Executive Summary

1. Working paper 5 (WP5) covers a number of extremely important issues that will have far reaching implications whichever methodology Ofgem selects to specify the default tariff cap. While we welcome the working paper's recognition of these issues, we are concerned by the lack of detail or indication as to Ofgem's "minded to" position.
2. Ofgem's characterisation of the advantages and disadvantages of the methodologies considered in WP5 are not well justified. They do not draw on the four criteria that Ofgem set itself for the evaluation of potential methodologies back in the December consultation, nor has Ofgem set out an alternative set of criteria that it is now working to.
3. Both of the price cap methodologies described in WP5 ("Option 2" and "Option 3") have the CMA's prepayment (PPM) price cap at their core. In our response to Ofgem's December consultation we set out, in some detail, the serious errors of approach in the current PPM methodology.
4. In addition, we have submitted compelling independent economic analysis that describes ways in which these issues could be overcome. We have also submitted evidence that demonstrates that British Gas makes losses on PPM customers to such a degree that patently could not be explained by cost inefficiencies alone.
5. As such, we would have expected WP5 to explore these concerns - and those raised by other stakeholders – in some detail. However, the treatment of these issues in WP5 is cursory, suggesting that Ofgem's thinking has not progressed in this regard since last December. This is a significant missed opportunity.
6. Ofgem makes no real attempt to look at these issues through the lens of the statutory duties currently set out in the Bill. In this absence of an analytical framework based on those duties, it is highly likely that Ofgem's approach – and its conclusions – will depart from what is required by law.

Necessary cost adjustments

7. As set out in previous working paper responses, whichever approach Ofgem takes to setting the price cap will require adjustments for legitimate cost differences between suppliers – for example resulting from differences in customer mix or differences in the type and quality of service offered to customers. It is a serious omission that WP5 does not adequately explore how such adjustments will be made in the context of an "Option 3" methodology.
8. There is no mention of how Ofgem will take account of cost differences between suppliers relating to:
   - Smart meter costs: Ofgem will need to identify the implicit allowance for net smart meter costs within any benchmark, and adjust it to ensure that it is reflective of the costs of all efficient suppliers. It will also need to identify these costs so that they can be appropriately indexed forward. To do this Ofgem will need to ask for further data

on smart meter costs and benefits to ensure that the allowance included in the cap for this policy obligation is appropriately determined. We set out what this request needs to cover in our response to WP4. A failure to properly allow for smart meter costs will see the number of smart meter installs per year fall, with serious implications for consumers given delays to the realisation of their benefits. Given that smart meters will be an important driver of competition, Ofgem's decision about the allowance it determines for smart costs will have a direct impact on whether the conditions are in place for the cap to be removed. This is a requirement of clause 7(2) of the Bill and it is something Ofgem should be thinking about now, so as to ensure that the criteria for removal of the cap can be met, thereby meeting the will of Parliament in having a temporary cap. We refer to our comments in WP4 on this.

- ECO costs: Ofgem will need to adjust the benchmark to remove historic ECO costs, before reflecting the costs of ECO3. We discuss this further in our response to WP4.

9. We are also seriously concerned by the fact that Ofgem states – without providing any explanation or evidence to substantiate its thinking – that it has not as yet identified a "compelling reason" to make adjustments to address concerns that have been raised regarding the treatment of wholesale costs. We provide further evidence about why these adjustments must be made in Annex 2 of this paper.

10. In addition, we do not agree with Ofgem's assessment that it will only need to take into account differences in operational costs between companies on a "largely qualitative" basis. Provided Ofgem requests the appropriate data there is no reason why these costs could not be assessed quantitatively. Indeed, it is imperative that they should be quantified, given the importance associated with understanding the difference in cost to serve associated with supplying different customer bases, providing different service types and quality.

11. Significant work will be required to model and properly take account of these cost differences. We are therefore concerned by the lack of apparent progress in this modelling work, and expect that this will be a major area of focus in Ofgem's forthcoming policy consultation.

Criteria for setting a benchmark

12. Were Ofgem to adopt an "Option 3" approach to setting the cap, we agree that careful thought must be given to the selection of the benchmark firms.

13. We agree that certain suppliers should be excluded from the benchmark where it is likely they will not provide an appropriate comparator and/or adjustments cannot be made to put them on a comparable basis. This would mean excluding suppliers who:

    - have been subject to a provisional order (due to serious concerns about supplier behaviour);
    - have not been subject to detailed cost data collection by Ofgem (as detailed and reliable cost data will be necessary to make subsequent benchmark adjustments);
    - have been trading for less than a year (given uncertainty over whether such suppliers have a viable long term business model); and

- have ceased trading.

14. There is a trade-off between making further exclusions at this stage of the analysis or alternatively making adjustments to take account of differences between suppliers at a later stage. We believe that the criteria we have put forward are particularly conservative and there is a strong case for making further exclusions (rather than adjustments). In particular, there is a strong case for also excluding companies that have not been operating at sufficient scale for a reasonable period of time. This is to avoid including any suppliers whose prices may not be sustainable and whose customer service arrangements are not proven at scale. As a starting point, we would suggest that only suppliers that have been operating with proven customer service credentials at reasonable scale for over one year are included. We would suggest that "reasonable scale" should start at the 250,000 customer account obligation threshold.

15. It is essential that the criteria adopted in determining which suppliers are included in the benchmark are appropriate, objective, unambiguous and measurable. In contrast, a more arbitrary approach to selecting suppliers (e.g. on the basis of "lowest price") risks deriving an artificially low benchmark, which in turn would have serious implications for the market and ultimately for consumers.

16. Ofgem needs to provide visibility to stakeholders of the adjustments it will (and will not) make to determine the benchmark so that stakeholders have the ability to scrutinise the robustness of the results. In the absence of a clear and compelling reason to the contrary, we would recommend that Ofgem set up an electronic data room, accompanied with strict confidentiality agreements, to enable suppliers to verify the benchmarking data referred to in this working paper. This is likely to be a requirement in order to ensure a fair and transparent process and will apply whichever option Ofgem uses to set the cap if it relies on an assessment of confidential data. Suppliers are entitled to understand fully how Ofgem intends to set the control.

Next steps

17. We are concerned that Ofgem is not planning to release any further working papers for comment ahead of its policy consultation in May. This is despite there being a range of critically important issues that have not been covered by any of the working papers. For example, Ofgem has not:

    - engaged with stakeholders regarding the treatment of smart meter costs;
    - set out how it intends to update the level of the initial cap over time (instead focusing on how it will calibrate the initial level of the cap) or provided any insight or detail on the proposed modelling;
    - responded to any of the concerns raised regarding Option 2 (in response to the December consultation) despite considering Option 3 which builds on the approach taken when setting the current safeguard cap; or
    - explained in detail the opportunities or challenges of Option 4 (the bottom up model).

Response to Ofgem's Working Paper #5

Context

18. This working paper covers two of Ofgem's four options for setting the initial level of the cap: options 2 and 3 (the 'reference price' methods). In Centrica's view the content of WP5 is vague and lacks the detail required to enable stakeholders (and indeed Ofgem) to properly engage on issues that will have a significant impact on the design of the cap.

19. In this regard, the consideration by Ofgem of Option 2 is extremely light touch. Despite having had over three months to do so, Ofgem has failed to take into account the stakeholder responses that it has already received on Option 2 following its December consultation[1] and it has not developed its approach from that date. This is a significant missed opportunity.

20. As we set out in our response to the December consultation[2], if Option 2 is to be pursued, a number of changes must be made before it could be used as a basis for setting this cap, given that the existing PPM cap methodology is based on a number of material errors in approach. These mean that the methodology fails to produce a tariff cap that reflects efficiently incurred costs and leaves insufficient headroom for suppliers to compete effectively. In November 2017, we submitted an independent report we commissioned from Frontier Economics that:

    - described and explained these methodological flaws in detail, and
    - considered what the emerging evidence of the effect of the cap on the PPM market indicated about the effect of these issues in practice, including that the cap:
        - is forcing British Gas to make losses on PPM customers of a scale that patently could not be explained by cost inefficiency alone; and
        - even though the cap has been in force for a relatively short period of time, there are already signs that it is having an impact on supplier and customer behaviour in a way that is consistent with a reduction in competition.

21. For these reasons, simply extending the existing PPM cap methodology to default tariff customers would be untenable. In WP5, Ofgem lists only three examples of issues where it is considering making changes (the benchmark at nil consumption, the treatment of smart costs, and levels of online account management). We assume that Ofgem is also considering the other issues that were raised by stakeholders as part of the December consultation including, but not limited to, changes in the cost of shape, the weighting of different cost categories and payment cost differentials.

22. Further, as we set out in our response, even if these adjustments were made, additional steps would need to be taken to address the outstanding problems with the PPM cap methodology. These were summarised in Table 6 of our response which is reproduced for reference in Annex 3 to this response.

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1 "Providing financial protection to more vulnerable consumers", Ofgem (20 December 2017).

2 "Providing financial protection to more vulnerable customers", Centrica letter to Rob Salter-Church (31st December 2018).

23. Ofgem's characterisation of the advantages and disadvantages of each approach are not well justified. They do not draw on the four criteria that Ofgem set itself for the evaluation of potential methodologies back in the December consultation[3], nor has Ofgem set out an alternative set of criteria that it is now working to. In particular, it is not clear that "familiarity" is a good reason for choice of an option: understanding an option and failing to take account of its flaws would be wholly inappropriate.
24. It is also the case that Ofgem should ensure that any methodology is not subject to undue "uncertainty". Any expedition of this consultation process at the expense of allowing Ofgem to adequately acquaint itself with the relevant and necessary information for it to make a fully informed decision would leave any final decision open to challenge.
25. As with WP5, the remainder of this response focuses on Option 3, the updated reference price methodology.

High-level criteria for including suppliers in updated benchmark

26. Ofgem appears to be suggesting a two-stage process that would involve:
    - identifying firms that are pricing competitively, based on an assessment of firms' customer bases and price levels; and then
    - making adjustments to the tariffs of these benchmark firms (or excluding them) to control for tariff differences that could be attributable to legitimate differences in cost.
27. In principle, we agree with the high-level criteria that Ofgem has set out for identifying a suitable benchmark. However, we consider that Ofgem should undertake a more iterative process to identify the benchmark involving three stages.
    - First, it should identify and exclude any supplier from the benchmark that would not make a suitable comparator and/or where it would not be possible to make accurate adjustments in order for it to become a suitable comparator. There is no point in including such suppliers within further stages of assessment, if there are *a priori* reasons for them to be excluded.
    - Once those suppliers have been excluded, Ofgem should then use a set of criteria that are appropriate, objective and measurable to determine which of the remaining suppliers should be included within the benchmark.
    - As a final step, Ofgem then needs to look at the suppliers within the benchmark and make adjustments to reflect a detailed assessment of firms' customer bases and price levels to ensure that the resulting benchmark is appropriate. It is critical that any such benchmark controls for legitimate cost differences between the benchmark firms and other suppliers. Failure to control for this could lead to unintended consequences ranging from steep declines in supplier service quality to suppliers exiting the market altogether.

[3] Ofgem (December 2017) para 3.4.

Pricing competitively

28. As we set out above, we believe that Ofgem should first identify and exclude any supplier from the benchmark that would not make a suitable comparator and/or where it would not be possible to make accurate adjustments in order for it to become a suitable comparator. We believe that Ofgem should exclude from any benchmark, as a minimum, any supplier that meets the following criteria.

    - *Any supplier that is (or has been) subject to a provisional order in accordance with Section 25(2) of the Electricity Act 1989 and Section 28(2) of the Gas Act 1986.* If Ofgem has had sufficient concerns about the behaviour of a supplier to prevent it from acquiring new customers, it should be clear that this would not make an appropriate benchmark company.
    - *Any supplier that is below any threshold Ofgem has determined for collecting data as part of its recent RFI requests covering past and forecast cost information that have been issued for the purposes of determining the price cap[4].* The nature of the adjustments that must be made to any benchmark (discussed further below) will require Ofgem to have access to detailed cost data. We understand that these were issued to "medium and large suppliers". We therefore expect that this will exclude any supplier that falls below Ofgem's definition of a medium supplier.
    - *Any supplier that has been trading for less than one year from the date at which the benchmark information is collected.* We do not believe that there will be sufficient certainty as to the long-term viability of the business model of such suppliers, nor adequate data on which to undertake a comparison with other suppliers.
    - *Any supplier that has ceased trading since the date at which the benchmark is taken.* The fact that a supplier ceases trading must demonstrate that the tariffs being offered were not sustainable. Additionally, from a practical perspective data on such firms may not be available in the form required by Ofgem.

29. There is a trade-off between making further exclusions at this stage of the analysis or alternatively making adjustments to take account of differences between suppliers at a later stage. We believe that the criteria we have put forward are particularly conservative and there is a strong case for making further exclusions (rather than adjustments). In particular, there is a strong case for also excluding companies that have not been operating at sufficient scale for a reasonable period of time. This is to avoid including any suppliers whose prices may not be sustainable and whose customer service arrangements are not proven at scale. As a starting point, we would suggest that only suppliers that have been operating with proven customer service credentials at reasonable scale for over one year are included. We would suggest that "reasonable scale" should start at the 250,000 customer account obligation threshold.

30. When deciding which of the remaining suppliers to include within a benchmark, Ofgem must set out and adhere to a set of criteria that are appropriate, objective, unambiguous and measurable. If it fails to do this and instead just focuses on those with the lowest prices, it will essentially just be 'cherry picking' suppliers to derive the lowest benchmark

[4] This includes the RFI requests issued on 28 March 2018

rather than estimating the correct one. For example, if Ofgem is using 'engaged' customers as a key filter for determining the suppliers to be included then it must provide an adequate definition of what is meant by this term, as it is not clear from this working paper.

31. We do not agree that Ofgem should use customer mix (e.g. the proportion of customers on fixed term tariffs) as a proxy for pricing competitively. The fact that a supplier has a "high proportion" of customers on fixed term tariffs or has "low prices" are, absent further specification, arbitrary definitions. They could also simply reflect the fact that the supplier is looking to expand its customer base by charging unsustainably low acquisition tariffs. This supplier's tariffs will not be reflective of the "competitive" tariff level that would be sustainable over the longer-term. Given this, there would be no justification for limiting the benchmark group to just this subset of suppliers.

32. Whatever suppliers are included within the benchmark, it is essential that the benchmark must be based on a weighted average of all of the tariffs of any supplier within it, and not just its lowest tariffs. This reflects that a supplier's pricing strategy can only be assessed by looking at all of its tariffs across the whole of its customer base. This methodology is consistent with the CMA's approach. We are reassured that Ofgem seems to recognise this in paragraph 4.3 of the working paper.

Relevance as a market-wide comparator (after feasible adjustments)

Comments on overarching approach

33. In our response to working paper 2, we highlighted a concern that Ofgem has failed to be clear about what it means by the "long-run costs of an efficient supplier", given that the definition used will be central to the determination of the level of the cap, whatever methodology is used to set it.

34. There are at least two important dimensions to this: the type of company that is held to be the benchmark (for example relating to scale of operation or years of operation) and the type of customer that needs to be served. Ofgem must be clear about the assumptions that it is making, and stakeholders given the opportunity to challenge these assumptions as part of a substantive consultation in its own right.

35. In particular, we note that Ofgem will need to beware of unintended consequences if the resulting cap does not cover the costs of the most expensive customers to serve, considering the negative impact this would have on suppliers' financial incentives to compete to acquire and retain such customers. We continue to have concerns that Ofgem is not doing this. For example, how can Ofgem determine what a relevant market-wide comparator is within its benchmark without first determining what type of supplier it is seeking to determine the efficient costs for?

36. In determining the "long run costs of an efficient supplier", we agree that it is critical that the methodology takes account of the fact that:

- Some suppliers may be able to price more cheaply because they may have atypically low costs due to differences in customer mix or exemptions from social and environmental obligations.[5]
- Some suppliers may currently be setting their tariffs at too low a level to allow them to make a sustainable return on capital.[6]

37. However, as we explain below, these are not the only factors that Ofgem must control for when designing the cap.

Controlling for differences in wholesale costs

38. Ofgem acknowledges in WP5 that stakeholders have raised concerns about the existing PPM tariff cap methodology's approach to modelling wholesale costs. However, Ofgem then states – without providing any explanation or evidence to substantiate its thinking – that it has not as yet identified a "compelling reason" to adjust the methodology to address these concerns.

39. Contrary to this statement, there are at least three clear and compelling reasons that an adjustment will need to be made to wholesale costs if a competitive reference price methodology is used:

- First, by combining a snapshot view of retail prices for a selection of benchmark firms with a mechanism for updating energy costs that bears no relation to the costs incurred by them, this methodology could result in a price cap that makes an entirely inappropriate – and in all likelihood insufficient – provision for wholesale energy costs.
- Second, the methodology fails to take account of the evolution in seasonal structure and shaping costs that will result in it further underestimating increases in wholesale costs going forwards.
- Third, even setting aside the errors described above, the "6-2-12" strategy used by the existing PPM cap to update fuel costs has several other unattractive features that should be addressed.

40. We explain each of these concerns in turn, along with the changes that should be made to the methodology to address them, in Annex 2 to this response.

Controlling for differences in network costs:

41. We agree with Ofgem's proposal to follow the existing PPM cap methodology's approach to network costs. These are clearly pass-through costs that are beyond the control of suppliers, and so should be treated as such by the cap methodology.

42. Such costs also need to include any industry levies resulting from the supplier of last resort process. We continue to believe that it is unfair that suppliers who follow responsible business models have to bear the costs of those that fail. We assume that any such levies will be treated as a pass-through cost in the cap given that they are recovered via network charges.

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5 As referenced in paragraphs 5.8 to 5.11 of Ofgem WP5.

6 As referenced in paragraph 12 of Ofgem WP5.

Controlling for differences in social and environmental obligation costs:

43. In the event that suppliers are included within the benchmark who are not fully obligated, we agree that Ofgem must adjust the benchmark tariffs to ensure that they reflect the social and environmental costs of a fully obligated supplier.

44. In addition, Ofgem will also need to make an adjustment to any benchmark involving obligated suppliers to reflect the change in ECO costs following the introduction of ECO3. We note that Ofgem has published a separate working paper (WP4) focusing specifically on this cost category. We provide more detailed comments on this element of the tariff cap methodology in our response to that working paper.

Controlling for legitimate differences in operational costs:

45. Ofgem rightly notes that suppliers' operational costs may vary due to differences in business model, scale of operation and legacy requirements.[7] However, differences in suppliers' tariffs may also reflect other legitimate differences in suppliers' operating cost bases not referenced in the working paper, namely those resulting from differences in service type, quality and customer mix.

46. Ofgem must carefully assess suppliers' operational costs with these considerations in mind and make adjustments to the benchmark tariffs to accommodate these. Alternatively, as Ofgem suggests in relation to payment methods, it could instead apply a separate uplift to account for these additional costs outside the benchmark when calculating the cap level. However, Ofgem would still need similar data in order to appropriately assess the size of any uplift.

47. Ofgem suggests that in many cases these differences in operational costs would need to be assessed on a "largely qualitative" basis. We do not agree with this. Provided Ofgem requests the appropriate data there is no apparent reason why these costs could not be assessed quantitatively. Furthermore, they are of a level of materiality equivalent to other cost adjustments that Ofgem has indicated that it will consider. Given this, Ofgem should quantify the costs associated with supplying different customer bases and/or providing different service types and quality.

48. Below, we describe some of the key differences in operating costs. These relate to the smart meter rollout, customer contact costs for vulnerable customers, difference in contact costs for online-only customers, and the costs of bad debt. We also set out the information that Ofgem would need to gather in order to quantify these cost differentials.

Differentials in smart meter rollout costs

49. An important omission from this working paper is any discussion of smart meter costs in the context of construction of the benchmark. Ofgem needs to look at these points in the context of the likely statutory duties which are currently before Parliament in the Bill. It is very hard to see how a pure top-down approach – which did not make specific, quantified allowance for smart meter costs – could possibly meet the requirements of the Bill. For example, the need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence will require that Ofgem make properly-informed assessments as to costs which are not directly within suppliers'

[7] Working paper #5: Updated competitive reference price, para 5.9, para 5.10, para 5.11

control. Because, if it is a requirement that suppliers must be able to finance activities authorised by regulation, then it must also be a requirement that they can recover the costs of activities required by regulation, whether that is through the licence or through other instruments.

50. The CMA did not explicitly estimate the level of smart meter costs that were included within the PPM benchmark. It also indexed the implicit costs forward by CPI, despite the fact that industry smart meter costs would be developing on a completely different trajectory over the course of the smart meter roll-out. Ofgem must not repeat the CMA's error.

51. Ofgem will therefore need to address two issues.

- First, Ofgem will need to identify the implicit allowance for net smart meter costs within any benchmark, and adjust it to ensure that it is reflective of the costs of a representative efficient supplier. In particular, if Ofgem constructs a benchmark based on suppliers that either (a) have not progressed their roll-out or (b) have costs that are not representative of other suppliers' efficient costs then Ofgem will need to make an adjustment to the benchmark to reflect this.
- Second, Ofgem will need to identify these costs so that they can be appropriately indexed forward based on changes to the number of meters installed and the stock of smart meters over time.

52. We provide further views on the analysis that Ofgem needs to undertake to ensure it can appropriately consider smart meter costs and benefits in our response to working paper 4.

Differentials in contact costs for vulnerable customers

53. As explained in our response to working paper 1, certain groups of vulnerable customers (for example, those on the Priority Services Register) will have higher costs to serve. Larger energy suppliers tend to have more such customers, and will therefore experience higher costs. Ofgem already collects data on the proportion of customers on the PSR. According to Ofgem's 2017 Consumer Vulnerability Report, medium and small suppliers had around 6% of their portfolio on the PSR during 2016. This compares to around 18% of large suppliers' customer base. As of the start of 2018, ✂ of British Gas's customers were on the PSR.[8]

54. One example of the higher cost to serve of these customers is that they are much more likely to contact energy suppliers. While British Gas's customers have on average a ✂ chance of calling during a year, this figure rises to ✂for customers on the PSR. In addition to the increased propensity to call, average call lengths are also longer for this group, as agents will provide additional help and support appropriate to customers' needs. As contact costs are a significant proportion of indirect costs, suppliers with a higher proportion of vulnerable customers will have a higher average cost per customer.

55. These additional costs can be quantified by Ofgem, providing it asks suppliers for the data to do so.

[8] British Gas's Social Obligations Reporting Return (2017).

- Ofgem would need to gather data on the proportion of vulnerable customers by supplier. This information should already be available to it.
- It would then require data on the total costs of contacting customers. The recent RFI includes a line for call centre costs. Ofgem will need to confirm with suppliers whether any central overheads should also be allocated to call centres (since a material change in call volumes would have an impact on costs such as telephony, IT, property and HR).
- Finally, it would need to ask suppliers for a cost driver that can be used to allocate total contact costs by customer type. British Gas has previously used a simple "effort" metric, equal to number of calls multiplied by average handling time.

Cost differentials for online customers

56. As described in our response to WP1, the cost to serve is much lower for customers who manage their account entirely online. Ofgem will therefore need to make adjustments to the tariffs of suppliers that have a higher than average proportion of their customers using predominantly online services.

57. Ofgem has previously asked for information on the online/offline differential as part of its February RFI. When assessing this information, it is important that Ofgem recognises a distinction between suppliers that offer online only tariffs that have additional restrictions relating to the use of those accounts (for example, prohibiting any access to call centres) and those whose online offerings are typically less restrictive. If the benchmark tariff includes suppliers where online customers are not able to use call centres, a much larger adjustment will be required. An indication of the required differential can be seen from OVO's online-only tariffs, which offers a £60 per customer discount.[9]

Costs relating to bad debt

58. As highlighted by Ofgem,[10] a variety of measures of vulnerability (for example customers with poor mental health and low income) are linked to higher incidences of debt. As mentioned earlier, British Gas's portfolio (as well as those of other large suppliers) includes a higher proportion of vulnerable customers than those of smaller suppliers. As a result, British Gas faces higher bad debt charges and collection costs per customer. Ofgem should be able to quantify these costs, in a similar way to the higher contact costs discussed above.

59. In addition, British Gas takes more action than many suppliers to help those in debt. For example, unlike many suppliers, British Gas runs a trust fund which is open to all customers, not just its own. Ofgem has also found that small and medium suppliers are less proactive in assisting vulnerable customers, with only 27% of their indebted customers on repayment plans, compared to 62% of indebted customers of larger suppliers.[11] If Ofgem wishes for suppliers to continue to offer such support, it is essential that any price cap includes an allowance for their costs.

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9 https://www.ovoenergy.com/pay-monthly/compare
10 Ofgem (2017). Vulnerable customers in the retail energy market 2017
11 Ofgem (2017). Vulnerable customers in the retail energy market 2017

Ensuring that efficient suppliers can cover their cost of capital

60. Ofgem rightly recognises that suppliers must be able to earn an EBIT margin that is consistent with a normal rate of return on capital – and that the tariffs of any benchmark suppliers not earning a sufficient return must be adjusted upwards to address this.

61. However, Ofgem cannot simply follow the CMA in assuming that a 1.25% EBIT margin would be sufficient for these purposes. This is because – for the reasons set out in detail in previous submissions[12] – the analysis of economic profitability on which the CMA based this assumption made a number of errors in approach.

- The CMA's 1.25% margin assumption rested on a contentious hypothesis that the "efficient" benchmark supplier would make use of an intermediary trading arrangement, thereby obviating the need for the supplier to hold trading collateral. The CMA itself recognised that in the absence of such intermediary arrangements, suppliers would need to earn a higher EBIT margin than 1.25% to cover their cost of capital, since they would need to hold more capital for trading purposes. It would be inappropriate to assume that such an arrangement would be available to a standalone supplier of scale on the terms that the CMA assumed. Neither the CMA nor Ofgem have provided any evidence to support the hypothesis for a standalone supplier of scale.
- The CMA materially understated the working capital requirements of energy retail businesses, since they only allowed for average working capital requirements when suppliers must in reality hold sufficient working capital to allow them to cover their peak requirement. For a large supplier, this additional working capital can be highly material. We have previously calculated this requirement as being in excess of £✂m.
- The CMA's methodology did not make adequate allowance for the risk/contingent capital that a large stand-alone supplier would need to hold in order to be able to withstand short-term losses that suppliers will periodically face as a result of unpredictable demand shocks that are beyond their control. These risks of short-term losses – and therefore the need to hold capital – arise irrespective of the supplier's chosen hedging strategy. Since suppliers cannot immediately adjust their tariffs in response to these shocks, they must set capital aside to ensure that they can withstand periodic losses.
- The CMA's assessment of capital requirements for regulatory collateral was based on errors in approach. The CMA assumed that suppliers could rely primarily on letters of credit rather than setting aside any capital for this purpose. However, it provided no evidence to substantiate its assumption that a large standalone supplier would have access to such facilities on the terms that its methodology assumed, particularly given the extremely thinly capitalised business model that the CMA was envisaging that such a supplier would operate.

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12 For example, see our response to Working Paper 1 for further detail.

62. In previous submissions to the CMA we concluded that a more reasonable range for competitive EBIT profits for an efficient supplier would be 4-6%[13]. This is what would need to be used to make the appropriate adjustment if Option 3 is pursued.

Payment methods

63. Ofgem is correct that, if the benchmark is not based on a mix of tariffs reflective of the different mix of payment methods faced by other efficient suppliers, it will need to apply a separate payment method uplift outside the benchmark when calculating the cap level.

64. As we discussed in the section on operating costs above, there may be other reasons why Ofgem will also need to make such adjustments to reflect differences in the business models and customer mix of different suppliers.

Assembling a benchmark

65. We recognise that controlling for the legitimate cost differences described above may not be a straightforward task. However, given the serious risks of setting the cap at the wrong level, it is essential that Ofgem devotes the resources required to do the job properly.

66. It would be entirely inappropriate for Ofgem to limit the number of benchmarked suppliers, or fail to make the appropriate adjustments outlined in the previous section, because of reasons of time or resource. This element of the price cap design is critical to get right. Centrica stands ready to assist Ofgem with this analysis wherever possible. To the extent that there are unavoidable limitations in data availability or quality, and/or unavoidable uncertainties around the drivers of differences between different suppliers' costs, Ofgem should take a conservative approach given its need to ensure that holders of supply licences who operate efficiently are able to finance activities authorised by the licence.

67. For all of these issues, Ofgem needs to provide visibility of the adjustments it will (and will not) make to determine the benchmark to stakeholders, so that they have the ability to scrutinise the robustness of the results. Confidentiality rings and data rooms are common practice where this kind of issue arises. This kind of approach is frequently used by the CMA, for example in its investigation into retail banking[14] and, of course, the Energy Market Investigation[15].

68. It is worth noting that the statutory framework for disclosure of confidential information by public authorities applies as equally to Ofgem as to the CMA. Further examples from sectoral regulators include the Civil Aviation Authority, whose guidance explains the use of confidentiality rings and data rooms[16][17]; the Payment Systems Regulator has

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13 https://assets.publishing.service.gov.uk/media/5717442eed915d73db000000/centrica-pdr-response.pdf, page 23.

14 CMA, Retail banking market investigation, *Notice of the CMA's intention to operate a confidentiality ring to allow submissions on a research survey undertaken by Charterhouse Research in respect of SMEs in Northern Ireland*

15 CMA, Energy market investigation, *Notice of the Competition and Markets Authority's intention to operate a confidentiality ring following publication of the Provisional Decision on Remedies*

16 Part 9, Enterprise Act 2002

17 See §4.50, *Guidance on the Application of the CAA's Competition Powers*

published similar guidance too.[18] Confidentiality rings, backed up by contractual commitments, have also been used by regulators discharging sector-specific functions.[19]

69. In summary, the analysis is the same across different regulators: the need for confidentiality arrangements is considered on a case by case basis, having regard to the balancing exercise required by statute, which looks at the need for disclosure on one hand, and the harm that may be caused by disclosure on the other. In the current case, as set out above, there is a clear case for disclosure.

70. In the absence of a clear and compelling reason to the contrary, therefore, we would recommend that Ofgem set up an electronic data room, accompanied with strict confidentiality agreements, to enable suppliers to verify the benchmarking data.

71. This is likely to be a requirement in order to ensure a fair and transparent process under any of the options that Ofgem uses to set the cap, if they are based on an assessment of confidential data. Suppliers are entitled to understand fully how Ofgem intends to set the control. They are entitled, as a basic requirement of procedural fairness, to see the evidence and to comment on Ofgem's proposals with a full understanding of all the evidence.

72. We would also observe that it is suppliers who understand this data best. It is therefore to the benefit of the process more broadly to allow suppliers to view this data. A more transparent process generates better outcomes and this is why regulators are generally required to act transparently. Ofgem suggests that it may consider stripping out specific tariffs that are difficult to include for practical reasons or because they are difficult to analyse. We agree in principle that this may be justified in some instances but we expect full transparency by Ofgem where this is the case.

73. We also agree that careful thought should be given to how to weight the different suppliers that comprise the benchmark. A simple average, where each supplier included would have the same weight is unlikely to be appropriate for the reasons that Ofgem sets out. Instead we would expect each supplier should be weighted by its number of customers.

74. While each tariff should be weighted to reflect expected customer usage on that tariff there are circumstances where taking a simple snapshot of current usage patterns may be inappropriate for this purpose. For example, suppliers aggressively growing their customer bases may currently have a disproportionately high proportion of customers on cheap acquisition tariffs that would be unsustainable unless a proportion of customers migrated to higher tariffs over the longer-term.

Next steps

75. Given that WP5 is intended to be the last working paper prior to the policy consultation; we are concerned that stakeholders have not been given the opportunity to consider,

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18 See §5.10, PSR, *Enforcement of the Competition Act 1998*

19 For example by Ofwat in its PR19 process: https://www.ofwat.gov.uk/wp-content/uploads/2017/07/Appendix-9-Company-bid-assessment-frameworks-the-principles.pdf

review or comment on a number of significant elements of the cap. For example, Ofgem has not:

- engaged with stakeholders regarding the treatment of smart meter costs;
- set out how it intends to update the level of the initial cap over time (instead focusing on how it will calibrate the initial level of the cap) or provided any insight or detail on the proposed modelling;
- responded to any of the concerns raised regarding Option 2 (in response to the December consultation) despite considering Option 3 which builds on the approach taken when setting the current safeguard cap; or
- explained in detail the opportunities or challenges of Option 4 (the bottom up model).

76. It is also clear from WP5 that Ofgem is still waiting to receive the supplier data necessary to inform its view (para 6.10 – 6.11), and that significant amounts of work (and, indeed, further engagement with suppliers) will be required before Ofgem can sensibly take an informed view on how to proceed. Yet, despite this, Ofgem is pressing ahead with its intention to publish a policy paper in May.

77. We set out further detail regarding these concerns in the legal considerations annex to this response.

Annex 1: Legal Considerations

78. This Annex deals with legal points arising in relation to WP5.

Introduction

79. Centrica has serious concerns about both the content of this working paper and also the wider process being followed by Ofgem as it moves forward with developing the design, level and implementation of the cap.

80. In particular, we are concerned by Ofgem's decision to ignore submissions made by stakeholders in recent times; to press ahead with the consultation process without devoting sufficient time or resources to enable it to consider, and consult on, key elements of the design and implementation of the cap; and its apparent disregard for its wider statutory and administrative law duties. We would note, in particular, that Ofgem has not published responses to the previous WPs, and this is a real problem in terms of transparency and stakeholders being able to engage meaningfully with evidence that Ofgem may use to set the cap. In our view, unless Ofgem corrects its approach, any final decision relating to the cap will be open to legal challenge.

81. Ofgem has made no real attempt to set out a coherent framework for this analysis based on the likely duties in the Bill. This is a serious omission.

82. This annex addresses each of these elements in turn.

Ofgem's analytical framework is not based on a view of its likely duties

83. In an exercise of this sort, we would expect Ofgem to give an account of its likely legal duties and to explain its framework for applying those duties to the issues in the working paper. Ofgem does not do this. So, for example, when Ofgem sets out its high level criteria for including suppliers in an updated benchmark (in section 3 of the working paper) it does so without reference to the statutory framework.

84. The likely duties are set out in Clause 1(6) of the Bill:

> *The Authority must exercise its functions under this section with a view to protecting existing and future domestic customers who pay standard variable and default rates, and in so doing it must have regard to the following 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.*

85. In the rest of this section we briefly assess what the criteria might mean for some of the key issues in this working paper. Before doing that, we stress this: it is not possible for us to comment properly on Ofgem's proposals because Ofgem has not explained how they fit with the likely statutory framework. We are happy to offer our own views. But this is no substitute for an opportunity to comment properly on what Ofgem is proposing, and why.

86. **Selection of benchmark firms**: the proposed statutory criteria are likely to be particularly important here. For example, clause 1(6)(b) requires that the cap be set at a level which supports competition for domestic supply contracts of all types (i.e. not just customers on SVTs and/or default tariffs). Selection of the wrong firms is highly likely to undermine this requirement. For example, merely selecting benchmarks with the lowest prices is likely not to be reflective of genuinely competitive levels and will therefore undermine competition in the medium term. It is also axiomatic that a cap based on the lowest possible level will prevent competition below that level.

87. In order to meet this criterion it is likely to be necessary that a benchmark level is based on the prices of broadly representative suppliers and, within those suppliers, a representative set of customers. The aim should be that the benchmark produces a "competitive" tariff level that would be sustainable over the longer-term and which takes proper account of the costs involved in serving the customers which are most expensive to serve.

88. None of these factors are properly considered by Ofgem. For an explanation of how they can be properly taken into account, see paragraph 28 above.

89. If the cap is set based on a benchmark which does not meet the competition criterion in the Bill, it is also highly likely to breach the stipulation in clause 1(6)(d) that suppliers must be allowed to finance their activities. This is because over time the prices of suppliers in a competitive market will tend to the level which allows those suppliers to recover their costs – including a return on capital – and no more. If the cap is set below that level it will not be possible to make returns to shareholders and bondholders. And those investors will not commit their money to finance the operations of suppliers if they cannot make a return; they will invest elsewhere instead.

90. It might be said that any under-recovery in SVT/default tariffs can be made up elsewhere and that, for this reason, there will be little risk to the ability of suppliers to finance their activities. In this world, other customers are subsidising SVT/default customers. However, this too would be likely to run contrary to clause 1(6)(b) and (c). These clauses emphasise competition and switching incentives for <u>all</u> domestic supply contracts. Measures which require cross-subsidy between customer groups – which increase costs for one group to benefit another – would not be likely to be consistent with this principle.

91. **Making adjustments for legitimate cost differences between suppliers:** at the moment Ofgem makes little more than token efforts to reflect the fact that in competitive markets different suppliers will have different costs. These could be driven by a number of factors: non-price competitive factors will generate cost differences; some customers are more expensive to serve than others (because, for example, they tend to use call centres rather than managing their accounts online); and regulatory and wholesale costs may differ.

92. All of these are legitimate, objective reasons why cost bases may look different. At the moment Ofgem simply does not address them, saying (for example) in relation to wholesale costs that is has not identified a "compelling reason" to adjust for these legitimate differences.

93. This statement shows that Ofgem is approaching the question from the wrong end. Ofgem should be building an analytical framework on its likely statutory duties. As noted above, these duties place importance on competition, switching incentives, and the ability of suppliers to finance their activities. These requirements cannot possibly be met unless the cap properly takes account of legitimate price differences between suppliers. To put it crudely: suppliers with a high-cost customer base will not be able to cover their costs if the benchmark is based on the lowest market price. This is unlikely to be a "competitive" price in any meaningful sense. Those suppliers will be unable to compete because they will be loss-making. Switching incentives will disappear. Their ability to finance their activities will be threatened. All of this will run contrary to the clear intention of the Bill.

94. Crucially Ofgem makes no attempt to assess or balance the likely statutory criteria. This makes it almost impossible to comment on what Ofgem is doing. We have tried to explain how some of these factors play out in practice – there is more detail in Annex 2. However it is simply not possible for respondents to this working paper to build their own model for applying the likely statutory framework in the two weeks available for responses; and, even if it were, it would not be a substitute for Ofgem's own work

95. In short, Ofgem currently has the cart before the horse. Ofgem's thinking is proceeding without being tied back to its likely statutory duties. These duties provide a roadmap for what Ofgem should be doing. If the thinking in the working papers is not properly anchored in the statutory framework it is highly likely that its conclusions will depart from what the law requires.

96. We have repeatedly encouraged Ofgem to undertake this exercise and to equip itself with the information required to make a proper assessment of, for example, the cost differences between suppliers. At the moment, Ofgem explains nothing about whether and how it has carried out this work. In the absence of that explanation, we can only conclude that it has not been done. If it has been done, we would invite Ofgem to explain how it has been done, with reference to the relevant written materials, in the interests of transparency.

Ofgem's failure to take account of the submissions made by stakeholders

97. Based on our review of the working paper, it is clear that Ofgem has failed to take account the concerns raised by stakeholders in response to other documents, such as the December consultation,[20] working papers 1-3, and other submissions,✂ which should have a direct bearing on the design of the cap.

[20] Ofgem consultation: Providing financial protection to more vulnerable customers, dated 20 December 2017

98. When responding to the December consultation,[21] we made a number of points, including that:

    a) "the PPM cap is already endangering efficient cost recovery, putting service levels, investment and innovation at risk" (page 13);

    b) Whilst going on to explain that the PPM cap exposed suppliers to risks that they could not control and "submitted a report written by Frontier Economics that described and explained the methodological flaws of the PPM cap and looked at the problems that are arising following its introduction" (para 18).

    Ofgem is yet to respond in detail to these concerns.

99. In response to working paper 1, we made a number of observations, including:

    a) **Smart meter costs**: we explained that the "CMA's treatment of smart metering costs was fundamentally flawed in numerous respects. In setting this element of the cap, an appropriate allowance must be included that reflects all net costs of smart meters and this must be indexed forwards correctly." (para 8-10). Yet Ofgem has failed to provide any details about how it proposes to deal with smart meter costs.

    b) **Operating costs**: we explained that it was "critical that Ofgem conduct a systematic analysis of the cost drivers and controls for legitimate differences explicitly in any benchmarking analysis … Ofgem will need to understand and accept the potential effects on consumers if the cap fails to provide adequate recovery of costs" (paragraph 13-14). Yet Ofgem published working papers without having received the relevant data to allow it to understand operator costs; it has also opted not to publish a separate working paper on suppliers' costs. It will not be possible for Ofgem to construct a proper and effective benchmark (with the necessary adjustments) without fully understanding suppliers' costs; including considering a more appropriate level for the EBIT margin (para 17).

    c) **Wholesale costs**: we explained that it is also vital that "Ofgem be explicit about the wholesale index that it assumes in setting the cap and it is essential that there is no retrospection in its implementation". We also set out that "we do not believe the index assumptions underpinning the PPM methodology would be appropriate for the default tariff cap." We went on to propose alternatives (para 16). Ofgem has provided no view as to why is considers the PPM approach should not be adjusted.

100. Centrica is seriously concerned that despite very specific issues being raised by stakeholders regarding the current cap, the working papers have been vague and lacked the detail required to enable stakeholders (and indeed Ofgem) to properly engage on issues that will have a significant impact on the design of the cap. This failure to take account of previous submissions is a serious procedural error which is likely to have material practical consequences.[22]

101. It is imperative that Ofgem devotes the required time and resources to analyse the data and information before it properly, before progressing with the consultation process.

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21 Please see: https://www.ofgem.gov.uk/system/files/docs/2018/03/centrica_-_response_to_ofgem_on_providing_protection_to_more_vulnerable_customers_-_redacted_non-condfidential.pdf

22 See *R. v. North and East Devon H.A., ex p. Coughlan* [2001] QB 213 (CA), per Lord Woolf MR, giving judgment for the Court, at [108].

Ofgem's proposed timetable will negate its ability to consult on the relevant aspects of the price cap

102. The content of the working papers has not served to alleviate the concerns Centrica has regarding Ofgem's approach to the design and implementation of the cap. The issues covered by WP5 (like the other WPs) are of significance to the cap; but the time allowed for responses to WP5 was extremely short and the response period overlapped with that of WP4 and WP3. The content of all of the working papers has also been light, with a number statements not being substantiated by evidence.

103. It is incumbent on Ofgem to assess what is required by its statutory duties, to gather evidence accordingly, consult properly and then reach a decision which is properly informed by the evidence and the submissions it has received.

104. WP5 sets out that it is intended to be the last working paper before the policy consultation in May (para 7.3). However, it is clear from WP5 that Ofgem is still waiting to receive the supplier data necessary to inform its view (para 6.10 – 6.11), and that significant amounts of work (and – indeed – further engagement with suppliers) will be required before Ofgem can sensibly take an informed view on how to proceed. It is clear that Ofgem is intent on pressing ahead with its proposed timetable despite not being in a position to do so.

105. Centrica would emphasise that whilst the Government (and indeed the Bill) would like the cap to be set "as soon as practicable" Ofgem is still required to devote sufficient resources to this process and must engage in the required analysis before it can progress its views. Ofgem must allow sufficient time for it to conduct its enquiries, before proceeding to the next consultation.

Ofgem has misconstrued the obligations imposed by the Bill

106. As set out in ✂ our previous responses to the working papers, we believe that Ofgem appears to have mis-directed itself as to its obligations under the Bill (assuming that it is enacted in its current form) which requires it to impose the tariff cap "as soon as practicable" (the "ASAP obligation").

107. To be clear, ASAP obligation does not give Ofgem an excuse to cut corners in terms of its evidence gathering and analysis, nor relieve it of its wider legal duties:

    a) First, the ASAP obligation is not yet in place: therefore, there is no obligation for Ofgem to act in undue haste now.

    b) Secondly, the need for the cap to be introduced "as soon as practicable" does not give Ofgem an excuse to cut corners in terms of thorough evidence gathering and analysis. In this context, "as soon as practicable" is a direction to Ofgem to devote sufficient resources to ensuring it undertakes a meaningful and rigorous consultation and decision-making process. It does not imply that either the *process* or the *substantive decision* Ofgem must reach on the design of the cap may be any less rigorous or informed than they would otherwise need to be.

    c) Thirdly, the Government's "expectations" when introducing a Bill to Parliament are not law, and have no role to play in Ofgem determining its legal duties and the

considerations it should have regard to when designing the price cap. Ofgem is required as a matter of EU law to act as an independent regulatory authority and as a matter of public administrative law not to act beholden to any third party including the Government. Ofgem should not be influenced by such political considerations.

108. Ofgem is, mistakenly, treating itself as beholden to a deadline set by Government and is designing a process to meet that deadline, rather than designing a decision-making process which meets its legal obligations.

Ofgem's administrative law duties

109. Ofgem's administrative law duties are clear: it is required to consult when its proposals are still at a formative stage; must include sufficient reasons for its proposals to allow those consulted to give intelligent consideration and an intelligent response; adequate time must be given for this purpose; and Ofgem must take conscientious account of the responses received from stakeholders.[23]

110. Ofgem is required to ensure that its consultations are proper ones which (among other things) conform with the requirements of fairness as developed in the case-law.[24] Ofgem has a clear obligation *"to equip [it]self with the information necessary to take an informed decision*":[25]

111. The process and substantive decision Ofgem must reach on the design of the cap must be rigorous and informed. Ofgem's duties under the Bill are no different to those that would apply in any other context.

112. There are clear duties that apply, for example:

a) The Tameside Duty[26] means that a failure by Ofgem to acquaint itself with the relevant information so as to enable itself to answer the question would leave itself open to a claim for breach of this common law duty; and,

b) The duty on Ofgem to properly consider and grapple with the materials it receives,[27] means that the Court would consider whether Ofgem has:

"…(ii) *properly considered the information which is available to him and (iii) come to an opinion which is consistent with that information, recognising that it is his responsibility to evaluate the material which is available to him*"[28]

On this duty, the Court will also consider whether there was a "*failure by the council to go through the logical and required process.*"[29]

113. The current Ofgem process falls short on a number of fronts and must be corrected.

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23 See *R. v. North and East Devon H.A., ex p. Coughlan* [2001] QB 213 (CA), per Lord Woolf MR, giving judgment for the Court, at [108].

24 See *R. (Easyjet Airline Co Ltd) v Civil Aviation Authority* [2008] EWCA Civ 755.

25 *R (DF) v Chief Constable of Norfolk Police* [2002] EWHC 1738 [Admin] at paragraph 45

26 *Secretary of State for Education and Science v Tameside Metropolitan Borough Council* [1977] AC 1014, paragraph 1065B

27 The duty of conscientious consideration.

28 *R v Secretary of State for the Home Department, ex p Iyadurai* [1998] Imm AR 470, at paragraph 475, Lord Woolf MR.

29 *R v Lambeth London Borough Council, ex p K* [2000] 3 CCLR 141, at paragraph 149H

Annex 2: Wholesale cost adjustments

114. This Annex deals with the wholesale cost adjustments that Ofgem will need to make if it is to pursue a competitive reference price methodology.

Introduction

115. Ofgem acknowledges in the working paper that stakeholders have raised concerns about the existing PPM tariff cap methodology's approach to modelling wholesale costs. However, it then states – without providing any explanation to substantiate its thinking – that it has not as yet identified a "compelling reason" to adjust the methodology to address these concerns.

116. Contrary to this statement, there are at least three clear and compelling reasons to change the existing PPM cap methodology's approach to modelling wholesale costs:

    - First, by combining a snapshot view of retail prices for two benchmark firms with a mechanism for updating energy costs that bears no relation to the costs incurred by the benchmark firms, the PPM methodology could result in a price cap that makes an entirely inappropriate – and in all likelihood insufficient – provision for wholesale energy costs.
    - Second, the existing PPM tariff cap methodology fails to take account of the evolution in seasonal structure and shaping costs that will result in it further underestimating increases in wholesale costs over time.
    - Third, even setting aside the errors described above, the 6-2-12 hedging strategy used by the existing PPM cap to update fuel costs has several other unattractive features that should be addressed.

117. All these concerns would apply irrespective of whether Ofgem extended the existing PPM tariff cap methodology to default tariff customers (Ofgem's Option 2) or fully refreshed and updated the inputs for the purposes of setting the default tariff cap (Option 3). However, there are also steps Ofgem should take in relation to each of these concerns that Ofgem could readily implement.

118. We explain each of these concerns in turn below, along with the changes that should be made to the methodology to address them.

Inconsistency between wholesale costs used to calculate the base level of the cap and the hedging strategy used to roll forward the cap over time

119. In November 2017 we submitted an independent report to Ofgem that we had commissioned from Frontier Economics, which drew attention to a number of concerns with the hybrid reference price and roll-forward methodology that the PPM tariff cap employs to model wholesale costs.[30] As the Frontier report explained, in order to produce a coherent and sustainable tariff cap that appropriately allows for energy costs in each period, it is essential that both the "reference price" and "roll forward" stages of the methodology employ the same assumption about the hedging strategy employed by

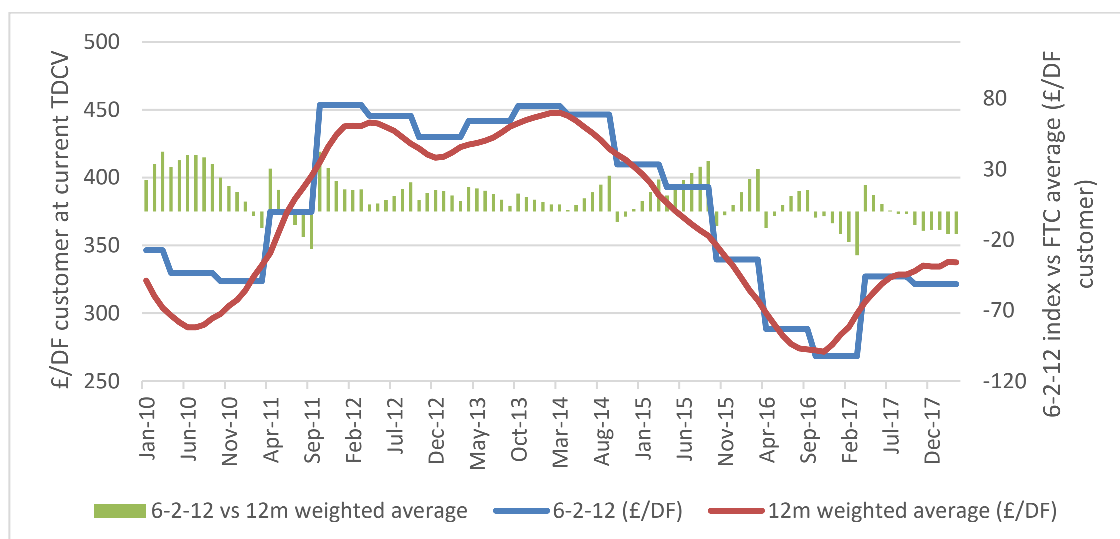
[30] Frontier Economics, *Understanding the PPM control*, November 2017.

the benchmark firms. However, the PPM tariff cap methodology has not followed a consistent approach in this respect:

- The CMA's analysis employs a "6-2-12 hedging strategy" for the purposes of rolling forward the reference prices over time.
- However, there is no reason to think that this was the hedging strategy used by the two "benchmark" firms (OVO and First Utility) during the 2015 reference period to calibrate the initial level of the cap.

120. Figure 1 below compares the evolution of historical wholesale costs using a 6-2-12 strategy against the average cost of 12 fixed price products launched monthly to model the commodity costs of a simplified small supplier.[31] While we have selected this strategy for illustrative purposes, we consider it likely that firms such as Ovo and First Utility that regularly launch one-year fixed-price products may adopt a similar hedging strategy to this in practice.[32]

Figure 1 comparison of evolution of wholesale costs associated with a 6-2-12 hedging strategy and the cost of 12 fixed price products launched monthly



Source: Centrica analysis.

121. As the green bars in Figure 1 show, there can be material differences – of up to +/-£30 per typical dual fuel customer on an annualised basis – between the wholesale energy costs associated with the 6-2-12 strategy and the cost of regularly launched 1 year fixed price products. Furthermore, these temporary differences will be baked into the methodology on the basis of whatever the difference between the 6-2-12 wholesale cost and the benchmark suppliers' actual hedging strategies were at the time the cap was calibrated.

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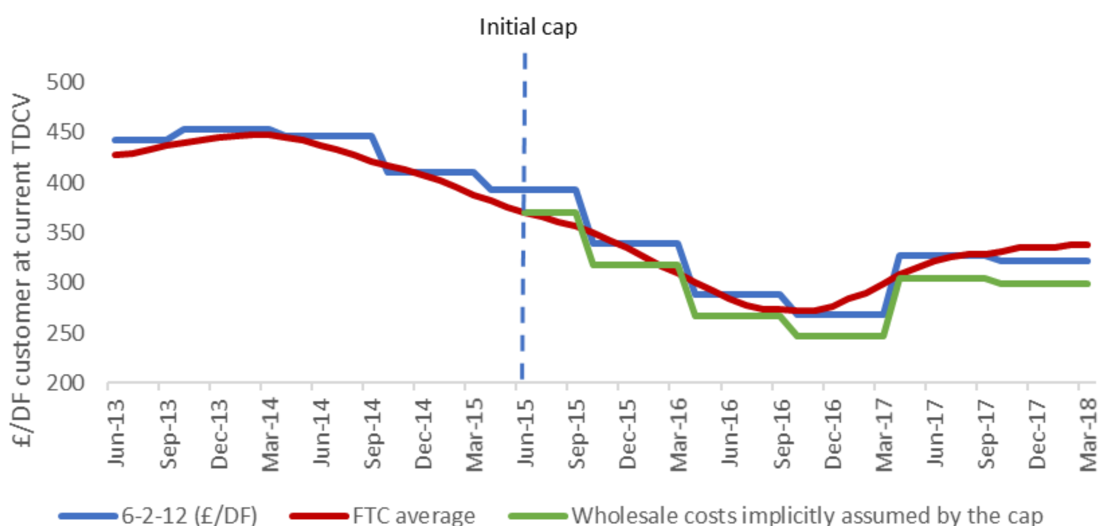
31 The average cost of regularly launched fixed price products is modelled assuming that equal proportions of customers are on fixed price tariffs that were launched in each of the previous 12 months. The cost of each those the fixed price products is based on the supplier purchasing all the energy needed to deliver for the contract over the year at the time that the product is sold based on prevailing forward prices at the time.

32 This is because we would expect suppliers who regularly launch new one-year fixed-price contracts to buy additional energy over the year to match the uptake of these contracts by customers.

122. This concern will apply – and therefore must be addressed – irrespective of whether Ofgem follows Option 2 or Option 3 for the purposes of the default tariff cap. Figure 2 below shows the effect of this inconsistency on the level of the PPM cap (setting aside the additional concerns that we discuss further below). As the chart shows:

- If the tariffs used to calibrate the initial level of the cap in 2015 were based on the tariffs of suppliers incurring the costs of regularly launched 1 year fixed price products (or similar), but were then updated over time on the basis of changes in wholesale costs associated with a 6-2-12 strategy, then the tariff cap methodology will assume that wholesale costs of an efficient firm should follow the green line.
- However, as can be seen from the chart, these assumed costs are consistently – and materially – lower than those associated with either the 6-2-12 strategy or regularly launched 1 year fixed price products. In other words, the CMA's initial calibration of the price cap has likely baked in a wholesale energy cost assumption that is below the level that an efficient large energy firm could have achieved, irrespective of its chosen heading strategy.[33]

Figure 2 impact of inconsistency between strategy



Source: Centrica analysis.

123. Ofgem cannot address this concern simply by refreshing the inputs into the existing PPM tariff cap methodology and selecting a different snapshot date for the purposes of calibrating the default tariff cap (i.e. Option 3). Selecting another snapshot date will not resolve this issue unless – by chance – the wholesale costs associated with the 6-2-12

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[33] In response to the concerns described above, the CMA questioned whether the wholesale costs of the benchmark firms used to calibrate the initial level of the PPM tariff cap (i.e. First Utility and Ovo) were in reality lower than those associated with a 6-2-12 hedging strategy. The CMA pointed to Table 14.7 of its Energy Market Investigation Final Report, which suggested that the implied Ovo and First Utility wholesale cost on the 2015 snapshot data used to calibrate the initial level of the benchmark were higher than the costs associated with the base level of the 6-2-12 index on that snapshot date. However,✂, the CMA's Table 14.7 did not provide a like-for-like comparison between the costs that First Utility and Ovo actually incurred and the costs that they would have incurred if they had been following a 6-2-12 hedging strategy – and so could not be used to draw any inferences about this. ✂

strategy happen to match the wholesale costs associated with the hedging strategy that the benchmark firms are actually using at the time. This would be akin to simply selecting a different point on the X-axis of Figure 1 and would again be likely to lead to material inaccuracies in hedging costs being baked into the cap.

124. To address this error in the PPM tariff cap methodology, the benchmark firms' tariffs must be explicitly adjusted to match whatever wholesale hedging strategy is assumed for the purposes of rolling the cap forward over time. Ofgem should strip out the wholesale costs of the benchmark firms and adjust the initial benchmark prices accordingly to be consistent with the hedging methodology used to roll the cap forward over time.[34]

125. The result will be a tariff cap in which the wholesale costs are accurately calculated on a bottom-up basis, with reference to a consistent and explicitly specified hedging strategy in every period. This approach is entirely feasible, and has the additional advantage of being fully transparent – thereby allowing suppliers to match their hedging strategy to that assumed by the cap.

The existing PPM tariff cap methodology fails to take account of the evolution in shaping costs and costs arising from the seasonal structure of demand

126. Even setting aside the concerns described above, the existing PPM tariff cap methodology would still have systematically understated Centrica's efficiently incurred wholesale costs and the increases in wholesale costs over time, because the methodology has not adequately control for:

- Increases in the cost of shape.
- Cost mismatches arising from the seasonal structure of energy demand and curve backwardation.

127. With regard to the **cost of shape**, the existing PPM tariff cap methodology uses an assumed 70/30 fixed split between baseload and peak volumes purchased for the purposes of updating all wholesale costs over time – including bulk energy purchases and shaping costs.

128. The indexation approach for wholesale electricity costs should track the total cost of wholesale energy, including shaping costs over time. However, as explained by Frontier Economics[35] and set out in pages 35 to 37 of our response to working paper 1, holding the 70/30 weighting fixed in this way does not appropriately account for changes in shaping costs.

129. The evidence presented in the Frontier report of November 2017 showed there to be an increasing trend in the proportion of wholesale costs that would need to be indexed to

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34 As recognised by the CMA and Ofgem these updated benchmark prices would then need to be adjusted further to accommodate legitimate cost differences between the benchmark suppliers and an efficient supplier of scale, and to enable suppliers to make a sustainable margin (i.e. a profit margin that would allow them to cover their cost of capital).

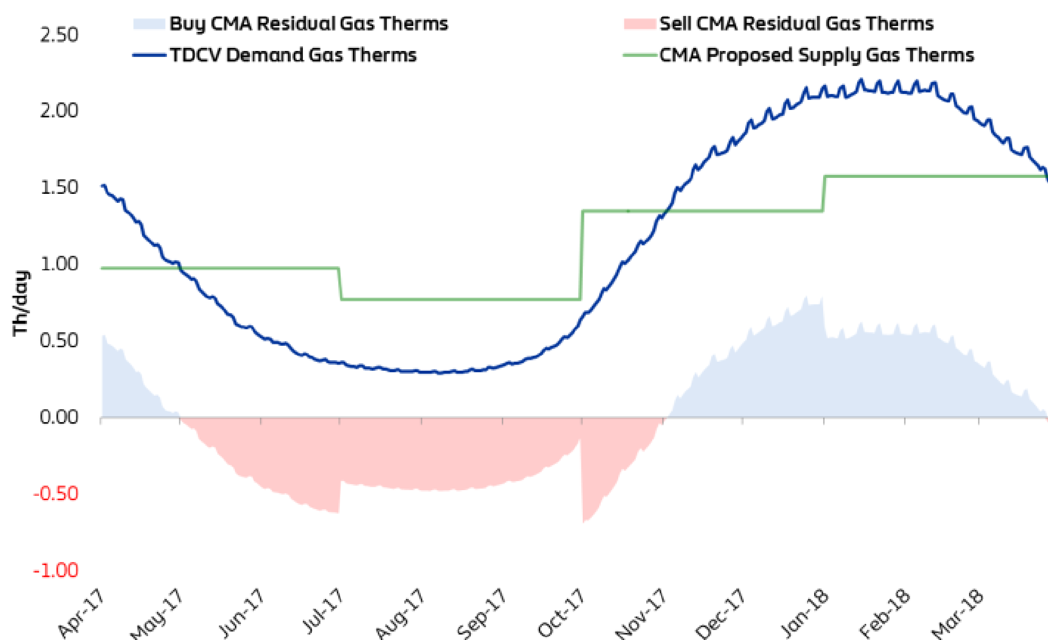
35 The CMA has suggested that it is unclear whether the trend increase in the proportion of costs that would need to be indexed to the peak contract to match domestic supply costs will continue. In particular, the CMA suggests that load shifting associated with the roll out of smart meters may counteract this effect. However, the proportion has already increased since the 2015 snapshot date used to set the initial level of the index, and there is unlikely to be material load shifting unless and until time of use tariffs become widespread. Therefore, it would seem reasonable to assume that the increase observed since 2015 will endure for some time. ✂

peak contract prices to match the weighted average cost of delivering electricity to match a domestic demand profile.[36] Updating the weightings to reflect this would allow for changes in the cost of shape to be picked up in the analysis. The increasing trend shows that a fixed 70/30 volume ratio will not appropriately reflect changes in total wholesale costs.

130. In addition to this, the existing PPM tariff cap methodology does not take account of cost mismatches arising from the **seasonal structure** of energy demand. In particular:

- The existing PPM tariff cap methodology assumes that suppliers purchase energy for the coming 12-month period using a 6-2-12 strategy, but then refreshes this calculation every six months. This means that methodology will systematically understate increases in wholesale costs if – as has been the case recently – wholesale costs have been trending up, but the wholesale commodity curve is in a state of backwardation. Given the market shape at the time the PPM cap was set and the smaller volume affected it was possible to hedge this risk for a manageable cost. The current shape of the wholesale gas and power curves and the substantially larger volume affected by the default tariff cap effectively preclude suppliers from being able to hedge this risk for the default tariff cap.
- The existing PPM tariff cap methodology underweights the level of demand over the winter peak months, relative to the summer months when wholesale energy costs are typically lower. This mismatch in demand profiles is illustrated by Figure 3 below.

Figure 3 standard industry profile gas consumption vs CMA quarterly split



Source: Xoserve gas profile and CMA index weighting both based to Ofgem TDCV consumption.

131. Ofgem should again address these concerns by explicitly calculating wholesale costs from the bottom up in each period for the purposes of its tariff methodology. Table 1 below provides a breakdown of the additional cost components – over-and-above the

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36 Frontier Economics, *Understanding the PPM control*, November 2017, Figure 3.

basic costs implied by the 6-2-12 index – that Ofgem must take account of in this bottom-up modelling exercise. The table also provides details of the sources of information that Ofgem could use for this purpose.

132. For each of the costs lines set out in Table 1 Ofgem needs either to model each of these cost adjustments separately from the index or to correct the limitation in the indexation by changing the assumptions on the shape of domestic demand.

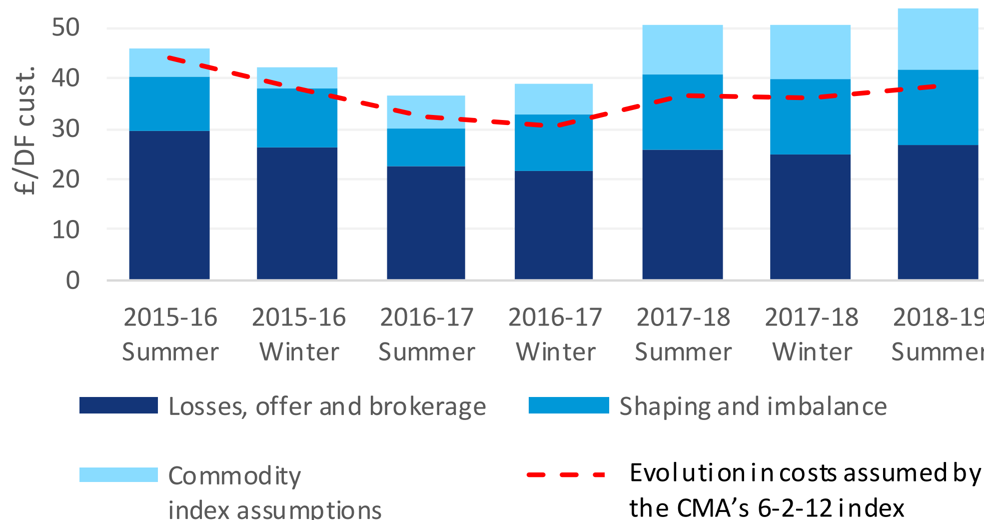
Table 1 additional wholesale energy cost components that need to be covered by the default tariff cap

Commodity Component	Current Cost	Issues and risks	Data sources for Ofgem
Seasonal structure (index assumptions)	£13/DF	Backwardation – 12-month calculation currently at a discount vs 6-month pricing period (£7/DF). CMA index underweights seasonal and quarterly demand (£5/customer for gas and £1/customer for electricity).	ICIS Heren, ICE Xoserve gas profiles, Elexon power profiles
Shaping to monthly	£6/DF	CMA index does not cover monthly variances within seasons (£5/ customer for gas and £1/ customer for electricity).	ICIS Heren, ICE
Shaping to daily (gas) & half-hourly (power)	£9/DF	CMA index has no allowance for within-month gas shaping and 30/70 peak/baseload split is insufficient for power (£7/customer for gas £2/customer for electricity).	ICIS HEREN, N2EX, APX
Imbalance	£1/DF	A comparatively small cost component, but can be high-risk.	Elexon, National grid
Offer, brokerage & losses	£27/DF	Cost of trading and uplift to cover T&D losses (£11/customer for gas and £16/customer for electricity).	ICIS Heren, brokers, National grid, DNOs

Source: Centrica analysis.

133. As the table above shows, these additional wholesale energy cost components are material – summing to £56 per typical dual fuel customer (on an annualised basis) in Summer 2018. Furthermore, as Figure 4 below illustrates, these cost components can vary materially over time, and indeed have increased materially relative to the increase in cost assumed by the PPM tariff cap methodology. This further underlines the need for these costs to be modelled and periodically updated from the bottom up.

Figure 4 impact of inconsistency between strategy



Source: Centrica analysis.

Other unattractive features of the 6-2-12 hedging strategy

134. Even setting aside the errors described above, the methodology used by the existing PPM cap to model wholesale energy costs has several other drawbacks that should be addressed if it were to be used for the default tariff cap. These include:

- **Smoothing:** the PPM cap wholesale index can result in significant price variations from one cap period to another, creating a potential price shock for customers.
- **Market liquidity:** the PPM cap wholesale index starts observing prices only eight months before each cap period starts. Given the significant volumes at stake, this would considerably reduce liquidity beyond that period if suppliers align their hedging approaches to the index, and run against Ofgem's objective to improve market liquidity in order to support competition and promote market entry.

135. We provided further explanation and evidence on each of these issues in Annex A of our response to working paper 1. We also explained that all these issues can be significantly mitigated by following a rateable purchasing strategy rather than a 6-2-12 strategy.[37] It would consist of building the index rateably over a period of time and then fixing the volumes not secured on the rateable strategy at the average price of the final month prior to the price assessment (January for the cap applying from the following April to September and July for the cap applying from the following October to March).

136. We believe an 18-month rateable strategy would protect customers from volatility to a greater extent than the PPM index while addressing the market liquidity and seasonality issues, but even a shorter period such as a 12-month rateable (in line with the Supplier Cost Index) would be more suitable than the PPM methodology's index. As we have

[37] Centrica, *Response to Ofgem's Working Paper #1*, 26 March 2018. Please see in particular Annex 1.

previously explained, a transitional strategy could be implemented to address the fact that these indices make use of observed prices over a longer history.[38]

[38] Ibid. Please see in particular paragraphs 63-68 and 171-181.

Annex 3: Table 6 from Centrica's response to Ofgem's consultation on providing financial protection to more vulnerable customers

Table 2 Assessment of options for addressing issues with PPM cap methodology identified by Frontier Economics

Area of concern	Specific issue	Most likely impact on the cap	Would the changes on which Ofgem is consulting address this issue?	If not, what additional changes to the PPM cap methodology would be needed to address the issue?
1. The PPM cap methodology does not accurately model the **wholesale energy costs** that an efficiently-run energy supplier can be expected to incur	Inconsistency between calibration and indexation hedging strategies	Cap too low	No	Need to adjust the original June 2015 calibration to replace Ovo's and First Utility's actual wholesale costs with what their wholesale costs would have been if they had been following the same a "6-2-12" hedging strategy that the methodology employs for the purposes of rolling forward the wholesale costs to subsequent periods
	CMA's methodology may have hard-wired in any transitory wholesale cost advantages arising from luck	Cap too low	No	Need to investigate Ovo's and First Utility's actual wholesale costs during the period used to calibrate the initial level of the cap (June 2015) to establish whether they had any temporary cost advantages at the time above and beyond those being delivered by their hedging strategies

Area of concern	Specific issue	Most likely impact on the cap	Would the changes on which Ofgem is consulting address this issue?	If not, what additional changes to the PPM cap methodology would be needed to address the issue?
	The methodology makes inappropriate assumptions around baseload/peak electricity weightings	Cap too low	Potentially (Ofgem is considering introducing a separate index for the cost of shape. The same logic would suggest that this separate index could – and should – also be created for peak product costs)	
2. The **chosen benchmark firms** (Ovo and First Utility) are not good comparators for an efficiently-run large energy retailer serving a diverse set of customers	PPM tariff cap fails to control for the effects of average consumption levels for Ovo and First Utility	Cap too low	No	Need to establish how far standing charges typically fail to recover all fixed costs and then adjust the standing charge at nil consumption to accommodate this
	PPM tariff cap fails to control for higher proportion of Ovo and First Utility customers who are online	Cap too low	No	Need to: 1. Identify an appropriate cost to serve differential for online/offline customers 2. Calculate the weighted average difference in cost to serve across between Ovo/First Utility and other suppliers (based on different relative proportions of online only customers when the cap was calibrated in 2015) 3. Apply this cost uplift to the cap

Area of concern	Specific issue	Most likely impact on the cap	Would the changes on which Ofgem is consulting address this issue?	If not, what additional changes to the PPM cap methodology would be needed to address the issue?
	1.25% permitted margin lower than the sustainable margin in a competitive retail market	Cap too low	No	Mechanically straightforward to adjust the permitted margin built into the cap. Further work would be required to identify what a competitive margin would be in light of the concerns raised by industry stakeholders about the assumptions underpinning the CMA's analysis of economic profitability that informed the 1.25% permitted margin figure
	Adjustments made to benchmark firms' overhead costs materially affect the cap, but are highly opaque	Unclear – but likely to be material	No	In the first instance, need greater clarity as to the steps that the CMA took to control for potential differences in overheads
3. The methodology does not accurately model the **policy-related costs** that an efficiently-run energy supplier can be expected to incur	The methodology relies on an incorrect assumption that the benchmark adequately covers smart meter rollout costs, and does not consider how unit costs can be expected to change over time as the smart meter rollout gathers pace	Cap too low	Potentially (Ofgem is consulting on changes to the way in which smart meter rollout costs are built into the methodology and it would depend on how this was applied.)	
	The costs associated with the programme to move to faster and more reliable switching need to be taken into account	Cap too low	No	While these costs are not yet certain, they are material under a number of the proposals currently being discussed (e.g. the range considered in Ofgem's June 2017 Switching Programme options paper ranged from £200m to £700m over the 15 year period)