Ofgem Default Tariff Cap Working Papers #4 and #5: Energy UK response

3 May 2018

Introduction

Energy UK is the trade association for the GB energy industry with a membership of over 100 suppliers, generators, and stakeholders with a business interest in the production and supply of electricity and gas for domestic and business consumers. Our membership covers over 90% of both UK power generation and the energy supply market for UK homes. We represent the diverse nature of the UK's energy industry – from established FTSE 100 companies right through to new, growing suppliers and generators, which now make up over half of our membership.

Our members turn renewable energy sources as well as nuclear, gas and coal into electricity for over 27 million homes and every business in Britain. Over 730,000 people in every corner of the country rely on the sector for their jobs, with many of our members providing long-term employment as well as quality apprenticeships and training for those starting their careers. The energy industry invests £12bn annually, delivers £88bn in economic activity through its supply chain and interaction with other sectors, and pays £6bn in tax to HMT.

This is a high-level industry view in response to Working Papers #4 and #5; Energy UK's members may hold different views on particular issues raised by the working papers and we expect them to respond individually. We would be happy to discuss any of the points made in further detail with Ofgem or any other interested party if this is considered to be beneficial.

Executive Summary

It is important for Ofgem to base their decisions on robust evidence and analysis that stakeholders are able to review and comment on while policy proposals are still at a formative stage. To date, while the series of working papers have given a welcome glimpse into Ofgem's preliminary thinking on some issues, the lack of underlying evidence at a sufficient level of detail to inform detailed analysis has limited the usefulness of the working papers. Energy UK would, therefore, expect to see a greater level of detailed analysis being put forward in the policy consultation that Ofgem expects to publish later this month.

In particular, clarity needs to be provided on how Ofgem will take into consideration important aspects of suppliers' costs such as smart meter rollout programmes which have so far been omitted from the tariff cap working papers. We would also urge Ofgem to properly assess the cost implications that the upcoming changes to the Energy Company Obligation (ECO) scheme will have for suppliers, noting that BEIS' consultation on the 2018-2022 phase of the scheme has only just closed. Exactly how Ofgem will look to update the level of the cap overtime and adapt to increases in external policy costs should also be detailed in May's policy consultation.

Working Paper #4: Treatment of environmental and social obligation costs.

Energy UK welcomes Ofgem's recognition in Working Paper #4 (WP4) that the majority of the costs discussed in the paper were outside of suppliers' control. As such, it is essential for the sustainability of the tariff cap throughout its temporary life, as well as the long-term competitiveness of the market, that such costs are properly accounted for in the initial level of the cap set. Equally important is for changes to these external costs to be given full consideration in the re-assessments that the Bill requires Ofgem to undertake at least every six months. We would welcome more details from Ofgem in their upcoming policy consultation as to how they envisage the re-assessment to be conducted and how stakeholders will be asked to feed-in to the process.

In addition, we would welcome clarity in the upcoming policy consultation on Ofgem's thinking regarding any process that could be available for identifying, highlighting or rectifying any errors made in either the initial setting of the cap or any subsequent updates, as suggested in our response to Working Paper #1.

While we welcome the publication of a working paper on these costs, Energy UK is concerned that there has so far been no consideration of how smart meter rollout costs will be assessed, which is a significant omission as it had been highlighted as a working paper topic in Ofgem's open letter of 6th March.[1] We also note that a proposed RFI on smart meter costs had not materialised. Stakeholders have previously highlighted material concerns about the treatment of smart costs in the context of the PPM cap and its subsequent application to the WHD safeguard tariff, and the need to revisit this issue in relation to any wider cap.[2] It will be important for this topic to be addressed fully in May's policy consultation.

Furthermore, WP4 highlights OBR forecasts as sources of data for numerous policies' future costs. Energy UK is concerned that these forecasts are not always reflective of suppliers' actual costs, either due to differences in national costs, as well as costs associated with specific profile classes. A suitable recovery mechanism should be considered to ensure full pass through of outturn costs.

Energy Company Obligation (ECO)

BEIS has just concluded consultations on the next phase of ECO intended to begin in October, ECO3,[3] as well as the Warm Home Discount Scheme for winter 2018 to 2019.[4] It is imperative that, whichever option is chosen to set the cap, the actual costs for suppliers resulting from the changes being made to these schemes are accurately and appropriately accounted for in the level of the cap.

With specific regard to the assessment and treatment of Energy Company Obligation (ECO) costs under the tariff cap, we note that WP4 states Ofgem will draw on information requested from suppliers in relation to the cost of ECO. However, Energy UK would highlight that historic costs are highly unlikely to be a good indication of the future scheme's costs, especially given the current consultation on ECO3 and its move towards becoming a 100% fuel poverty focused obligation. Energy UK believes that while BEIS' impact assessments, which set expectations on the cost of delivery and operates within the £640m cost envelope for which

[1] Open letter: Update on our plans for retail energy price caps, *Ofgem,* 6 March 2018

[2] Energy UK's response to Ofgem's consultation: Providing financial protection to more vulnerable consumers, January 2018

[3] Energy Company Obligation: ECO3, 2018 to 2022 – Consultation, BEIS.

[4] Warm Home Discount Scheme 2018 to 2019 – Consultation, BEIS.

BEIS are responsible, are a better starting point for the recovery of costs sustained by suppliers when meeting their obligation, Ofgem's reliance on the IAs should not be uncritical.

In Energy UK's response to the ECO3 consultation we highlighted a number of concerns with assumptions made in the Consultation Stage Impact Assessment (IA)[5] that would impact the accuracy of any cost calculations:

- The IA does not consider how costs will change over the length of the obligation which is important given that suppliers will be dealing with a three-and-a-half-year scheme.
- The IA makes no assessment of the impacts of both the existing Local Authority flexibility as well as the introduction of innovation into the new obligation. Given that the two elements combined could amount up to 45% of the scheme, Energy UK considered that it would have been helpful for BEIS to carry out a full assessment of its impacts especially in relation to scoring and wider costs.
- The ECO3 consultation makes reference to Each Home Counts and the Quality Mark (QM) that is currently in the process of being established. There is a lack of clarity as to what will be required to demonstrate compliance with the standards, and the IA makes no assessment of potential added costs to suppliers.
- Energy UK raised concerns regarding the assumption in the IA that the proposed rural sub-obligation under a 100% Affordable Warmth scheme will not have any increased cost implications as it assumes that suppliers will deliver 20% to rural households. Energy UK would strongly question that as the rural element will increase from being 4.5% of the total obligation under ECO2t to being 15% under ECO3. This is a significant increase and the IA further does not take into account that previous experiences with a very similar sub-target (CSCO rural under ECO1) proved extremely difficult for suppliers to deliver with the added eligibility criteria. The IA also does not take into account that once something is made a sub-obligation this tends to drive up costs as a premium is placed on these measures as suppliers focus on delivering their obligation.
- Due to these concerns, Energy UK also highlighted that the calculation of search and administrative costs in the IA could in reality be significantly higher than projected.

Energy UK hopes that BEIS will address these concerns within its revised Impact Assessment, and make appropriate adjustments. However, this remains uncertain at this stage. If Ofgem does use BEIS' impact assessments as the basis for its treatment of ECO costs under the cap then Energy UK would urge Ofgem to take into account any unaddressed concerns that have been raised as to the accuracy of their underlying cost assumptions, and adjust accordingly.

Working Paper #5: Updated competitive reference price.

Energy UK has a wide range of membership including larger, medium and smaller suppliers, with differing views on the proposed cap and how to best determine an efficient level of costs. As we noted in our response to Working Paper #1 (WP1), Energy UK will not be putting forward a position on the preferred method for the determination of an efficient level of costs and we instead expect members to respond individually.

However, given the significance of the cap for the domestic supply market and the volume of households it will impact, we would like to stress how vital it is that the efficient costs benchmark is robustly designed from the start, whichever option Ofgem ultimately chooses. In particular, Ofgem should take into account that in a competitive market with suppliers of all sizes and varying customer bases there will inevitably be a range of efficiencies, costs and

[5] Energy Company Obligation: ECO3, 2018 to 2022 – Consultation Stage Impact Assessment, BEIS.

business models, and the level of the cap should be set at a level that ensures they can continue to operate competitively.

While this series of working papers have given stakeholders a glimpse of Ofgem's thinking on these issues at an early stage, Energy UK is concerned that Ofgem is yet to present any detailed analysis of the options or potential decisions. Ofgem needs to base any decisions on reliable evidence that stakeholders can evaluate and contribute towards. Economic modelling requires iteration including transparent consultation on assumptions. We would not want to see a self-imposed deadline of five months following the passing of the Bill for implementation undermine the economic robustness of the cap.

As highlighted in our responses to Working Paper #3, the "as soon as practicable" provision in Clause 1(1) of the Bill in no way suggests that Ofgem can compromise due process and accuracy of the cap construction for the sake of speed. We would therefore hope to see a greater level of detail in the analysis being put forward in May's policy consultation.

If you would like to discuss the above or any other related matters, please contact me directly on 020 7747 2931 or at steve.kirkwood@energy-uk.org.uk.