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Dear Retail Price Regulation Team,

Working paper #1: setting the default tariff cap

Thanks for the opportunity to comment on this working paper. Our general position on price caps is a matter of public record, has not changed, and is not repeated here. However, npower welcomes Ofgem's engagement on the *design* of the tariff cap, ahead of formal policy consultation.

Our position on the *level* of the cap is also a matter of public record and not repeated here. We reiterate that accuracy is essential for a wide cohort and flaws in the current benchmark/indexation need to be addressed (e.g. appropriate reference price; full recovery of increasing smart costs, wholesale risks).

In designing and setting the cap, Ofgem should demonstrate how it has discharged its duty in accordance with Clause 1(6) of the Tariff Cap Bill, notably the financing of licensed activities and facilitating competition. Clearly, the allowable rate of return / margin and appropriate recovery / re-opening processes are key design features in this regard.

Our specific comments on the issues raised in the working paper are set out in the Appendix to this letter. Please contact me if you would like to discuss any particular point(s).

This submission is not confidential.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Paul Finch".

**Paul Finch
Regulation**

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APPENDIX: npower comments on working paper #1 - setting the default tariff cap

Estimating an efficient level of costs

Initial level

We do not comment on **Option 1** (basket of market tariffs) or **Option 2** (existing CMA benchmark), suffice to say that we believe these options should be dismissed due to the concerns/flaws highlighted in responses to Ofgem's December paper: complexity; appropriate reference price; full inclusion of increasing smart costs; wholesale indexation, etc.

Both **Option 3** (updated price benchmark) and **Option 4** (bottom-up costs) have merit.

Option 3 – we reiterate that it is inappropriate and flawed to benchmark smaller or mid-tier suppliers in a growth phase (with high levels of newly acquired direct debit customers on heavily discounted short term tariff products and facing lower policy obligation costs) with larger suppliers (with a range of different types of customers, paying by different methods and facing the full costs of delivering the government's social and environmental obligations). Any efficiency benchmark should include all obligations and all customer types, taking into account payment type differentials. Essentially, it should be reflective of the long-run costs of a wide sample of suppliers who serve the majority of Standard Variable Tariff (SVT) customer types and incur the full range of policy costs, including those costs for which there are numerous exemptions for smaller suppliers. There must be full transparency of any adjustments for comparability purposes.

Option 4 – this would, theoretically, be a more robust approach, again subject to the cost-reflectivity points we make above.

We have specific concerns in relation to the recovery of certain costs:

Smart costs – as this is a significant obligation driven by Government policy, there should be an explicit and transparent allowance for all associated costs, separated out from business as usual indirect / metering costs. The programme is subject to specific risks and cost drivers. It is manifestly inappropriate to simply lump in with opex and index to CPI. The current cap will not include DCC overruns and increased costs, or the higher costs of a compressed roll-out. DCC costs charged to suppliers should be included in the index. It is essential that Ofgem clarifies its position on smart costs.

Wholesale costs – we welcome that Ofgem will review possible changes to the current index and recognise supplier risks such as the hedge/cap mismatch and transition phase. Ideally, the forward contract and price cap delivery periods should be aligned, whether they be 6 or 12 months.

We reiterate that suppliers are exposed to the material risk (several £ms) of not being able to perfectly match hedging to the wholesale index. We have experienced the impact of this as a result of the PPM price cap. This justifies the development of a recovery mechanism within the price cap, for any over/under-recovery during a charging period. Alternatively, rather than the current 6-2-12 method, a variant of the existing model could be developed which would be easier to hedge (see paragraph 14 of our response to the CMA)¹

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https://assets.publishing.service.gov.uk/media/58347537e5274a5918000000/prepayment_price_cap_draft_order_response_RWE_npower.pdf

Generally, Ofgem identifies the relevant issues on which we have the following comments:

- **Shaping** - the 70/30 baseload to peak ratio looks sensible. We assume that peak refers to 7am to 7pm weekdays. It should be noted that the half-hourly profile actually consumed has a higher cost than this simplified peak. This can be empirically verified with historic data and applied as an uplift.
- **Smoothing** - in addition, all suppliers face uncertainty in the effect of the price cap on churn and hence customer numbers – this in turn causes extra buying and selling (similar to temperature related “swing” and daily imbalance) which has a cost that should be included.
- **Seasonality** – we would reiterate the additional risk for suppliers arising from the forward contract and price cap delivery periods mismatch, which should ideally be aligned.
- **Transition** – this is an important issue. Suppliers currently have a forward hedge profile that extends beyond a year (Ofgem has published on the hedge profile). The hedge profile is likely to shorten and this leaves suppliers with stranded hedges that may have favourable or negative mark to markets. Since this depends on the level of the cap it is not possible at this point to re-hedge accurately.

Environmental & Social Costs – In the case of the Energy Company Obligation (ECO) scheme, we do not agree that historic information on average realised costs across the industry is a reasonable approach to take to setting the initial level of the benchmark. As the economics of ECO III will be materially different to previous ECO schemes, our view is that the benchmark should be based on the BEIS Impact Assessment (IA) price (used by suppliers and the supply chain and which sets an expectation of costs). In any case, the IA will to an extent factor in historic costs reported by suppliers, with greater rigour within government on monitoring the impact the policies have on energy bills (primarily through the Levy Control Framework), the costs of ECO and the assumptions in the IA are broadly robust.

The difficulty with benchmarking based on supplier reported costs is that suppliers use different methodologies to produce the reports, leading to potential inconsistencies across the data provided. A further problem with assessing costs is that it presents each supplier’s price for delivering ECO at that time, which is not the same as the price for complying and could therefore understate the cost allowance, penalising compliant suppliers. Suppliers will also phase delivery of ECO measures/spend differently across the numerous scheme periods (“Phases”), making a meaningful comparison of incurred costs in any one phase problematic. We are concerned that the operation of the price cap does not in any way reduce suppliers’ flexibility in delivering their obligations.

Whilst corrections for volume and price could be made to a linear delivery profile for the main obligation and all sub-obligations (necessary as each sub-obligation has a discrete volume and cost to deliver), this will be complicated. A better approach would be to simply include an allowance across the entirety of the price cap based on the BEIS IA for ECOIII. This is effectively a cap subject to the Levy Framework and would provide suppliers with an incentive to deliver efficiencies, consistent with Clause 1(6)(a) of the Bill.

Feed-in Tariff (FiT) - in our view, levelisation does not account for all of the costs in managing the FiT scheme, with insufficient allowance for administration costs (anticipated to increase with identifying smart metered sites for export payments).

The actual rate (i.e. £/MWh) of FiT for a charging year is known six months after the delivery period following the annual levelisation process. Therefore, it is important to estimate this cost accurately when setting the cap. Failure to do so could have an adverse impact on suppliers’ cost recovery. The FiT scheme is anticipated to be closed for new entrants after March 2019. As a result, growth of the scheme would be considerably reduced. However, we believe there would still be some exceptions due to pre-

accredited installations. Also, the implementation of EII exemptions and the potential widening of the EII exemption eligibility criteria would impact the future chargeable volume base, hence the FiT rate. It is important to capture those uncertainties within the FiT cost forecast used when setting the cap so that an accurate view of this charge is reflected within this process. A recovery mechanism would further mitigate these risks.

Network costs – Ex-ante published network charges are currently applied to the appropriate cap period. However, this mechanism does not apply to Balancing Services Use of System (BSUoS) charges and indeed the choice of reconciliation run used for settlements can cause retrospective charging of BSUoS. Hence, the use of a recovery mechanism in the index for BSUoS is important, albeit that BSUoS is one of the smaller charges. For the avoidance of doubt, socialised supplier default costs re-claimed via the Supplier Of Last Resort levy should be included.

Return on capital – Ofgem’s calculations must be transparent and it would be helpful to clarify the references to “other energy sectors and from previous GB regulatory determinations”. Ofgem notes that the CMA estimated a return in line with 10% pre-tax nominal WACC. The calculation that solves for earnings margin should be made transparent. We would also reiterate that we disagreed with the CMA’s reliance on Return on Capital Employed, inappropriate for “asset light” supply businesses and understating the economic value on which to base allowed earnings.

Updating the baseline

a) updated to reflect trends in a basket of market tariffs.

We do not think this approach is viable due to the same concerns and issues with Option 1 for setting the initial baseline.

b) updated based on a periodic review of suppliers’ realised costs.

This option has merit and would complement Option 4 for setting the initial baseline. It is important that the indexation, if bottom up cost based, does not miss out costs, as the cap would then drift over time away from costs.

c) updated based on third party data and/or a pre-specified allowance for certain cost items.

This option has merit, subject to satisfactorily addressing the known flaws with the indexation of the existing safeguard caps.

Re-opening the methodology – we have noted above the role of recovery mechanisms. In addition, the SVT / default tariff is a significantly wider market intervention over a potentially longer timeframe, compared to the existing caps. It is wholly appropriate to include a formal process for re-opening the cap, in order to mitigate supplier risk (for example, in the event of a material change in obligations/costs) and avoid unintended consequences.

Design specifics

- **Number of caps** - we agree that the existing approach is appropriate.
- **How the cap varies with consumption** - npower supports a cap on bills that is linear in relation to consumption i.e. a standing charge cap and unit rate cap form the upper envelop of maximum bill. Any more complex mechanism would lead to confusion and would lead to complex seasonal and carry forward effects if the cap period is other than annual.

The ratio of standing charge to unit rate is a policy decision. High standing charges are regressive and unpopular. Low standing charges may however not be cost reflective, leading to distortions.

The CMA stated that “The future of the Hydro Benefit Replacement Scheme is currently the subject of consultation and the scheme is reported to cost less than £1 per customer per year. We therefore do not propose to provide a specific allowance for this cost”². £1 per customer per year may have been relatively immaterial for the Prepayment cap, but would no longer hold for a wider SVT cap.

The issue of unidentified gas under NEXUS also needs to be considered.

- **Multi-register tariffs** – we agree with the proposal to use assumed consumption splits, but note the practicalities associated with supporting an increasing number of more complex tariffs. There are many multi-register tariffs and a generic mechanism may be needed. We note that many of these tariffs have a core that is either single rate or Economy 7 and hence the caps can be built using the single rate cap or an Economy 7 cap (which possibly needs unit rate caps for each register plus a standing charge cap).
- **Payment methods** – we believe that it is sufficient to have a Receipt of Bill (ROB) cap with no separate cap for Direct Debit (DD). Ofgem needs to strike a balance between protection and competition. Direct debit customers are financially included with banking services and less likely to be vulnerable. In this regard they are less in need of protection and it seems then that the best thing is not to cap DD.

Whilst Smart may reduce the DD-ROB differential in terms of a potential reduction in bad debt (increased bill accuracy & remote PPM switching), we do not expect it to be eliminated and the working capital differential will remain.

In general, we have viewed SLC27.2A on cost reflectivity by payment type as not applying where one payment type is price regulated. In any event, suppliers will need clarification from Ofgem on how SLC27.2A is to be applied.

² CMA Energy market investigation Final Report, page 996, para 14.232