Name Paul Finch
Phone 07795 353787
E-Mail paul.finch@npower.com

23rd April 2018

Dear Retail Price Regulation Team,

Working paper #3: approach to headroom

Thanks for the opportunity to comment on this working paper.

Headroom is a key consideration in the design of the cap and we note the analysis that Ofgem says it is considering undertaking. It is important that sufficient analysis to a high level of rigour is undertaken, published and not compromised by a compressed timetable.

Whilst Ofgem must design the cap in accordance with the proposed legislation, there is a lack of clarity regarding the cap's success criteria and other variables against which to assess the need for headroom. For example, our assumption is that the Bill requires the cap to maintain switching rates at or around current levels. The benchmark for efficient costs has yet to be determined. Ofgem will need to demonstrate how its design of the tariff cap, in the round, delivers the policy intent of balancing protection, competition and sustaining the ability of efficient suppliers to finance their activities.

Role of headroom

After a two year investigation, the CMA decided that explicit headroom was required in the Prepayment cap to enable competition to co-exist. We see no reason to disagree with the CMA's decision and therefore why it would not apply to the SVT/default cap. There is a significant risk that setting the cap too low will impact cost recovery, the ability to offer profitable tariffs below the cap and the savings required to sustain competition. Should Ofgem reach a different conclusion to the CMA, it must clearly articulate why it has done so and how such risks have been mitigated.

The combination of the two interventions of supplier exemptions and price cap, has consequences that should be explicit and modelled by Ofgem in the consideration of headroom, not least since all regulatory pricing interventions to date have had unintended as well as intended consequences. We note recent press coverage of [ ] and then its acquisition by [ ], when it was cited that the consequence of Government policy is likely to erode the differential between challenger supplier prices and the tariffs of larger suppliers, with a significant adverse impact on customer's propensity to switch.

npower

Oak House
Bridgwater Road
Worcester
WR4 9FP

T 07795 353787

Registered office:
Npower Group plc
Windmill Hill Business Park
Whitehill Way
Swindon
Wiltshire SN5 6PB

Registered in England
and Wales no. 8241182

As suppliers grow, the cost advantage of full and partial exemptions to government obligations erodes and the prospective gains from switching fall, and there is circumstantial evidence of suppliers maintaining a size to stay below the exemption limits. To a large extent the exemptions are a false driver to switching, since customers taking advantage of the obligation cost differential by switching to exempt suppliers causes the differential to increase as the unchanged total cost of the obligations fall to a smaller number of customers. Since supplier efficiency cannot change the obligation cost, then the increase in its cost as the obligation base falls must be taken into account in the headroom and indexation, *necessarily* according to the legislation under consultation and existing legislation.

The CMA also stated[1] that in addition to facilitating competition, another key basis for headroom is to mitigate the risk that the cap does not allow for the recovery of efficient costs, along with minimising the perception of regulatory risk. We recognise the time pressure faced by Ofgem in designing a SVT/default cap, which heightens this risk and further justifies the inclusion of headroom. Concerns with the CMA's analysis of efficiency are well documented. In the first instance, this does not negate the need for Ofgem to allocate sufficient resource and expertise to the design of the tariff cap.

To an extent, there may be trade-offs between the level of headroom, the level of the allowance for efficient costs to enable licensees to finance their activities, and mechanisms for recovery, error correction and re-opening the price cap.

The paper refers to other regulated markets and sectors that do not include an allowance for headroom. We note the relative lack of competition in the Northern Ireland energy market compared to the GB market, both in terms of the small number of suppliers and relatively lower switching rates, significantly so in gas[2]. The payday lending cap protects engaged customers by removing access to excessive cost short term loans (a discretionary product), whereas the energy cap is aimed at protecting disengaged customers who are being supplied with energy (a necessity, for which costs must be recovered). As such, we do not believe that these examples are comparable to the GB energy market.

The paper also refers[3] to concerns that headroom could reduce protection for disengaged consumers, because suppliers could set their default tariffs at the level of the cap to maximise their margin, as there would be little risk of them losing customers by doing so. If this concern is driven by price convergence around the PPM cap, we submit that this is due to the design flaws and insufficient cost allowance, rather than suppliers taking advantage of headroom to maximise margin. If the cap is designed correctly, there may be scope to price below the level of the cap to stimulate competition. If it is designed similarly to the PPM cap with its flaws, it is less likely that suppliers will be able to price below the cap. If no headroom is included, this increases the likelihood of suppliers pricing to the level of the cap, whilst removing the opportunity to make a reasonable margin and reducing the scope to offer savings.

---

[1] For example: Paras 141 and 7.170, Provisional decision on remedies (17th March 2016)
[2] https://www.uregni.gov.uk/sites/uregni/files/media-files/Transparency%20Report%202017%20Q4%20UPDATED%202018-03-02.pdf
[3] Paragraph 3.4

The paper states[4] that suppliers could offer tariffs below the level of the cap without headroom. This would be a big assumption and a leap of faith. It is likely that actual monetary savings would be much lower so those suppliers would be less likely to attract new customers. Suppliers could price below cost in order to attract customers but this is obviously unsustainable and will likely lead to fewer suppliers in the market as they struggle make a margin. A critical dependency would be the benchmark for efficient costs, particularly if this is set at or close to the efficiency frontier, rather than average efficiency (which we believe would be consistent with Ofgem's duty under the Electricity/Gas Acts). Headroom would help to preserve competitive market conditions, whereby the more efficient suppliers can offer lower prices, incentivising other suppliers to improve their efficiency and move towards the frontier. This would be reinforced by the programme of consumer engagement activities.

The paper states[5] that competition and switching could focus on fixed tariffs, with the cap set at the lowest possible that doesn't unduly impact competition. It's unclear whether this envisages a degree of headroom. It's clear that there is a risk that setting the cap too low could adversely affect competition. How would Ofgem define an undue impact on competition in fixed tariffs? How would Ofgem square this with the need to maintain switching? What would Ofgem do if there was an undue impact on competition, for example, revisit the cap design and/or level? This reinforces the need for a cap that enables the conditions for effective competition and is temporary in nature, rather than self-perpetuating.

The paper also states that suppliers would still be able to differentiate and innovate by encouraging customers to actively choose new fixed tariffs. This ignores the likelihood that a relatively disengaged customer will be unlikely to move to a fixed tariff when they can do nothing and get a cheap price. Without headroom, where will the funds come from for innovation and differentiation? There is a real risk that the cap could lead to a withdrawal from, or significant dampening of competition within, the fixed tariff market.

Analysis

The overview of analysis in Table 1 does not refer to the impact on the fixed tariff market, which will be key for sustaining competition. This may be covered under "impact on supplier incentives", but should be explicitly recognised.

Price differentials and switching

We note that Ofgem are looking at including results from trials based on actual observed consumer behaviour[6]. We would welcome transparency on the nature and terms of reference of all trials used to inform the design of the cap. For example, how such trials will mitigate the risk of participant's behaviour being influenced by being part of a trial. If customers are unwilling to switch for savings of c£2-300, it would be strange if customers switched for a much lower saving as a result of a trial.

Ofgem also indicate that they will look at qualitative research, potentially using its Consumer Panel[7]. As always, it will be important to ensure that a broad spectrum of

[4] Paragraph 3.5
[5] Paragraph 3.6
[6] Paragraph 4.18
[7] Paragraph 4.19

consumers participate, both engaged and disengaged. The latter are likely to be particularly prone to the risk of a safeguarding effect, whilst engaged customers may become less engaged as a result of a price cap.

Ofgem cites a lack of evidence regarding a reduction in PPM switching rates and states that PPM suppliers continue to grow at a similar rate to prior to the PPM cap. We have seen recent analysis (available on a subscription basis from an established and respected industry commentator) that reports considerably lower growth for PPM suppliers and seemingly lower PPM churn, since the PPM cap. Switching will continue to be driven by the larger tariff differentials due to small supplier exemptions from WHD and ECO, rather than validating the level of the PPM price cap (including headroom).

One of the major PCWs also produced a report in October 2017 (again on a subscription basis), showing that for PPM either side of the cap, savings had almost halved, conversion rates fallen and PPM switches as a proportion of all switches had also halved**.** A similar trend can be seen for PPM savings available via the MSE Big Energy Switch.

Generally, there is an abundance of insight into switching behaviour available from PCWs that should be readily available to Ofgem on request. We note that the CMA found the mean saving required for consumers to switch was £158 per annum[8].
[ ].

We maintain that headroom of 10% per fuel would be reasonable, with a minimum level of 8%. This would give dual fuel headroom levels of c£85 and c£65 respectively, at typical consumption.

We reiterate that in the interests of transparency, we believe that non-confidential consultation responses should be published by Ofgem in a timely manner. This redacted submission is not confidential.

Yours sincerely,

Paul Finch
Regulation

Cc: Chris Harris, Head of Regulation

[8] [8] Energy Market Investigation, A report for the CMA by GfK NOP