headroom-allowance>
- Default tariff cap working paper – updated competitive reference price approach
<https://www.ofgem.gov.uk/publications-and-updates/default-tariff-cap-working-paper-updated-competitive-reference-price-approach>
- Working paper – environmental and social obligations costs under the default tariff cap
<https://www.ofgem.gov.uk/publications-and-updates/working-paper-environmental-and-social-obligations-costs-under-default-tariff-cap>

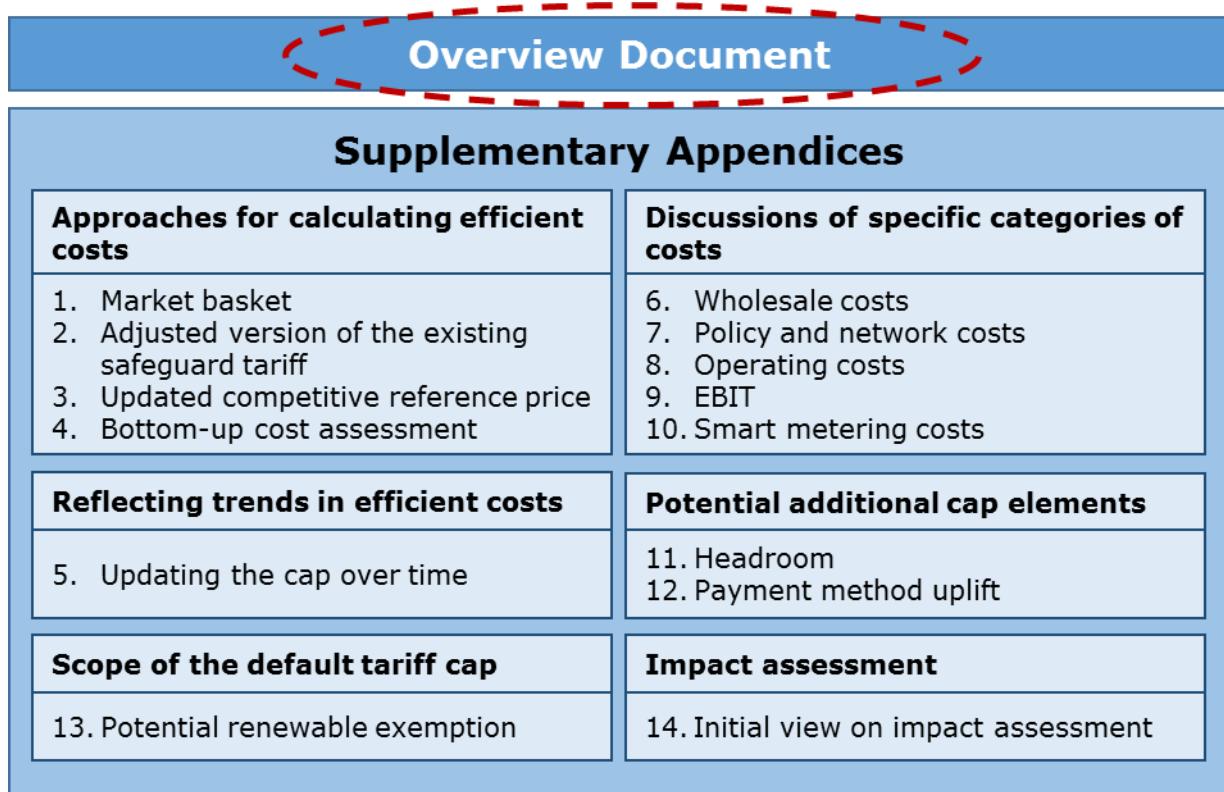
Document map

This is the main document of our policy consultation. It provides an overview of our proposals. Please read our supplementary appendices for more detailed discussion of our approach, the options we have considered, and detailed consultation questions.

In chapter 7 of this document, we state all questions included in this document, and include more detailed questions from the supplementary appendices. Please read the supplementary appendices to view these detailed questions in context.

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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Executive Summary

Consumers with default tariffs pay too much

The retail energy market does not work well for consumers on default tariffs. They engage with the market less, so are less able to protect their interests. Many pay too much. In March 2018 the average Standard Variable Tariff (SVT) offered by large suppliers to consumers paying by direct debit was £1,135, substantially more than the cheapest available tariffs.

To address this problem, Government introduced the Domestic Gas and Electricity (Tariff Cap) Bill ("the Bill") to Parliament. It requires Ofgem to temporarily cap all SVTs and default fixed-term tariffs. The Bill requires us to introduce the cap as soon as practicable. We expect that the cap will come into force before the end of this year in order to provide protection for consumers this winter.

Following our series of working papers, in this policy consultation we propose how we might design the cap. We seek views from stakeholders on our approach, and on how the cap will affect consumers, suppliers, and the market as a whole.

How will a cap help?

The objective of the cap, as provided for by the Bill, is to protect current and future consumers who pay SVTs or default tariffs. This is the most important thing we have in mind when making our decisions. We expect that people paying the highest prices will make significant savings.

In complying with the objective of the Bill we must have regard to the cap's impact on other matters:

- Creating incentives for suppliers to improve their efficiency. The CMA concluded that in many cases large suppliers' costs were higher than they would be if competition working more effectively. The cap should ensure that inefficient suppliers have incentives to reduce their costs.
- Enabling suppliers to compete effectively and maintain incentives for customers to switch. The cap is not intended to replace competition. It should ensure sufficient cheaper tariffs are offered to engaged consumers, while protecting consumers not on those deals.
- Ensuring that efficient suppliers are able to finance their licensed activities.

The level at which we set the cap will be crucial and will be a judgement that we will need to make in the light of various trade-offs. This consultation seeks stakeholders' views on how we should balance these matters when setting the default tariff cap.

How will we set the cap?

This consultation does not propose at what level the cap should be. Rather, it explains how we might make that complex judgement, and seeks stakeholders' views on how we can manage the uncertainty involved and support the Bill's aims.

Firstly, we will judge what level of costs an efficient supplier should incur. This estimate will include some uncertainty, as we face several inherent challenges. The

efficient level of costs is not something we can directly observe; it will be less than many suppliers' actual costs. Suppliers' costs may also differ for reasons that are not related to their relative inefficiency (eg. due to differences in their customer bases). Suppliers also face costs, particularly when purchasing energy, which are difficult to anticipate when setting the level of the cap. The data we rely on introduces uncertainty too. Reliance on cost data can risk overstating the efficient benchmark, as suppliers have an inherent advantage when they present and explain their costs. However, price data can underestimate the benchmark, as suppliers may offer loss-leading tariffs. We will need to bear these factors in mind when setting the methodology and cap level.

We present four methods for estimating an efficient level of costs, and discuss their advantages and disadvantages. We propose ruling out one approach (the market basket) and welcome stakeholders' views on the three methods remaining.

Secondly, we propose assessing whether any additional amount – known as 'headroom' – is required above the allowance for efficient costs. Headroom can account for any remaining uncertainty and risk in our efficient benchmark. As such, we would decide whether to include any headroom, and how much, at the same time as we decide on the efficient benchmark.

When setting the cap, we will consider the cap's impact on consumer protection – which is the ultimate objective – but also give regard to how the cap level affects each of the matters set out in the Bill. Any cap level will involve judgement about difficult trade-offs, which we will make in the round. To understand these judgements, and for the purposes of helping stakeholders to engage in this consultation, we are considering a range of cap levels either side of the approach the CMA adopted in the PPM cap (about £30 of headroom for an average customer). We focus on cap levels from no headroom, to a level around £40 higher than the level included in the PPM cap. We assess this wider range because: the default tariff cap will affect many more consumers; a benchmark for this wider market is likely to be more uncertain; and to assess how options that place greater emphasis on switching affect consumers.

At low levels, the cap would provide greater savings for consumers on default tariffs. It would also create strong incentives for inefficient suppliers to reduce their costs. However, it could have an impact on switching: by reducing price dispersion consumers might be less likely to engage in the market and actively choose their tariff and supplier. There are also risks that efficient suppliers, with above-average costs due to their customer base, might not be able to cover their costs.

Conversely, while a higher cap would protect default customers from very high prices, the amount saved by most customers would be less. In general suppliers would be under less pressure from the cap to cut costs and realise efficiencies. It would put less financial pressure on efficient suppliers that have atypically high costs because of their customer base. At higher cap levels there is likely to be more competition for engaged consumers and incentives for them to switch. We would be more reliant on this competition to provide incentives for suppliers to improve their efficiency; however, those savings would be unlikely to be passed onto customers on default deals. As such, we would expect, all other things being equal, for a higher cap to offer less customer protection.

How will we update the cap?

The cap should rise and fall as suppliers' costs – buying energy, network charges, and government policy costs – change. We also want to provide stability for consumers, and limit frequent price changes. We propose updating the cap every six months, but welcome views on whether we should update it more frequently.

We have considered three options for updating the cap. This consultation presents our preferred option: using cost indices and data, outside of suppliers' control, to adjust the initial cap. This approach is very similar to how we update the existing safeguard tariff (PPM cap). We are seeking views on our proposal to adjust for changes in the net cost to suppliers of rolling out smart meters (because the drivers of change for these costs may be different from suppliers' other operating costs).

Will there be an exemption for tariffs supporting renewable energy?

The Bill requires us to consider and consult on whether SVTs that appear to support renewable energy should be exempt from the cap. This consultation sets out criteria and options we have considered. We want to prevent suppliers 'gaming' the cap – exempt tariffs should genuinely add to the overall support for renewable energy and reflect genuinely higher costs of providing the tariff.

We propose not to provide an exemption. But we are considering providing derogations from the cap if suppliers satisfy us that their tariff genuinely adds to support for renewable energy and incurs materially higher costs. We would expect to set a high bar for agreeing to a derogation request.

When will the cap be removed?

The cap is temporary. The Bill requires that it be removed in 2020, but allows it to be extended in increments of 12 months. Government can only extend the cap three times. It must end by 2023. From 2020, we will assess whether conditions for effective competition are sufficient for government to remove the cap.

This consultation sets out what we could consider when assessing whether conditions for competition. We would not be able to monitor whether competition is effective while the cap is still in place. Rather we will consider how progress with technological changes and other initiatives (such as prompts to engage) could help customers engage and enable greater innovation once the cap is removed.

Next steps

We seek responses to this consultation by **12.30pm on 25 June 2018**. We are exploring other ways for stakeholders to feed in views outside of a formal consultation response. For example, smaller organisations can offer their views by email or over the phone. We will also hold events during the consultation period to discuss aspects of the consultation in more detail. Please contact retailpriceregulation@ofgem.gov.uk for more information.

Subject to the review of responses and the passage of the Bill through Parliament, we plan to issue a statutory consultation on these proposals in August 2018. This means that the cap will come into force by the end of this year so that it is in place to provide protection to consumers this winter.

1. Introduction

In this chapter we discuss:

- how market conditions affect consumers on default tariffs;
- what impact Government intends the cap to have;
- how a cap will work in practice; and
- the structure and purpose of this consultation.

Market conditions for consumers on default tariffs

1.1. The retail energy market is not working well for all household consumers. Consumers who are able and willing to shop around can usually get a good deal. But competition isn't working well for consumers who are less engaged. 60% of consumers are on a default tariff (either a Standard Variable Tariff (SVT), or a default fixed tariff). In March 2018, the average SVT offered by large suppliers, cost consumers £1,135 if they paid by direct debit. This was around £235 more than the cheapest fixed-term tariff offered by those large suppliers, and around £280 more than the cheapest tariff in the market.¹

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

1.3. Our ambition is that all consumers get better outcomes in the way they meet their heat and power needs. The energy market is undergoing a fundamental transformation, as a result of technological change and the roll-out of smart meters. We have a programme of work that is aiming to create a future retail market, which capitalises on these changes, helps customers engage and enables greater innovation. It is a market where competition delivers better outcomes for all consumers and the benefits of competition are shared with disengaged consumers.

1.4. We recognise that implementing these changes will take time, and even still, a proportion of consumers may remain less-engaged. In the meantime, government is introducing legislation to enable Ofgem to provide a 'back-stop' for less engaged consumers – ensuring suppliers do not exploit their position by charging unjustifiably high prices. We already protect many of the consumers that need it most. The PPM cap protects customers with prepayment meters. We introduced our safeguard tariff – set at the same level as the PPM cap – to protect consumers receiving Warm Home Discount.

¹ Ofgem, [Retail Market Indicators](#), correct as of April 2018.

The default tariff cap

The Domestic Gas and Electricity (Tariff Cap) Bill

1.5. This year Government introduced the Domestic Gas and Electricity (Tariff Cap) Bill ("the Bill") to Parliament.

1.6. The Bill seeks to protect current and future consumers paying default tariffs. The cap should protect consumers, but would not necessarily provide the cheapest possible prices. In this context, the Bill requires us to have regard to four other matters:

- a) The need to create incentives for holders of supply licences to improve their efficiency;
- b) The need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts;
- c) The need to maintain incentives for domestic customers to switch to different domestic supply contracts;
- d) The need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

1.7. Under the legislation, the cap will be temporary. In 2020, we must review whether the conditions are in place for effective competition, and publish a report, including a recommendation on whether the cap should be extended or not. The Secretary of State would then decide whether to extend the cap. If the cap is not removed, we would carry out further reviews in 2021 and 2022. If the cap is extended after each of our reviews, it will cease to have effect at the end of 2023.

1.8. The Bill requires us to introduce the cap "as soon as practicable" after the Act has passed. Given this, and the fact that the Bill requires a temporary cap, we will ensure that the data required, and the time taken, to design and implement the cap is sufficient to meet the Bill's intention. The Bill is currently receiving scrutiny in the House of Lords and we anticipate that Parliament will approve the Bill in the summer, and the cap will come into force at the end of 2018 in order to provide protection to consumers this winter.

1.9. The Bill states that the cap will not apply to customers covered by the PPM cap. It also states that the cap may not apply to any consumers who benefit from a cap because they appear to be vulnerable by reason of their financial or other circumstances. The Bill allows us to exempt certain SVTs if we consider that they provide additional support to renewable energy. The Bill requires us to consider and consult on whether an exemption is necessary and workable.

How a default tariff cap will work

1.10. The default tariff cap will set an upper limit on the amount people on SVTs and other default tariffs pay. It will set a maximum on the amount in pounds that a supplier can charge a customer, which will increase in proportion to the amount of energy that they use, and include an allowance at nil consumption. This reflects the fact that most of the costs incurred by a supplier scale with the amount of energy a customer consumes. It also recognises that suppliers incur costs that do not change as customers increase or reduce their consumption.

1.11. For a particular customer, the exact level of the cap will vary depending on some of their circumstances. Currently prices vary across the country (to reflect differences in the costs of transporting energy in different locations) and between individuals (to reflect differences in the cost of serving people with different consumption habits or payment types). The cap will also take some of these differences into account, which we discuss in Chapter 2.

1.12. The cap will also need to vary over time to reflect changes in the costs that suppliers have little or no control over. Therefore we propose to develop a set of indices and recalculate the cap level every 6 months, using these indices. This means that the cap level will rise or fall twice a year as suppliers' costs change.

Our work so far

1.13. As part of our analysis so far, we have published five working papers covering the following issues: setting the default tariff cap; setting the cap using a market basket reference price; headroom; policy costs; and updating the competitive reference price.

1.14. We are grateful for stakeholders' responses to these working papers and previous consultations. We have received 73 responses to the working papers and have used them to inform this policy consultation. We have published non-confidential submissions alongside this document and provided summaries of feedback in the relevant appendices.

The structure of this consultation

1.15. This consultation explains how we might design and implement the default tariff cap. It sets out the options we are considering, and in many places, which approach we intend to take. Where we state our minded-to position, we seek stakeholders' views on whether they agree. Where we present options, we seek stakeholders' views on their relative merits to help inform our final decision.

1.16. To support this consultation, we have published a number of detailed appendices on our methodology, including a set of detailed consultation questions. This consultation document is structured in the following chapters:

- In **Chapter 2: setting the initial cap** we outline the four methodologies we have considered for estimating the efficient costs of supply and the range of headroom we are considering. We seek stakeholders' views on which of the options we outline best achieves the Bill's objective.
- In **Chapter 3: updating the cap** we outline the options we have considered for updating the cap, and which of these we intend to implement. We seek stakeholders' views on whether they agree that our proposed approach best achieves the Bill's objective.
- In **Chapter 4: Potential exclusions from the tariff cap** we discuss whether an exemption for tariffs that charge consumers more to support renewable energy is desirable and workable. We welcome stakeholders' views on this issue.
- In **Chapter 5: Annual tariff review** we present how, from 2020, we intend to assess whether market conditions mean that competition would be effective enough for the cap to be removed. We welcome stakeholders' view on these issues will intend to consider.
- In **Chapter 6: Plan and next steps** outlines the current programme plan and how stakeholders can engage with us.

1.19 The response date for this consultation is **12.30pm 25 June 2018**.

2. Setting the initial cap

In this chapter we set out:

- the challenge of estimating efficient costs;
- the options we are considering for establishing suppliers' efficient costs;
- the range of headroom, in addition to efficient costs, that we are considering to achieve the Bill's objectives; and
- design features to accommodate different costs to serve and consumption levels.

Assessing the efficient cost of supply

2.1. This chapter discusses setting the initial level of the cap. In the next chapter we discuss how we propose to update it.

The challenge of estimating efficient costs

2.2. To set the cap, we need to estimate what level of costs would provide an efficient benchmark for suppliers.

2.3. The Bill requires us to have regard to ensuring that suppliers who operate efficiently are able to finance their licensed activities. It also requires that we have regard to creating incentives for suppliers to improve their efficiency. We understand this to include ensuring inefficient suppliers reduce their costs.

2.4. Estimating a single efficient benchmark for suppliers' costs involves several challenges. Whatever approach we take, our estimate will contain uncertainty. This is because we cannot directly observe what an efficient level of cost should be. While we can observe suppliers' historical costs, in many cases these will be above the efficient level. In its investigation, the CMA concluded that large suppliers' costs (and profits) would have been lower, were competition working more effectively.

2.5. If we knew that the only differences between suppliers were due to their relative efficiency or inefficiency, then we could simply set the allowance at the level of the lowest cost suppliers. However, in practice, costs can vary between companies for reasons that are not related to their efficiency (eg due to differences in their customer bases, such as the proportion of customers receiving paper bills). When estimating efficient costs for the market as a whole, there is a risk we set a level where efficient suppliers, with business models or customer bases that cost more than our benchmark allows, cannot recover their costs. Equally, we need to be concerned about allowing suppliers to charge more than they need to, by setting the cap too high.

2.6. More generally, it is inherently uncertain what the efficient level of suppliers' costs is, particularly when setting a cap on future costs. Table 1 shows the costs a supplier incurs providing energy to an average customer. Some of these costs are uncertain in advance, particularly in relation to wholesale energy and the costs of

environmental and social obligations. The comparability and reliability of data on costs also creates uncertainty. Cost information will generally not be held in the exact form required, and in many cases information related to the relevant economic variables will not be held at all.

Table 1: Breakdown of a dual fuel bill in 2016

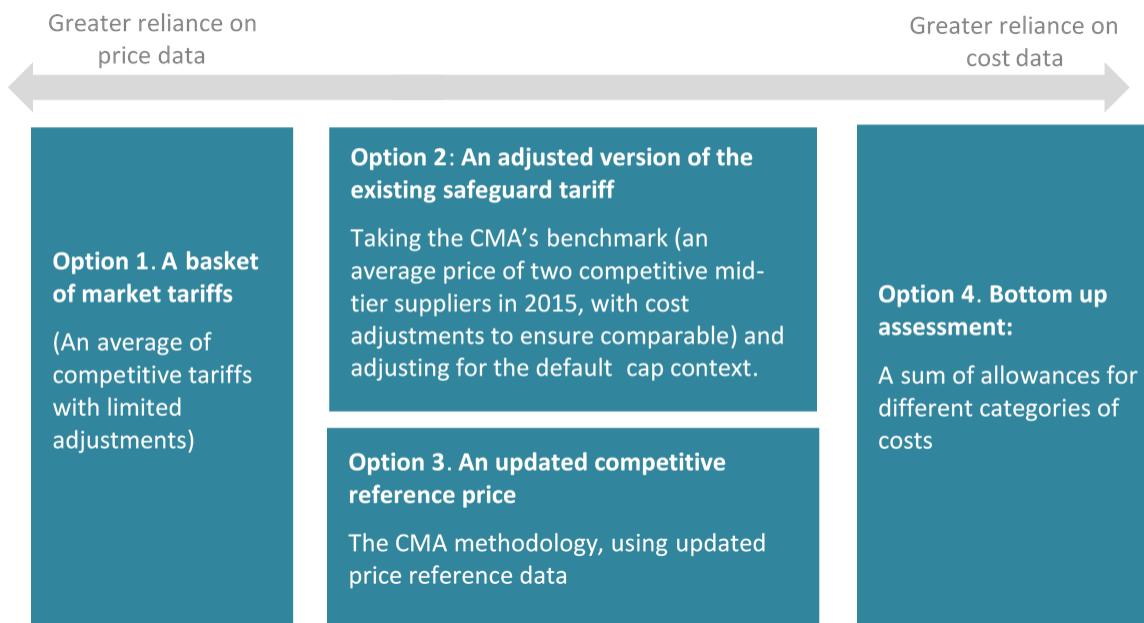
Cost category	Proportion of bill
Wholesale	38%
Network	26%
Policy	8%
Other direct	1%
Operating	17%
Profit	5%
VAT	5%

Source: Ofgem retail market indicators, based on the Consolidated Segmental Statements of the six largest suppliers

2.7. To estimate how much an efficient supplier would require to recover their costs we have considered four approaches. To different extents they use data on market prices and data on suppliers' costs, as shown in Figure 2 (next page). Price data allows us to observe how much suppliers charge in the competitive section of the market. The rationale is that competition drives the price down to the efficient level of costs, but no further. Cost data allows us to observe directly the costs that suppliers actually incur. However, suppliers have an inherent advantage when they present and explain their costs to us and may be incentivised to overstate costs or use cost allocation methodologies, which may be advantageous to them. As such, we need to examine critically information we receive from suppliers.

2.8. Relying on price data and cost data has advantages and disadvantages when estimating an efficient supplier's costs. When it set the PPM cap (existing safeguard tariff), the CMA used a hybrid approach. This recognises that the prices that suppliers charge their customers may depart from an efficient level of costs – for instance, when suppliers offer prices that are below their costs, in order to attract new customers. The CMA used cost data to adjust the reference prices, in order to make its benchmark more reflective of an efficient level of costs.

Figure 2: methods considered for estimating efficient costs



Note: In working paper 1, we referred to option 2 as the 'existing safeguard tariff'. For the default tariff we do not propose applying that methodology without any adjustment. For instance we would not include the allowance for serving prepayment customers, as that would not be relevant for the Default Tariff Cap.

Source: Ofgem

Option 1: A market basket of tariffs

2.9. A market basket of tariffs approach would set the efficient level of costs using an average of market tariffs offered in the competitive segment of the market. In March 2018 we published a working paper discussing how we would do this. In Appendix 1 we provide further discussion, analysis and responses to stakeholders' feedback.

2.10. We propose to rule out using a market basket of competitive tariffs to set the cap. We are concerned that the most competitive tariffs in the market may not reflect the long-run costs of an efficient supplier. First, market prices will depend on suppliers' pricing strategies and the degree of competition in the market, not just their underlying costs. Second, different suppliers may face different costs. The feedback to our working paper supported this view, but we welcome any further comments.

Option 2: An adjusted version of the existing safeguard tariff

2.11. The existing safeguard tariff is used to cap prices for prepayment customers and households eligible to receive Warm Home Discount. These caps are set using a methodology developed by the CMA, which estimates the efficient costs of supplying energy to prepayment customers. The CMA took price data (the average direct debit price in 2015 of two mid-tier suppliers – Ovo Energy and First Utility) and made adjustments to make the benchmark cost reflective for the market as a whole.

2.12. If we were to use the existing safeguard tariff as the basis of the methodology to set the default tariff cap, we propose adjusting the benchmark for efficient costs. We would do this to make it more applicable for SVT and other default tariff customers and to reflect changes since the existing safeguard tariff was introduced.

- We propose adjusting the payment method uplift. The existing safeguard tariff includes £66 (in summer 2018)² to cover the differential in costs that are specific to prepayment meters above the cost of serving direct debit customers. We intend to replace this uplift with costs appropriate for additional standard credit costs.³
- We are considering whether we should maintain the CMA's adjustment to overheads, which stakeholders have questioned. In 2015, the CMA reduced its estimate of efficient costs, because it reasoned that overhead costs would be lower for companies that were not growing, and operating at scale. We have collected more recent cost data that allows us to assess trends in overheads since 2015. We will assess this data, and will consider its implications, if any, for the adjustment. In Appendix 2 we explain the options we are considering for adjusting operating costs, should we deem that to be necessary.
- We propose adjusting how the benchmark is set for standing charges. The CMA set it in line with average prepayment standing charges offered by the large suppliers on 30 June 2015, weighted by customer numbers. We propose replacing that data with the average direct debit standing charges of the same suppliers as at 30 June 2015.
- We have considered other adjustments based on stakeholders' feedback. We will continue to analyse these issues and welcome feedback, but we are not currently minded to make other adjustments to the benchmark.

2.13. Please read Appendix 2 for further detail on our proposed methodology, the issues and options we have considered, and detailed questions on our approach.

² Ofgem, [Retail market indicators: Breakdown of the safeguard tariff](#)

³ We discuss additional costs of serving standard credit customers in Appendix 12.

Option 3: The updated competitive price reference approach

2.14. If we estimate efficient costs using an updated competitive price reference approach we will use the broad methodology applied by the CMA when it calculated the existing safeguard tariff. The key difference is that we would use recent price data, rather than rely on data from two suppliers in 2015. In April 2018, we published a working paper setting out our initial views.

2.15. To construct an estimate of efficient costs, using an updated competitive price reference, we would select competitive average price data and then make necessary adjustments, or exclude suppliers, to provide an efficient benchmark that is relevant to the market. The key steps in the approach are:

- To ensure that the prices we reference reflect those which we would expect under effective competition, we propose excluding suppliers from our analysis who have more than a quarter of their non-prepayment customers on SVTs for three or more years, and have less than half of their non-prepayment customers on fixed tariffs.
- We would propose to make an adjustment where the relevant suppliers do not incur the full costs of Energy Company Obligation and Warm Home Discount, to ensure the benchmark is reflective of the costs of a fully obligated supplier.
- To ensure the reference price is a relevant comparator for the market, we propose excluding suppliers with niche business models, and suppliers where we have proposed or enforced disciplinary action for non-compliance with licence conditions, such as those regarding minimum customer service levels.
- We propose adjusting tariffs so that they should be making a normal rate of return.⁴ In doing so, we intend to consider the adjustments made by the CMA to reflect instances where suppliers have higher overhead or customer acquisition costs due to their size. We will also consider other adjustments to operating costs, where these are particularly high or low due to factors other than the relative efficiency of the company in question (we discuss these in the bottom-up approach, as they apply to all methods and adjustments rely on cost data).

2.16. After applying these criteria, we propose using the price data to set the efficient cost benchmark. We would take an average of at least the cheapest two suppliers, and at most the cheapest half of all the suppliers analysed (after exclusions). Our final position would represent a judgement on what we consider to

⁴ See appendix 9 for a discussion of the CMA's assessment of normal rates of return, and our consideration of stakeholders' concerns.

deliver the most robust benchmark. We would take a simple average of the remaining suppliers to set the benchmark for efficient costs.

2.17. Please read Appendix 3 for further detail on our proposed methodology, the issues and options we have considered, and detailed questions on our approach.

Option 4: bottom-up cost approach

2.18. Finally, we are considering estimating efficient costs using a bottom-up cost assessment of data relating to the different costs that suppliers incur. Under this approach, we propose estimating efficient allowances for each cost category, and summing these together.

Wholesale costs

2.19. Estimating an efficient allowance for wholesale costs is challenging. We propose to estimate the majority of these costs with reference to the prices of forward energy products. To do so, we would use the model used to index the wholesale component of the existing safeguard tariff.

2.20. However, suppliers also face additional costs, beyond those reflected in the model. We are considering what, if any, additional allowance might be needed for these costs.

- Shaping: the additional expected cost of buying products to reflect the specific demand profile of customer across a season, and – for electricity – in each half-hourly settlement period.
- Forecast error and imbalance: the additional expected costs to suppliers associated with any errors in the forecasts used when purchasing energy in advance – including any imbalance charges.
- Transaction costs: non-energy costs such as broker and exchange fees, the cost of operating a trading desk, and the cost of credit and collateral (to the extent that these are not captured under the allowance for operating costs, or the EBIT margin).

2.21. We would also include under wholesale costs an allowance to reflect the domestic market's share of Capacity Market charges.

2.22. Please see Appendix 6 for further detail on our proposed methodology, the issues and options we have considered, and detailed question on our approach.

Network costs

2.23. For network costs, we would set the allowance using the same model⁵ we use to calculate and update the existing safeguard tariffs, as applied in the CMA's methodology. This combines published network charges with assumptions about load profiles and losses to estimate the charges incurred in each region. The allowance we include for networks will vary for different areas of the country because network cost differ by region. Please see Appendix 7 for further detail.

Environmental and social obligations

2.24. For the costs suppliers' incur in relation to their environmental and social obligations, we propose using data published by administrators of the different schemes to calculate the cost per customer and per MWh in the base period. Please see Appendix 7 for further detail.

Operating costs

Defining operating costs

2.25. For suppliers' operating costs we propose setting separate allowances for gas and electricity accounts, calculated on a per customer basis.

2.26. By 'operating costs' we intend to use as our starting point the definition of indirect costs as used in the Consolidated Segmental Statements that we required the large suppliers to publish each year, and then we propose to:

- **exclude** exceptional restructuring costs and fines, costs already captured within the categories above (eg the administration costs of the ECO and FiT schemes, transaction costs associated with purchasing energy), and costs associated with activities other than the supply of gas and electricity.
- **include** the administration costs of Elexon and Xoserve, administration costs associated with the Warm Home Discount and smart meter rollout (see below), and depreciation and amortisation charges. We also include marketing and sales costs – including third party commissions – within the allowance for operating costs (around 11% of operating costs).

2.27. We propose to include the costs associated with the smart meter rollout – including charges from the Data Communications Company and Smart Energy GB –

⁵ Please read appendix 7 for more details. The full model is available at [this link](https://www.ofgem.gov.uk/system/files/docs/2018/02/prepayment_price_cap_calculations_ne):
https://www.ofgem.gov.uk/system/files/docs/2018/02/prepayment_price_cap_calculations_ne
twork_charges_v1.6.xlsx

within the allowance for operating costs. This is because these costs are intrinsically linked with the core supplier functions of metering, billing and providing customer service.

Analysing efficient operating costs

2.28. The CMA concluded that a significant proportion of actual operating costs are inefficient. We have requested data on operating costs from all suppliers with more than 250,000 customers, for the period 2015 to 2017. The data – which we are continuing to analyse – shows significant variation; taking an average for each supplier over the period 2015-2017, the range between the highest and lowest cost supplier is over £50 per customer per year for gas, and over £40 per customer per year for electricity.⁶

2.29. In our view much of that variation reflects differences in efficiency. We could therefore base the efficient allowance on the lowest cost achieved by a supplier in our sample (and therefore lower than most suppliers' actual historical costs). But we recognise that there may be some variation in suppliers' operating costs that is driven by aspects of their operating environments that do not relate to effectiveness or efficiency. For instance, a supplier that is operating efficiently may have higher or lower costs due to the nature of their customer base (such as, the proportion of vulnerable customers), or their own circumstances (such as the stage of their smart meter rollout, or their size).

2.30. In some cases we may be able to adjust cost data to account for differences in suppliers' operating environments that are not related to efficiency. For example if a supplier had very few customers with paper bills, and this had a material impact on its costs, we could adjust its actual costs to an estimate of what it might incur if the supplier had an average proportion of those customers. Depending on the issue being considered, adjustments could be upwards or downwards. This approach is similar in principle to the adjustments made by the CMA in their reference price model used to set the existing safeguard tariffs, to take account of the higher reported overheads and customer acquisition costs of the benchmark companies.

2.31. However, in many cases it will be challenging to precisely identify the impact of a given factor on a supplier's costs - particularly given that different cost drivers will often be correlated. It may therefore be difficult to disentangle the individual effect of each factor and in some cases they could cancel each other out. Given this, our

⁶ These costs include DCC costs and third party commissions, so will not reconcile directly to costs in suppliers' consolidated segmental statements. In Table A8.1 in Appendix 8, we fully explain what is included in operating costs, and provide the range of costs per account that suppliers report for 2015 to 2017. Note that we have not, at this stage, excluded any suppliers from the sample, nor made any adjustments to the data beyond those listed in the note to the Table A8.1 in Appendix 8. We will continue to review the information provided, and anticipate making further adjustments prior to setting the level of the cap. We are also considering what periods we should use when setting the benchmark, and whether years should be weighted differently.

approach would be to consider these issues in the round, so that we understand the net impact on costs.

2.32. We would only seek to make specific adjustments where it appears material and we are able to robustly do so, without introducing greater risk of error into our analysis. Considering isolated adjustments would increase the risk we distort our assessment of costs either upward or downward, depending on the circumstances.

2.33. Where there is evidence of variation in operating costs that is not being driven by efficiency, and this is not captured in specific adjustments that we have made, we would take this into account in how we select our overall benchmark. For example, if we were to reach the view that an average supplier would have materially higher costs than the lowest cost supplier for reasons that are outside of their control, then we might choose to use lower quartile costs instead of the cost of the cheapest supplier in the sample to set the level of the operating costs allowance.

2.34. Please read Appendix 8 for further detail on our proposed methodology on operating costs, the issues and options we have considered, and detailed questions on our approach.

A normal level of profit

2.35. The efficient benchmark is not simply based on costs incurred by a supplier. An efficient supplier would make a profit. To ensure efficient suppliers can finance their activities, we would include a normal level of profit in our benchmark.

2.36. By a ‘normal’ profit level we mean that the cap should allow investors to make a reasonable return on their investment, but no more. If profits were to fall below the return required by investors, there is a risk that investment in suppliers – and services for consumers – would fall. Some suppliers may leave the market if they were unable to make the return required by investors. If profits were higher than investors require, we would expect new entrants to enter the market and compete for those high returns. This competition should reduce profits to the minimum required.

2.37. We propose using the CMA’s estimates of the normal rate of return. The CMA calculated two profit levels. One for a supplier using an intermediary for trading arrangement (1.25% profit margin) and one for suppliers not using intermediaries (1.9%). We would use the relevant margin for each circumstance.

2.38. We recognise that the CMA’s assessment of suppliers’ normal rate of return has received criticism. We discuss issues raised by stakeholders in Appendix 9. Having reflected on these discussions we believe that the CMA’s estimate is appropriate to use for the purposes of the cap. Their assessment was the product of an extensive investigation with substantial consultation where suppliers were able to provide evidence and views that were taken into account in the final assessment. The CMA’s judgement involved inherently difficult and complex issues. For the temporary cap,

we do not believe it is appropriate to delay introducing protection for consumers with default tariffs, to re-perform those judgements. We have no strong reason to believe that any new assessment would be more robust than the CMA's.

Choosing an approach

2.39. We have not proposed a preferred option for setting the default tariff cap. We note that each approach contains uncertainty when applied to all suppliers, and they have different advantages and disadvantages. There is not a clearly preferable option. Our final decision will include an element of judgement on the balance of pros and cons of each option.

2.40. Some stakeholders have expressed their preference for a bottom-up approach (option 4). The advantage of this approach, compared with setting the cap using a competitive reference price, is that it gives additional clarity as to exactly which costs are included in the benchmark, and how each element of costs is being treated under the cap. However, we have to make assumptions where it is not possible to observe the relevant economic variables. We have to estimate these using imperfect data that is not standardised across companies. This is particularly challenging as suppliers have a large asymmetry of information, having greater insight into their own costs than the regulator and incentives to use this to their advantage influencing the setting of any cap. This means we risk overstating the efficient benchmark.

2.41. Using price data to set the default tariff cap avoids many of the problems associated with relying on cost information – we are no longer reliant on companies to tell us what their costs are, and there is much less need for us to use our discretion to establish how different costs should be treated under the cap. Instead, we are able to rely on market prices to reveal what is an efficient level of costs.

2.42. The updated competitive reference price (option 3) provides us with an opportunity to implement the CMA's methodology with more recent data, addressing some of stakeholders' concerns with their original approach. However, it also introduces new areas of uncertainty and requires us to make judgments that have not and cannot be tested by experience.

2.43. The adjusted version of the existing safeguard tariff (option 2) provides us with an opportunity to use an approach that Ofgem and stakeholders have experience with and understand. This limits the possibility that the cap includes unidentified risks that could result in the cap being set at an inappropriate level in practice. Because we have several years' of experience and understanding of the methodology, we are well placed to address some of the issues that stakeholders have identified through experience.

2.44. However, the more we adjust this method (for instance by using cost data to adjust operating costs) the more we dilute the reference price as the central part of the methodology. This means we lose some of the benefits, such as avoiding risks associated with information asymmetry, and we introduce more uncertainty. The

methodology could become a less independent method and begin to evolve into a bottom-up cost assessment.

2.45. In order to offset these methodological risks, we could estimate efficient costs by taking the average of two of our options, or otherwise cross-reference or combine them to reach a final decision on the cap methodology. For instance, if we otherwise have reasonable confidence in both the adjusted version of the safeguard tariff and bottom-up cost assessment, but were concerned about the information asymmetry risk tending to result in efficient costs being overstated in the bottom-up model, we could use the mid-point between them.

Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

Setting the overall level of the cap.

2.46. As well as estimating an efficient level of costs, when setting the cap we need to consider whether an additional amount – referred to as headroom – is required, and if so how much. We set out the issues we need to consider below.

2.47. We cannot make a judgement about headroom independently of our assessment of efficient costs. Decisions on these two issues will need to be taken together, with all factors being considered in the round. We will set the level of cap considering what combined effect our efficient benchmark and headroom has on managing uncertainty and the matters set out in the Bill.

Accounting for uncertain costs

2.48. One reason we might include headroom is to account for the uncertainty and potential risks in our efficient benchmark (as set out in paragraphs 2.2 to 2.8 above). In this case, the amount of headroom required, if any at all, will depend on how we estimate efficient costs.

2.49. Each approach contains different judgements about efficient costs that affect the amount of uncertainty and risk in the benchmark. Where we are less certain about the reliability of a particular piece of data or there are particular challenges in comparing data, we could take this into account in setting the efficient benchmark. As such, the benchmark will already allow for uncertainty, reducing the need for additional headroom. On the other hand, where we have not already allowed for uncertainty and variation between suppliers, we may need to provide some degree of headroom.

Impact on the Bill's objective, and matters to give regard

2.50. We will set the level of the default cap considering its overall impact on protection for default consumers and have regard to the other matters set out in the Bill. This may require us to provide headroom, but not necessarily. At different levels of cap, it places different amounts of emphasis on the matters set out in the Bill, notwithstanding that the overall objective of providing protection to consumers is clear. Wherever we set the cap, it will involve trade-offs and the decision will require us to make a judgement in the round.

2.51. We have analysed a range of headroom values up to £110. This is a plausible maximum, as above this point there is limited short-term protection for consumers by way of energy bill savings. We are yet to make any decisions on headroom because we need to do so alongside our decision on the efficient benchmark. However, based on our initial analysis we believe the top end of this range will be reasonably unattractive and unlikely. Incentives for switching are much higher than at lower levels of headroom, but protection for default customers – the objective of the Bill – is relatively slight. Depending on the level of our efficient benchmark, there is a risk that many SVTs that are currently on offer below the potential cap level, would increase in price to match the cap.

2.52. Therefore, we are focussing our considerations around the level of headroom included in the PPM cap – from zero headroom (around £30 below the amount in the PPM cap) to £70 (about £40 higher than the level included in the PPM cap).⁷

2.53. We include values above and below the level in the PPM cap because the default tariff cap will likely have to manage more uncertainty, which the market would be more exposed to. For instance, the cap will affect a larger group of customers (more than 12 million on default tariffs), and potentially affect fixed-tariffs as well. This affects a much greater proportion of market revenue than the PPM cap. Also, variation in suppliers' efficient costs and their service offers is likely to be wider, given the larger market. The range also allows us to assess scenarios that place a greater emphasis on switching. This is a matter the Bill requires us to give regard, and it affects the type of incentives we create to improve efficiency.

2.54. Levels within our range affect differently the matters in the Bill to which we must have regard. We have summarised the advantages and disadvantages of each end of our range below, and welcome stakeholders' views on how we might weigh these difficult trade-offs. Please read Appendix 12 for a much fuller discussion of these (and other) scenarios. Due to headroom's interaction with the efficient benchmark, our final decision on the level of the cap needs to be taken in the round alongside our decisions on the benchmark.

⁷ Values are stated for a consumer with Typical Domestic Consumption Values.

2.55. The following is likely to occur with little to no headroom (around £30 below the PPM cap level of headroom), which would lead to a cap set at a relatively low level:⁸

- The cap would provide the largest savings to default customers. They would save around £70 more than at the top of our headroom range, and more than that against current SVT prices. Nearly all default customers would see a reduction in bills.
- The cap would likely be lower than inefficient suppliers' costs, so they would face strong incentives to improve their efficiency to prevent losses.
- We might expect many large or mid-tier suppliers to increase the price of their cheaper fixed term tariffs, as they would no longer be able to sustainably price them below their efficient cost.
- Switching and competition for engaged consumers might rely on small suppliers, including those who do not incur the costs from certain Government schemes. In responses to the working papers, some stakeholders have argued that overall levels of switching could fall, as there is less price dispersion so fewer consumers are incentivised to switch.
- An efficient supplier should be able to finance their activities. Depending on how our benchmark accounts for variation in efficient costs, it is possible that suppliers with significantly higher than average efficient costs face pressure.
- Inefficient suppliers will incur losses and need to reduce costs. We recognise this also increases the risk that suppliers cut costs quickly, by reducing quality of service and cutting corners. If we take this approach, we will be vigilant and hold them to licence conditions on service quality.

⁸ For this modelling we have taken the PPM cap and removed the payment level uplift for prepayment meters (£66). We included a weighted uplift for additional Standard Credit costs not included in the direct debit benchmark. Please read Appendix 11 section 4 for a fuller discussion.

2.56. The following is likely to occur with headroom toward the top of our range (£70, about £40 higher than the level in the PPM cap), it would lead to a cap set at a relatively high level:

- The cap would provide savings to most SVT customers, and protect those paying the highest prices.
- The cap would be set significantly higher than our assessment of efficient costs. Some argue that incentives to improve efficiency would come from competition. Engaged consumers applying competitive pressure on cheaper fixed term tariffs would apply pressure to costs, as suppliers are less able to use default tariffs to offset cheap tariffs. However, it is unlikely that these cost reductions would be passed onto default customers, so they would not benefit from the protection afforded by this competition.
- Some suppliers might increase fixed term prices to offset lost revenue from default tariffs, but we would expect many suppliers to compete for engaged consumers and maintain reasonable incentives for them to switch. There should be more scope for innovation in service provision and offerings.
- Suppliers with higher than average efficient costs should be able to finance their activities, even in uncertain circumstances. Overall, incentives to improve efficiency are likely to be lower: the cap would provide substantially more revenue from default tariffs than having no headroom at all, meaning that inefficient suppliers might face less financial pressure.

2.57. There will be advantages and disadvantages to wherever we ultimately judge to set the level of headroom and the efficient benchmark, which as noted above, are decisions that are interdependent. The Bill does not require us to give equal regard to each of the matters it requires us to consider, but it is clear on the need to protect consumers. It is possible, that when combined with our assessment of efficient costs, that relatively low levels of headroom allow suppliers to manage uncertainty and still maintain incentives to compete for engaged consumers to encourage switching.

2.58. We will set the level of the cap based on analysis of the combined impact of our efficient cost benchmark and headroom, and consideration of stakeholders' response to how we should assess trade-off between the matters set out in the Bill.

Calculating headroom.

2.59. We have discussed headroom with absolute values. We propose calculating headroom, if any is included, as a percentage of total costs minus network costs. This recognises that headroom helps suppliers manage uncertainty in policy costs

and wholesale costs, as well as uncertainty in what is an efficient level of operating costs.

2.60. We have not proposed reducing the level of headroom over time, either to further encourage suppliers to improve their efficiency, or to allow inefficient suppliers time to adjust. However, we remain open to this possibility and will consider it when finalising how to set the cap in a way that best supports the Bill. We welcome stakeholders' views on the advantages and disadvantages of such an approach.

2.61. We discuss headroom, trade-offs and their relative impacts on consumers and suppliers in Appendix 11. We also set out the criteria we will use to assess headroom levels, and the approach we are taking to conduct this analysis.

Question 2: What are your views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

Other design features

2.62. In this section we specify design features that accommodate different costs to serve and consumption levels.

The number of caps

2.63. For a particular customer, the exact level of the cap will vary depending on some of their circumstances. Currently prices vary across the country (to reflect differences in the costs of transporting energy in different locations) and between individuals (to reflect differences in costs of serving people). The factors we propose taking into account are:

- **Fuel and meter type:** three separate caps for gas, single-rate electricity, and multi-rate electricity.
- **Regions:** the cap level will vary across Great Britain, because the costs of transporting the energy from the generation source to the customer (the "network charges") vary by region.
- **Payment method:** Two separate caps for direct debit and standard credit consumers. Customers with Smart prepayment meters will be treated as direct debit customers.

2.64. The factors listed above overlap, so for an individual consumer, the level of the cap will depend on their specific circumstances. This is the same kind of approach adopted by the CMA, who included regional and separate fuel tariffs.

Calculating the cost of different payment methods

Higher costs for standard credit customers

2.65. At present, customers paying by standard credit typically pay more than those using direct debit. The large suppliers charge an average of £75 more to a standard credit customer with Typical Domestic Consumption Value. In 2015, the CMA estimated that the additional cost of serving a typical standard credit customer ranged between £88 and £158 in 2017 prices. Our current analysis, based on updated information submitted by suppliers, suggests an additional cost of £114.

2.66. We note that the additional costs appear to be higher than the difference in prices that most suppliers charge. In part this difference reflects cost allocation decisions by suppliers. In practice, the true additional costs of serving a standard credit customer may be less. It also reflects that sometimes it is more appropriate to spread a portion of these additional costs, such as bad debt, across all customers.

2.67. There are three main reasons for the additional cost of serving standard credit customers: additional working capital costs; additional bad debt costs; and other additional administrative costs, such as the administrative cost of bad debt, and use of call centres.

Allocating costs

2.68. From responses to our working papers, stakeholders (including consumer representatives) are broadly in favour of separate caps that are cost reflective. However, some have called for there to be a single cap, where all additional costs to serve standard credit customers would be socialised.

2.69. We propose separate caps for direct debit customers and standard credit customers to reflect the genuine additional costs to serve. But, where it is not possible to determine that additional costs are caused by customers paying on standard credit, we consider it more appropriate to spread these costs evenly across all customers.

2.70. We propose allocating additional working capital costs to standard credit customers, and spreading the costs of bad debt and other administrative costs between both payment types.

2.71. In our view, standard credit customers *who are paying their bills* are no more responsible than direct debit customers are for the bad debt and associated administrative costs of other standard credit customers *who have not paid their bills*. Therefore, we believe these costs should be spread across all customers, rather than just those that happen to share a particular payment method.

2.72. Quite differently, the additional working capital costs are a necessary consequence of using standard credit. It would not be justified to charge direct debit customers for these costs.

2.73. We will continue to consider whether all or a portion of the additional costs to serve claimed by suppliers (such as 50%) should be allocated in full to standard credit customers. Suppliers have argued that standard credit customers may be more likely to contact them (for instance by phone). However, we have not seen evidence to convince us this is a necessary result of their choice of payment method.

2.74. Our initial analysis suggests that our proposal would mean we set the cap for standard credit customers £22 higher than the cap for direct debit customers. We have calculated this by allocating all of the additional working capital costs to standard credit customers, and spreading the additional bad debt and administrative cost to all customers, as shown in Table 2.

Table 2: proposed treatment of additional standard credit costs

Additional cost	Value	Uplift for standard credit customers	Uplift for direct debit customers	Difference
Working capital	£22	£22	£0	£22
Bad debt	£56	£19	£19	£0
Administrative	£36	£12	£12	£0
Total	£114	£53	£31	£22

Source: Ofgem analysis of requests for information

2.75. Some stakeholders have raised concerns that standard credit consumers are more likely to be fuel poor, so cost differentials should be reduced on that basis.

2.76. We recognise these are important concerns, and there are difficult trade-offs to make. However, we do not think payment method is the perfect proxy for fuel poverty.⁹ While standard credit customers are twice as likely to be fuel poor than direct debit customers, around 50% of all fuel poor customers pay by direct debit, whereas only 20% pay by standard credit.¹⁰ As such, we need to be cautious about going further than cost-reflectivity and using the cap to cross-subsidise between payment methods. To do so, would mean increasing the prices paid by half of all fuel poor customers, to subsidise the prices paid by the twenty percent who pay by standard credit. We also believe that an element of cost reflectivity is important to encourage customers to move to lower cost payment methods where possible, as it improves overall efficiency. This is an issue we continue to consider, and we welcome

⁹ Ofgem, [State of the Energy Market 2017](#)

¹⁰ Department for Business, Energy & Industrial Strategy, [Fuel Poverty Statistics](#)

stakeholders' view on the merits of fully socialising costs between standard credit and direct debit customers.

2.77. In Appendix 12 we explain how we have calculated the additional costs to serve, the issues raised by stakeholders, and the options we have considered for

How the cap varies with consumption

2.78. Most tariffs on the market have a fixed charge (standing charge) and a variable element. The standing charge allows suppliers to recover costs that do not vary with a consumer's consumption, such as the majority of operating costs. Variable costs allow suppliers to charge consumers for the incremental costs they incur, such as fuel costs, and to recover the costs of the network and policy obligations in proportion to consumers' consumption.

2.79. We propose that the level of the cap will increase in proportion to consumption, and include a fixed 'standing charge' component. Therefore, we propose setting different levels of the cap at nil consumption and current Typical Domestic Consumption Values (TDCV).¹¹ The specific approach we will use to set the cap at nil consumption and TDCV will depend on the method we use for establishing the efficient cost.

2.80. Stakeholders have raised concerns that our intended design might reduce their ability to provide tariffs with low or no standing charges. These tariffs can benefit consumers with low consumption. The existing safeguard tariff has a derogation and rebate process for tariffs with low standing charges. This ensures that no consumer pays more than the cap level, but still allows such tariffs to be offered. We propose using this arrangement for the default tariff cap.

2.81. For multi-register tariffs, we propose that the cap would be based on assumed consumption splits, in line with the existing safeguard tariffs (ie estimates of the proportion of the consumption of customers with different meter types that will take place in peak and off peak periods). For Economy 7, the split would be the same for all suppliers and all regions, and would be updated periodically by Ofgem. For other restricted meter tariffs, suppliers would be required to propose a split to us based on historic consumption patterns of customers on each tariff, prior to the start of each price cap period.

2.82. Experience under the existing safeguard tariffs has shown this to be a practical approach to ensure customers with non-standard electricity meters continue to

¹¹ See [this page](#) for a description of what these values are. Note that the consumption values for which the level of the existing safeguard tariffs is set are those which were in place in 2015. <https://www.ofgem.gov.uk/electricity/retail-market/monitoring-data-and-statistics/typical-domestic-consumption-values>

receive protection, while avoiding the need for separate caps to be published for every possible metering arrangement.

2.83. In general, where we received comments on the treatment of multi-register tariffs, stakeholders supported this approach. Some respondents noted the greater number of metering arrangements captured by the default tariff cap, and the potential administrative burden. Where possible to do so, we will seek to align the submission of assumed consumption splits with those provided in the context of the PPM cap.

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

3. Updating the cap over time

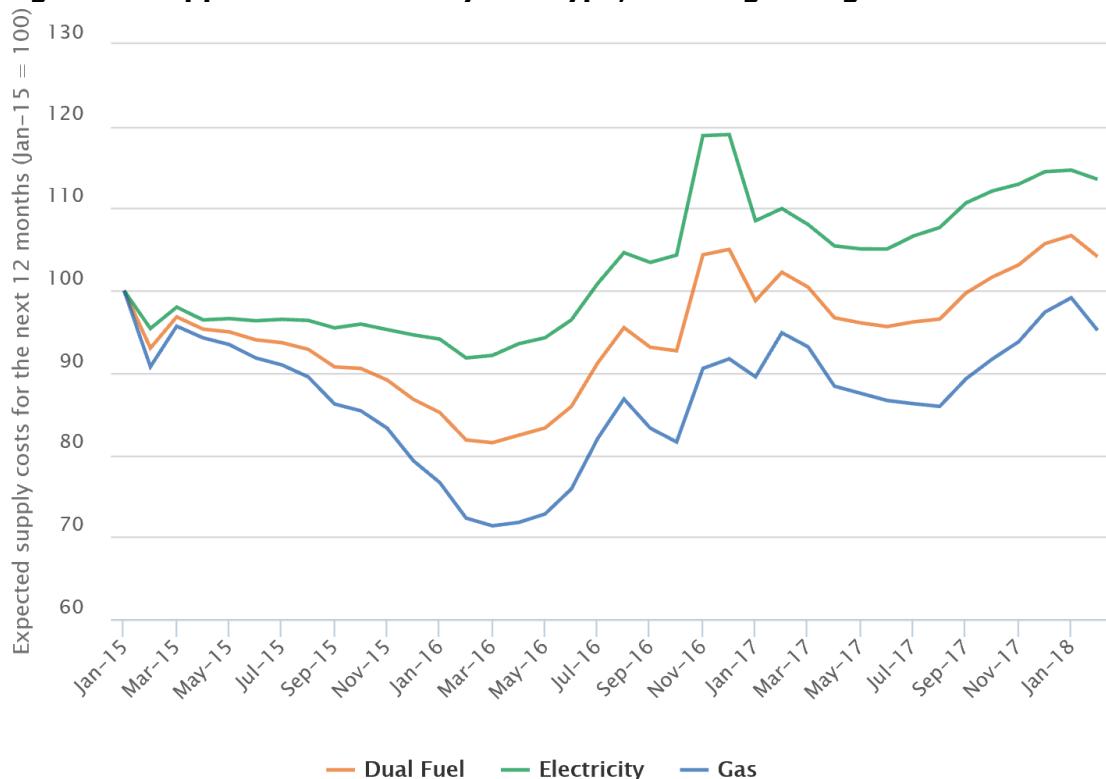
In this chapter we set out:

- why the cap needs to be updated;
- the options we are considering for updating the cap; and
- how updating the cap will work in practice.

Why the cap will need to be updated

3.1. The level of the cap will need to vary over time. It needs to reflect the increases and decreases in suppliers' costs that are outside of their control – for example, as a result of movements in wholesale prices, network charges, and the costs associated with funding government policies. Figure 3 shows Ofgem's Supplier Cost Index (SCI), which illustrates how suppliers' direct costs have changed since 2015.

Figure 3: Supplier cost index by fuel type, tracking changes in direct costs



Source: Ofgem, [retail market indicators](#), correct as of February 2018

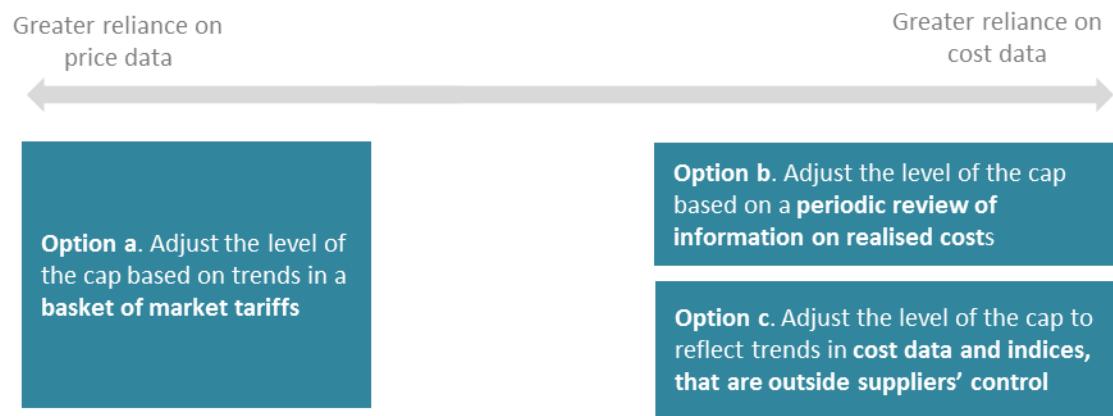
Notes: The Supplier Cost Index tracks ongoing trends in wholesale costs, network costs and the charges to suppliers associated with government programmes

3.2. Our key considerations when choosing how to update the cap are to ensure.

- that the cap tracks changes in efficient costs over time. This allows efficient suppliers to finance their activities.
- that the cap does not create unintended incentives for suppliers that are detrimental for consumers. This includes ensuring that the mechanism used to update the cap does not reduce the incentive for suppliers to improve their efficiency by cutting costs, or their incentive to compete for domestic customers.
- that the cap does not create undue uncertainty for suppliers or lead to disproportionate administration costs. This is because we would expect this to ultimately lead to higher prices (and so less protection) for customers on default tariffs.

3.3. We have considered three options for updating the cap (figure 4). To different extents they rely on price data or cost data. Our preferred option is to update the cap with reference to trends in cost drivers that are outside suppliers' control (option c), adjusting the cap every six months. This approach is very similar to the approach when updating the existing safeguard tariff and PPM cap. Our approach should be familiar to stakeholders, and we welcome their views on it.

Figure 4: Three options for updating the cap over time



Source: Ofgem

3.4. This chapter sets out the options we are considering, and how we propose that updating will work in practice. In Appendix 5 we provide further detail and detailed questions about our approach.

Options for updating the cap

Option A: a market basket of tariffs

3.5. The level of the cap could be updated to reflect trends in a basket of competitive tariffs. For instance, the cap could track changes in the average price of the ten cheapest tariffs in the market. The principle here is that rivalry in the competitive segment should mean that movements in prices reflect changes in the efficient level of costs.

3.6. We do not propose to update the cap using a basket of market tariffs. We are concerned that prices may be affected by trends in the nature of price competition in the market, rather than just movements in costs. For instance, suppliers sometimes offer loss-making tariffs to grow their market share.

3.7. We are also concerned that under this approach, suppliers' incentives may also be affected. They may avoid cutting prices if they knew that doing so could lead to a lower level of the cap. They may also increase tariffs in the competitive segment of the market, either to influence the cap, or to compensate lost revenue from customers on default tariffs.

Option B: a periodic review of suppliers' realised costs

3.8. The level of the cap could be updated based on a periodic review of suppliers' realised costs. This would involve periodically collecting historic cost information from different groups of companies, making any efficiency adjustments that were required, and then using this to set the revised level of the cap.

3.9. We do not propose to update the cap using periodic reviews of costs. This method would mean that we set the cap, for future periods, based on historic cost information rather than current trends. This would risk distorting competition in the market.

3.10. Moreover, tying the cap directly to trends in reported costs would risk reducing the incentive for efficient suppliers to cut their costs.

Option C: a set of cost drivers outside suppliers' control

3.11. The level of the cap could be updated based on a set of cost drivers that are outside suppliers' control – linked to third party data and/or a pre-specified allowance for certain cost items. An approach of this type is used under the existing safeguard tariffs, which we update with reference to an index of wholesale prices, forecasts of policy costs and inflation.

3.12. This is the approach we propose to use to update the level of the default tariff cap. We consider that an indexation approach has a number of advantages over the alternatives:

- the accuracy of this approach is not sensitive to trends in the intensity of competition in the market, nor on the quality of supplier data
- it will to a greater extent allow costs to be recovered in the period in which they are incurred
- it avoids creating unintended incentives in relation to how suppliers price, and their efforts to cut costs. This is because suppliers cannot influence the indices via their actions in the market
- it provides the greatest predictability to suppliers, and minimises the administrative burden
- The key drivers of trends in suppliers' costs – accounting for the largest part of the bill – can be estimated accurately using third party data

How updating the cap will work

Cap periods

3.13. We propose updating the cap every six months. This is similar to how often customers on default tariffs currently face price changes. Where they prefer stability, we seek to protect consumers from unnecessarily volatile or uncertain prices, and from the administrative costs of price changes. We welcome further views on whether more frequent updates would be preferable.

3.14. The first active cap period will be irregular, dating from December 2018 to 31 March 2019. Each cap period after that first period, will date from either 1 April to 30 September, or from 1 October to 31 March. The period would align to the updating process for the existing PPM safeguard tariff.

3.15. After the first period, the updates align with when we update the existing safeguard tariff for prepayment customers. These periods align most consistently with seasonal wholesale contracts for gas and electricity, network charging years, and the obligation periods of a number of environmental and social obligations. Alternative dates would require us to set the level of the cap with reference to an average across multiple contracts, years, or obligation periods, reducing the accuracy of the cap.

The first cap period will be updated from an earlier base period

3.16. When we discuss setting the initial cap (in the previous chapter) we refer to setting the efficient benchmark in a historic base period. We propose setting the base period as either 2015 or 2017, depending on the approach we take to efficient costs. When the cap comes into force in December 2018, it will be an update from the base period.

3.17. The base period depends on the data used for setting the cap.

- **Option 2 - An adjusted version of the existing safeguard tariff.** The base period for this approach is 2015.
- **Option 3 - An updated competitive price reference approach.** The base period for this approach is 2017.
- **Options 4 – Bottom-up cost assessment.** The base period for this approach is 2017.

Updating the cap

3.18. We propose to update the cap to reflect the individual trends in each cost category, recognising that they have different drivers. Table 3 (next page) summarises the approach for each category. These are described in detail in the appendices referenced. Our approach is similar to that used for the existing safeguard tariff. However, for the default tariff cap we also propose to adjust operating costs, so that they reflect the expected impact on suppliers of rolling out smart meters, as well as other factors.

Weighting the initial base period, for updating

3.19. To update the cap, we must divide the initial cap into its constituent cost components. This will differ depending on how we set the cap.

3.20. For the bottom-up cost assessment, we will simply use the cost components used to construct the cap.

3.21. For the price reference approaches, we have to estimate the weighting of each cost component. For each of the price reference approaches we propose deducting the absolute cost of known components (for example, network charges), and then weight the remaining value in proportion using relevant cost data. The specific approaches are explained in Appendix 2 and Appendix 3.

Table 3: Approach to indexing each cost component

Component of the cap	Proposed approach to indexing	Detailed appendix
Wholesale costs	Updated with reference to the prices of wholesale contracts for future delivery. Indexed relative to wholesale prices in baseline period. Capacity Market costs updated using latest data on scheme costs and the demand base across which costs are recovered, indexed relative to costs in baseline period.	6
Environmental and social obligations	Updated using a combination of scheme data, OBR forecasts, and information on the expected demand base across which costs are recovered. Indexed relative to costs in baseline period.	7
Network charges	Allowance for each period calculated directly using network charging statements	7
Suppliers' operating costs, and a normal profit level	Indexed with reference to CPIH, plus an uplift to reflect the expected impact of the smart meter rollout on net costs.	8
Standard credit uplift	Partly set as fixed % of total costs (excluding headroom), partly indexed with reference to CPIH	12
Headroom	Set as fixed % of costs (excluding network costs)	11

Source: Ofgem

Dealing with uncertainty and error

3.22. We need to be sure that the cap tracks changes in underlying costs reasonably accurately. This is to ensure efficient suppliers can recover their costs, and that consumers do not pay more than they should. We need to be able to correct the method if the cap allows suppliers to charge prices that are too high, for example.

3.23. Differences between actual costs and those included in the cap could arise as a result of:

- Systematic issues due to features of the design – either the initial level of the cap, the weights chosen, or the indices used.
- Uncertainty in the forecast of future costs used to update the cap.

3.24. The Bill includes specific provision for us to make supplemental modifications to the licence condition. This would allow us to make any changes required to correct how the cap was updated, if it systematically and materially departed from an efficient level of costs. For example, we might consider making a modification were there a fundamental (and unanticipated) change to the environmental and social obligations that suppliers face, which had a material impact on their cost base.

3.25. To account for forecast uncertainty, we have considered the options of designing an automatic correction mechanism, a discretionary process to adjust the

cap, and no correction mechanism. We do not propose to include a specific mechanism to correct the level of the cap.

3.26. In reaching this proposed position, we have taken into account the fact that forecast error is a risk that suppliers already face when setting their fixed tariff prices. Even with an SVT, suppliers are only able to update their prices subject to 30 days notice – and have rarely done so more than twice a year in the period since price liberalisation. We are concerned that using an adjustment mechanism to correct for error in forecasts in the previous period would create a further distortion to the market.

3.27. Under a reference price approach, we would expect forecasting risk to already be reflected in suppliers' prices, particularly to the extent that the reference price benchmark was made up of fixed tariffs, where suppliers are unable to increase prices to reflect unexpected changes in costs. Under a bottom up approach to setting the cap, we will consider including a specific allowance to reflect material risks faced by suppliers where this would be expected to systematically lead to higher costs (eg a higher allowance for wholesale costs to reflect the net expected impact of forecast error).

3.28. More information on these issues is set out in Appendix 5, including further detail on our approach, options considered, rationale, and detailed questions.

Question 4: Do you agree with our proposals for how we will update the cap?

4. Potential exemptions from the cap

In this chapter we discuss whether SVTs that appear to support renewable energy should be exempt from the default tariff cap.

4.1. The Bill states that the default tariff cap may not apply to SVTs that have been chosen by the customer and that appear to the Ofgem to support the production of renewable gas or electricity.

4.2. The Bill requires us to consult on whether such a renewable tariff exemption is necessary, and if so, how to exempt the respective tariffs.

Is a renewable exemption appropriate for electricity?

Renewable tariffs

4.3. Our data suggests that there is a range of renewable tariffs available on the market. These range from suppliers who claim to offer:

- 100% renewable electricity;
- direct investment in renewable technology innovation;
- green gas and carbon offset for any gas that is from fossil fuels; or
- Renewable Energy Guarantees of Origins (REGOs).

4.4. Our initial analysis suggests that consumers can pay up to £300 more for their energy per year for an SVT with a supplier who claims to invest in renewable technology innovation, compared to a supplier who purchases REGO backed energy at a small cost. Our initial analysis suggests that more than half of the green tariffs in the market are fixed tariffs.

Challenges in designing an exemption

4.5. We support initiatives to promote energy consumption from sustainable sources. It is worth noting that all electricity consumers contribute to government policies to subsidise renewable energy. The cost of these policies, such as Renewable Obligation and Contracts for Difference, are passed on to consumers through their bills.

4.6. Where customers choose SVTs that provide additional financial support to renewable energy, we in principle, do not want the cap to prevent this. However, we need to ensure that suppliers cannot 'game' an exemption, using it to avoid the default tariff cap without providing any additional support, beyond that already provided by government policies. This could occur if a supplier allocated the energy they purchase from renewable sources to a particular tariff, by reducing their allocation to other tariffs. This practice would not increase the total level of support for renewable energy, and clearly be against the sentiment of the exemption.

4.7. The Bill requires that the exemption can only be provided at a tariff level, so we would not be able to consider a supplier's wider environmental credentials (such as the level of renewables across all their tariffs) in deciding whether to exempt individual tariffs.

4.8. The supply licence requires suppliers to be transparent to consumers about the claims of environmental tariffs and where a claim is made, ensuring that they can demonstrate the basis of the claim. However, this condition does not have any threshold for environmental benefit and therefore, we do not believe we can rely on it to prevent the gaming we described above. We are concerned that this gaming risk is still possible within the existing rules and an exemption for renewable tariffs may increase supplier incentives to not equally distribute the fuel mix across its customers.

Is an exemption appropriate?

4.9. We consider that for any exemption to be appropriate, it should meet the following criteria:

- exempted tariffs provide support for renewables, materially beyond support provided through subsidies, obligations or other mandatory mechanisms
- the exempted tariff involves materially higher costs
- the exemption can be clearly defined and robustly monitored
- the exemption should be difficult to game

4.10. We have developed and considered four options for the design of renewable exemption rules, which we describe in Appendix 13. Each of these options have challenges, and it is not clear to us that any of them would be capable of defining a tariff that materially supports renewables and is robust to gaming.

Derogation for electricity tariff exemption

4.11. We propose to not have an exemption. However, we propose to allow suppliers to apply to Ofgem for a derogation where the supplier could demonstrate its tariff satisfies a set of criteria or outcomes.

4.12. This approach provides flexibility for suppliers to demonstrate that its tariffs have an additional environment benefit, it is consistent with our broader approach to regulation, and it ensures consumers are protected unless there is sufficient evidence that the protection can be removed.

4.13. A derogation would be granted if a supplier could demonstrate their renewable tariff delivers the following outcomes:

- **Outcome 1:** By consumers choosing to be on the tariff, the supplier provides support for renewables, materially beyond what is provided by subsidies, obligations or other mandatory mechanisms.
- **Outcome 2:** The tariff costs the supplier materially more to provide compared to standard tariffs, due to the provision of renewable electricity under that tariff.
- **Outcome 3:** the supplier is able to provide unambiguous evidence that its tariff has materially higher cost than the cap and genuinely provides additional support for renewable energy.

4.14. We expect to set a high bar when granting a derogation. Based on our analysis to date, we struggle to see how a tariff could materially support the production of renewable energy over and above what is already in place. We are also very concerned that exemptions granted on a tariff-by-tariff basis would not prevent gaming.

Is a renewable exemption appropriate for gas?

Renewable tariffs

4.15. We are required by the Bill to consider whether an exemption is appropriate for both gas and electricity.

4.16. **We do not propose an exemption for renewable gas tariffs.** Overall, we think exempting renewable gas tariffs is more problematic than electricity, primarily because of the added difficulties with monitoring compliance. Also, our analysis also shows renewable gas is not currently widely available and therefore it would not be proportionate to include an exemption.

Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?

5. Conditions for removing the cap

In this chapter we discuss how we might assess whether the right conditions are in place for the cap to end, or whether we would recommend it be extended.

5.1. As we stated previously, the retail energy market is not working for consumers who remain on their supplier's default tariff, with little competitive constraint on the prices suppliers charge these consumers. As a result, they are paying more than they should.

5.2. The Bill introduces the cap to protect these consumers. The cap is temporary, because the Bill expects conditions in the retail market to transform, making competition more effective. This transformation – introducing smart meters, time-of-use tariffs, and our programmes to make switching easier, to name a few – should make it easier, and more likely, that less-engaged consumers can participate in the market and protect their own interests in future.

5.3. The cap will initially last until the end of 2020, with the potential for the Secretary of State to extend it annually for up to three years if conditions for competition are not ready for it to be lifted.

5.4. The Bill requires Ofgem to:

- carry out a review into whether conditions are in place for effective competition for domestic supply contracts;
- in that review, among other things, consider the extent to which progress has been made in installing smart meters for use by domestic customers; and
- on the basis of the review, send a report to the Secretary of State recommending whether the cap should be extended for another year.

5.5. In the remainder of this chapter we discuss what we might consider when assessing whether conditions are in place for effective competition.

Conditions for effective competition

Competition in the market

5.6. In our State of the Energy Market Report 2017,¹² we found that the retail energy market is delivering persistently poor outcomes for consumers who do not engage in the competitive section of the market. More than half of consumers have never switched supplier or have switched only once, and most consumers are on an SVT, which can be around £300 more expensive each year than the cheapest fixed-term deals. Consumers with low incomes are particularly affected, being much less likely to switch to the cheapest prices. In addition, quality of service is relatively poor compared to other sectors.

5.7. Given its temporary nature, the default tariff cap does not intend to replace competition. For consumers that are currently engaged in the market, government intends that the cap should maintain some incentives for them to switch. In setting the cap, the Bill requires us, among other things, to have regard to enabling suppliers to compete for domestic consumer accounts. For consumers that are currently less-engaged, the cap provides an opportunity for initiatives to be implemented that will increase their engagement, and enable suppliers to compete for their custom once the cap is lifted.

5.8. Broadly speaking, 'effective competition' under the current market model can be characterised by:

- rivalry between energy suppliers who are offering differentiated tariffs and services that meet the needs of consumers;
- unrestrained movement of energy suppliers in and out of the market; and
- informed and active consumers who are able to shop around easily for better energy prices and services.

5.9. When we assess whether conditions are in place for effective competition *should the cap be removed*, we will not be able to monitor these characteristics *when the cap is still in place*. We recognise that with a cap in place, the market is less likely to

¹² Ofgem, State of the Energy Market Report 2017. <https://www.ofgem.gov.uk/publications-and-updates/state-energy-market-2017>

fully exhibit these characteristics. The likelihood of consumers engaging in the market may reduce because:

- they may feel 'safe' and assume that a capped tariff gives them a sufficiently good deal that they don't need to engage with the market.¹³
- for the customers who currently engage, there is a risk that a price cap could reduce the potential savings available to them, and therefore reduce the number who switch.

5.10. Suppliers may also reduce the amount they compete in the market, affecting outcomes like prices in the competitive segment and service quality. For example:

- Reduced discounting to acquire customers: suppliers will consider the lifetime profitability of customers when deciding how strongly to compete for them, including through the pricing of their most competitive tariffs. The cap could reduce the average lifetime profitability of customers, as it constrains the prices that can be charged to those who later roll onto a default tariff. The prices of the cheapest tariffs in the market might therefore increase to some extent.
- Potential effects on non-price offerings: competition also involves factors beyond price – eg customer service and developing innovative new products. To the extent that non-price features apply across a supplier's business, a price cap may reduce firms' willingness to invest in them, if they consider that they would be unable to recover additional costs from customers who are subject to the cap. In addition, if engagement does reduce, this may reduce the case for investing in non-price features as a way of acquiring customers.

5.11. Therefore, we consider that looking at market outcomes while the cap is in force is unlikely to tell us what would happen to competition when the cap is removed. These outcomes are constrained to some extent by the cap.

5.12. We need a different set of measures, ones that indicate whether consumers that currently do not engage, will be more able to engage once the cap is removed, or might otherwise be protected from paying such a large price differential that they do in today's market.

¹³ This risk was noted by the Centre for Competition Policy in its response to pre-legislative scrutiny – it said "the cap may (falsely) reassure consumers so they stop shopping around and switching, reducing competitive pressure in the market".

Conditions for competition

5.13. We interpret “conditions for effective competition” as meaning that the right market framework is in place for competition to be effective for currently disengaged consumers once the cap is removed. In assessing whether the conditions for competition are in place, we would expect to analyse both the demand and supply side of the market. We would consider whether the market structure will promote good outcomes for disengaged consumers, and whether there are remaining barriers to engagement. We refer to market conditions and not current market outcomes.

5.14. On the demand-side, we are already looking at issues that might frustrate customers, and thereby discourage them from switching:

- The faster switching programme will reduce the time it takes between the decision to switch and the switch going through (from a couple of weeks, to the end of the next working day). It will also reduce the number of switches that go wrong.
- We are looking at making suppliers which delay a switch unnecessarily, or create other problems for customers during the process automatically pay compensation to consumers.
- We aim to make it easier for customers to share their data securely with third parties, meaning that they don’t have to look up, and enter, lots of data when they want to switch.
- We are working to promote engagement and to help customers identify the best deal. This includes a pilot of Cheaper Market Offers Communications, the rollout of the customer database and extension of the Check Your Energy Deal (CYED) trial, and trialling opt-in collective switching.

5.15. On the supply side, our annual report on the state of the energy market assesses issues such as barriers to market entry or exit, the level of competition between firms, and the range and quality of service offerings. For competition to work well for disengaged consumers, we could see more use of innovative business models that, for instance, enable consumers to reap the benefits of competition without requiring active engagement. Technological developments, for instance through smart metering and easy-to-use mobile phone apps, should help to increase the effectiveness of competition. Through our work on future supply market arrangements, we are also assessing whether more fundamental changes to the structure of the retail energy market may be needed to allow disengaged consumers to get a good deal. We will need to assess which (if any) of these we consider to be crucial to lifting the cap.

5.16. We expect to keep these factors under review as the market develops. We will report on progress in creating the conditions for effective competition alongside our annual reports on the energy market. In order for us to recommend that the cap

should not be extended for another year, we would expect to see sustained progress that would allow us to be confident that currently disengaged consumers could gain a reasonable deal from the energy market without price protection.

Question 11: Do you have any views on what information we should use to assess the conditions for competition?

6. Next steps

Overview

6.1. The Domestic Gas and Electricity Default (Tariff Cap) Bill requires us to consult on the development and implementation of the cap. The Bill provides Ofgem with bespoke powers to modify supply licence conditions to introduce the price cap (including consequential amendments). The Bill requires us to:

- Consult for at least 28 days on proposed changes to licence conditions and their intended effect; and
- Allow a period of no less than 56 days between publishing our decision and the licence condition changes taking effect

6.2. In an [open letter](#) published 6 March 2018, we set out our consultation approach and the key milestones for the design and implementation of the tariff cap. Here we will provide further detail on our timetable and how stakeholders can continue to engage with us.

Evidence Gathering

6.3. We continue to gather evidence and request information from suppliers.. At this point in time, we do not anticipate the need to publish further RFIs and will close down any remaining gaps through targeted lines of enquiry.

Consultation Approach

6.4. In this section we set out the steps of our consultation approach as they relate to the wider timetable. These include the statutory consultation on the licence conditions, and separately, consultation on the baseline value and input data. We will confirm baseline values and input data by notice.

Policy consultation

6.5. Our timetable underpins our commitment to implementing the cap as quickly and effectively as practicable to maximise protection for consumers this winter, whilst ensuring we provide opportunity to engage with stakeholders and refine the design. Our approach is also consistent with requirements in the bill to introduce the cap as soon as practicable.

6.6. To date we have published five working papers explaining our emerging thinking and inviting views on some of the key design considerations for how the price cap could be set. When developing this policy consultation, we considered stakeholders' responses to the working papers. Responses continue to influence our analysis.

6.7. This policy consultation sets out our current position across all aspects of cap design and other legislative requirements (eg. approach to renewable tariffs and conditions for competition).

6.8. In conjunction with the consultation we intend to hold several workshops to discuss aspects of the consultation in more detail. Where possible we will also set up supplier bilaterals and utilise existing industry forums to maximise our reach.

Consultation on outline licence conditions

6.9. We recognise that stakeholders may want to understand how we plan to modify the licence. We plan to publish draft licence conditions for consultation on the week commencing 11 June 2018. The draft licence condition consultation will set out the framework we plan to introduce, and how we plan to set the input data by notice. However it will not contain drafting for the elements we are currently consulting on, since this would not be appropriate in advance of receiving stakeholder comments on the policy consultation.

Statutory consultation on licence conditions

6.10. We intend to publish a statutory consultation in August on the required licence modifications, with a decision expected at the start of October.

6.11. The statutory consultation of the licence conditions will set out how the cap will work. It will not contain the final baseline value and input data for the cap. However, draft numbers for the respective components of the cap will be published alongside the statutory consultation together with the draft Impact Assessment.

Consultation on input data

6.12. The licence conditions will provide for us to populate the final input data for the cap by notice. In mid-September, we intend to consult on a draft of that notice.

Publish licence condition

6.13. We intend to publish the final licence conditions in early October 2018.

Issue notice

6.14. At the end of October, we intend to publish the final notice containing the input data for the cap.

6.15. At the same time, we will also publish the Impact Assessment, and notification on level for the first cap period.

Cap in force

6.16. The cap is expected to come into effect at the end of December – two months after the notification of the first cap level.

Key Implementation Milestones

6.17. Table 4 summarises the key milestones set out above.

Table 4: Key milestones

Milestone	Dates
Policy consultation response deadline	25 June 2018
Publish statutory consultation and draft Impact Assessment	Early August 2018
Deadline for responses to statutory consultation	End of August 2018
Publish draft notice, for consultation	Mid-September 2018
Publish decision on licence conditions	Early October 2018
Deadline for responses to draft notice due	Early October 2018
Publish notice on input data and final Impact Assessment	End of October 2018
Publish notification of initial level of the cap	End of October 2018
Default tariff cap implemented	End of December 2018

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 provided in this chapter.

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 an appendix to your response.

The main consultation – this document

Chapter 2 – setting the cap

Question 1: Which approach for setting a benchmark for efficient costs do you think would be most appropriate?

Question 2: What are your views on the issues we should consider when setting the overall level of the cap, including the level of headroom?

Question 3: Do you agree with our approach to accounting for different costs, in particular additional costs of serving consumers paying by standard credit?

Chapter 3 – updating the cap

Question 4: Do you agree with our proposals for how we will use cost data to update the cap?

Chapter 4 – potential exemptions from the cap

Question 5: Do you agree with our assessments of whether an exemption for tariffs that appear to support renewable energy is necessary and workable?

Chapter 5 – conditions for effective competition

Question 6: Do you have any views on what information we should use to assess the conditions for competition?

Supplementary Appendix 1 – Market basket

Chapter 1 – Overview

Question A1.1: Do you agree that we should not further consider the use of a market basket to set the initial level of the cap? We set out our reasoning in Chapter 3.

Question A1.2: Do you agree that we should not further consider the use of a market basket to update the cap over time? We set out our reasoning in Chapter 4.

Supplementary Appendix 2 – Adjusted version of the existing safeguard tariff

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 appropriate 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?

Supplementary Appendix 3 – Updated competitive reference price

Chapter 2 - Our proposed approach for setting the cap

Question A3.1 Do you agree with our proposed approach for an updated price reference approach? In particular, how we select price data and exclude suppliers or adjust data.

Chapter 3 - Key judgements

Question A3.2 Do you agree with the judgements we set out regarding consumer engagement, policy and wholesale costs, and constructing the benchmark?

Chapter 4 – Approach at nil consumption

Question A3.3 Do you agree that, under an updated competitive reference price approach, we should set the benchmark at nil consumption using the adjusted standing charges from the same suppliers included in the benchmark at typical consumption?

Chapter 5 - Approach for updating the cap

Question A3.4 Do you agree with our approach to weighting the benchmark at TDCV and nil consumption?

Supplementary Appendix 4 – Bottom-up cost assessment

Chapter 1 – Overview of the approach

Question A4.1: Do you agree with our assessment of the advantages and disadvantages of a bottom-up approach to estimating an efficient level of costs?

Chapter 2 – Categories of costs

Question A4.2 Do you agree with our proposed approach to categorising different costs under a bottom-up cost assessment approach to setting the default tariff cap?

Supplementary Appendix 5 – Updating the cap over time

Chapter 1 – Approaches to updating the cap

Question A5.1: Do you agree with our proposal to update the cap in line with trends in exogenous cost drivers?

Chapter 2 – Our proposal

Question A5.2: Do you agree with our proposed choice of cap and baseline periods?

Chapter 3 – Dealing with uncertainty

Question A5.3: Do you consider that further provision is required for us to re-open aspects of the design of the cap, beyond our licence modification powers – and if so, why?

Supplementary Appendix 6 – Wholesale costs

Chapter 3 - Setting the initial wholesale allowance

Question A6.1: Do you agree with our approach to setting the wholesale allowance? In particular using 2015 for the base period of the adjusted existing safeguard tariff approach.

Chapter 4 - Updating the allowance

Question A6.2: Do you agree with our approach to updating the wholesale allowance?

Chapter 5 - Adjusting the CMA's model and setting allowances - Bottom up and update approaches

Question A6.3: Do you agree with our proposed approach to use a semi-annual cap period, compared with a 6-2-12 annual model, or shorter observation period? Please explain how the alternatives would affect you, if we were to choose those options instead.

Question A6.4: Do you agree with our approach to modelling forward contracts? In particular: that initial shaping should be based on a 70-30 split between baseload and peakload, and the cap will be semi-annual. If not, please provide evidence to support alternative approaches.

Question A6.5: What are your views on the necessity and size of an additional allowance for shaping and imbalance costs? Please provide evidence to support this.

Question A6.6: What are your views on the necessity and size of an additional allowance for transaction costs relating to brokers and collateral?

Question A6.7: Do you agree that our approach to updating the benchmark for the first cap period is appropriate?

Supplementary Appendix 7 – Policy and network costs

Chapter 3 - Estimating the costs of environmental and social obligations in 2017/18

Question A7.1 Do you agree with the way we propose to estimate the costs of each of the schemes for setting the baseline level of the cap?

Chapter 4 - Estimating trends in the costs of environmental and social obligations

Question A7.2 Do you agree with our proposed approach to forecasting the costs of each scheme?

Question A7.3 Do you agree with the data sources that we propose to use to forecast the expected demand base for each scheme? Do you have any alternative suggestions which would more accurately track trends in eligible demand??

Chapter 5 - Network charges

Question A7.4 Do you agree with our proposal to use the existing model to estimate the network costs that suppliers incur?

Question A7.5 Do you have any views on the impact of using information on the average share of consumption that takes place in peak periods to estimate electricity transmission charges?

Supplementary Appendix 8 – Operating costs

Chapter 2 – Estimating an efficient level of operating costs

Question A8.1 Do you agree with our proposed approach to estimating suppliers' operating costs (including our focus on total historical costs per customer, and estimating separate values for gas and electricity)?

Question A8.2 Should a variable component of this allowance be split out to reflect differences in bad debt costs between customers with higher and lower consumption?

Question A8.3 Do you consider 2017 to be an appropriate period on which to base our benchmark, or are there reasons to think a longer period would be more representative?

Question A8.4 Do you consider that default tariff customers have higher or lower operating costs than other types of customers?

Question A8.5 Do you agree with our proposal of where to exclude suppliers from our benchmarking analysis?

Question A8.6 Do you agree with our proposal of what to include in our definition of operating costs?

Question A8.7 Do you agree with our proposed approach to benchmarking operating costs under a bottom-up cost assessment?

Question A8.8 Which if any of the factors listed in Table A8.2 do you think we should take into account when choosing our benchmark? Do you have any suggestions for how we could estimate the materiality of the impact of any of these factors on costs?

Chapter 3 – Updating the cap to reflect trends in operating costs

Question A8.9 Do you agree with our proposal to use CPIH to index the allowance for operating costs within the default tariff cap?

Question A8.10 Should the default tariff cap be reduced over time to reflect an expectation of general productivity improvements – and if so – at what level should this efficiency factor be set?

Supplementary Appendix 9 – EBIT

Chapter 2 - Our proposed approach for setting the cap

Question A9.1: Do you agree with our proposed approach to setting the EBIT margin?

Chapter 3 – Key judgements

Question A9.2: Do you agree that it is acceptable to retain the WACC figure used by the CMA? If not, do you have views on the factors we would need to consider if we were updating the WACC?

Question A9.3: Do you agree that we should maintain the CMA's estimates of the capital employed by energy suppliers? If not, please specify which element you think we would need to revalue.

Chapter 4 – Updating the cap

Question A9.4: Do you agree with our proposed approach to updating the EBIT margin?

Supplementary Appendix 10 – Smart metering costs

Chapter 1 – Our proposed approach for setting the cap

Question A10.1: Do you agree with our minded-to position to include a separate smart metering index to reflect the changes in costs from the baseline (2017) to the initial year of the cap (2018)?

Question A10.2: Do you agree with our minded-to position to include an adjustment to the Reference Price (SMRPA) in the event a material difference is identified between the smart metering net costs of the suppliers making up the reference price and the model?

Question A10.3: Do you agree with our initial assessment for the Smart Metering Net Cost Change, including our inclusion and assessment of the costs of SEGB, SMICoP and DCC charges?

Chapter 2 – Key judgements

Question A10.4 Do you agree with the judgements we have set out regarding smart costs; in particular our choice of data and model, identification of relevant costs and benefits, and approach to variation?

Question A10.5 Do you consider that there will be any significant change in the costs or benefits of smart metering from 2017 onwards? For example, installation costs or asset costs. Please provide evidence to support your view.

Question A10.6 Please comment on the proposed methodology for calculating the efficient cost of rolling out a smart meter, indicating a preference with supporting rationale, on the efficiency option (average cost approach, pure frontier cost approach, lower quartile approach).

Chapter 3 – Updating the cap

Question A10.7: Do you agree with our approach to updating smart costs? In particular, our intention to specifically index smart cost changes, based on net cost analysis (option 3), and whether any other approaches would be preferable to option 3.

Supplementary Appendix 11 – Headroom

Chapter 2 – Our proposed approach

Question A11.1: What are your views on headroom being a percentage? Do you think it should be applied to all cost components except for network cost? Alternatively, do you think headroom should be applied as a percentage to only controllable costs?

Question A11.2: What are your views on whether we should change the level of headroom over time?

Chapter 4 – Headroom scenarios

Question A11.3: Bearing in mind the analysis and scenarios presented, what are your views on the appropriate level of headroom to include in the default tariff cap?

Supplementary Appendix 12 – Payment method uplift

Question A12.1: Do you agree with our proposed methodology for allocating additional costs between standard credit and direct debit customers?

Question A12.2: Do you agree with our proposed methodology for calculating the additional costs to serve and the socialisation level?

Supplementary Appendix 13 – Renewable tariff exemption

Question A13.1: Do you agree with our minded-to positions not to provide exemptions for renewable electricity or gas tariffs?

Question A13.2: What are your views on whether to provide a derogation for renewable electricity tariffs?

Supplementary Appendix 14 – Impact assessment

Chapter 1 - Introduction

Question A14.1: What is your view on the overarching approach that is proposed for conducting the impact assessment? In particular, on the scope of the assessment, and material issues that we have not referred to. Please provide details of any relevant sources of data and evidence that you think should be considered.

Chapter 4 - Initial views on the impact of the default tariff cap

Question A14.2: Do you consider that suppliers will incur a change in administration costs as a result of the default tariff cap? If so, please provide estimates with supporting evidence. Please specify whether any administration costs are fixed or variable. If variable, on what basis do these costs vary? For example, on a per customer basis.

Question A14.3: Are you aware of any unintended consequences, in the form of detrimental impacts on customers that were observed as a result of the existing safeguard tariffs? If so, please provide details of these unintended consequences.

Question A14.4: Do you have reason to believe the default tariff cap could disproportionately impact any of the nine protected characteristics under the Equality Act 2010? Please provide any supporting evidence.

Question A14.5: Do you have any additional information or data on the impact of the implementation of the existing safeguard tariffs on switching rates that would inform this analysis?